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## A Free trade agreement with Mexico towards a north american free trade agreement (NAFTA).

Peter Morici

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## *The Institute for U.S.-Canada Business Studies*

Links with Canada constitute our nation's single most important economic and financial relationship. Moreover, as U.S.-Canada relations enter a new phase, the business communities of both countries face an increased need to understand the wide range of trade, investment and financial ties which link the two economies.

The Institute for U.S.-Canada Business Studies was created to facilitate access to resources -- human and documentary -- to enhance knowledge and understanding of this critical relationship. Our particular, though not exclusive, emphasis is on designing and providing materials

and services for business school programs.

Such materials and services include course modules, brief case studies using U.S.-Canada examples to illustrate generic business transactions, consultations with faculty to integrate U.S.-Canada examples into course content, availability of Institute staff as guest lecturers, and assistance to students working on Canada-related projects. New materials are constantly evolving as new contacts are made, custom-tailored services are made generic, and collaboration with students generates new case studies. - **Stephen Blank, Director**

### *A Free Trade Agreement with Mexico* *Towards a North American* *Free Trade Agreement* *(NAFTA)*

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# About the Module

This module pulls together current Canadian thinking about bringing Mexico into a free trade relationship with Canada and the United States.

A very real issue is what Canada's interests are in such a process. As the introduction points out, Canada wants to preserve and perhaps enhance the gains it made in the Canada-U.S. Free Trade Agreement that came into effect in 1989. As well, Canadians want to ensure that whatever gains are available bilaterally between Mexico and the U.S. are also available to Canadians. This is especially true with respect to tradeable services.

These overriding problems are reflected in another

question about a North American free trade area: whether it is to be organized on a "hub and spoke" basis, with the U.S. as the "hub", or center, having Canadian and Mexican "spokes". The alternative is a comprehensive relationship with rules and obligations generally common to all three parties. Clearly, from an investment standpoint, the U.S. would have a special advantage as a "hub" from which access to Canada and Mexico would be assured, while the "spokes" would each have their own rules for dealing with the "hub", that is, the U.S.

An investor in the U.S. would have greater choice than investment in Canada or Mexico.

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### The Institute for U.S.-Canada Business Studies

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Program Manager

*..About the Module cont'd.*

Remember, however, that Mexico is in many ways still a developing country. As such, it may well take positions that prevent it from participating fully in a free trade relationship with its economically more advanced neighbors. Would Mexico wish to pool its energy resources with those of the North American common market in energy, created by Canada and the U.S.? Consider, too, that on the labor front, the U.S. and Canada may be less willing to permit Mexican labor mobility among the three

countries on the same basis as Canadian and U.S. labor. Indeed, concerns about "cheap" Mexican labor is already expressed in the high tariff levels currently applied to some North American industries to exclude competition from southern tier countries.

Another issue, explored in greater detail in the introduction which follows, is that of rules of origin. Additionally, it should be noted that much of Mexico's new restructuring and readiness to take on membership in a North American free trade zone stems from what amounts to a unilateral reduction of tar-

iffs and non-tariff barriers. How viable a strategy would that be for either Canada or the U.S.? Would its success with respect to traded goods be matched by similar success for traded services?

Suppose you are responsible for a mid-size business doing well in North America. What course of action would you recommend with respect to free trade with Mexico? This module is designed to help students develop some considered responses to such questions.

### Introduction

## *A North American Free Trade Agreement?*

With the ink scarcely dry on the Canada-U.S. Free Trade Agreement (CUFTA), it may seem a little hasty to plunge into its expansion to include Mexico in some kind of North American Free Trade Agreement (NAFTA). For one thing, the CUFTA is still undergoing its initial shakedown cruise, as both countries develop experience and jurisprudence about the machinery of the agreement, such as the dispute settlement mechanisms.

Under this heading also falls what is the most difficult left-over from CUFTA, the subsidy issue, which nearly scuttled the deal in the final stages of its negotiation. Canada and the U.S. must sit down and agree on a subsidy code if Canadian grievances about U.S. "contingency trade protection" -- i.e. the alleged use of U.S. trade remedy legislation to curtail legitimate Canadian competition in U.S. markets -- is to be overcome. In the minds of CUFTA's designers, this setup is essential in greatly limiting the adversarial approach to trade dispute settlement in both countries. However, it is far from clear that the political machinery in either country is capable of meeting this challenge.

Nevertheless, and despite the al-

leged unpopularity of CUFTA in Canada (where, polls show, some 55 per cent of respondents in a national survey sample believes the deal was a bad one) Canadian producers are pressing for more trade liberalization. These

*can the political machinery  
meet the challenge...?*

issues are explored in the modules in the Free Trade Agreement Series, available from this Institute.

So where does Mexico fit into all this? Canada and Mexico have actually very little to do with each other, except for Canadian sun-seekers fleeing northern winters. But Mexico is, after Japan, the third largest trading partner of the United States. And Mexico's relationship with the U.S. is as closely bound up with the development of both countries as is Canada's, as summarized in the (Mexican) saying, "Poor Mexico: so far from God, so close to the United States."

What gives added importance to these more or less constant factors of

history and geography is a startling transformation in Mexico's approach to economic development. As with Canada, only more so, Mexico found the 1970s to be a disastrous decade in which attempts to achieve economic development through a strategy of import-substitution and resource-based exports failed dismally. So Mexico, like Canada, decided to embrace a new strategy based on acceptance of a globally competitive world in which trade liberalization and encouragement of entrepreneurship are the keys to rising living standards. Mexico applied for membership in GATT, slashed tariffs to the point where its average tariffs are lower than Canada's, and embarked on an aggressive process of privatizing state-owned industries to make the economy more competitive. Mexico also opened the country to foreign investment.

Also, like Canada, Mexico already has a partial free trade agreement with the United States in the form of the so-called Maquiladora plan. This allows processing of basic components from the United States into finished products for U.S. markets on a duty-free basis,

*...Continued overleaf*

much like the Canada-U.S. auto pact. The statistics in the table below provide a snapshot of where these developments have taken North America.

The trade and investment figures show that both Mexico and Canada are roughly equivalent in terms of their export-dependence on the United States. They also send approximately the same products into the U.S. market--oil, industrial electrical components, and automotive products. Clearly, these data indicate Canada and Mexico are directly competitive with each other--especially in oil and auto parts. A trade pact with Mexico is thus of great interest to Canadians concerned about market share in the U.S. In particular, Canadians would want to protect their access to U.S. markets.

On the direct investment side, Canada also has concerns, especially to ensure that it remains a relatively attractive host for FDI targeting the North American markets. Canada clearly hosts a far greater proportion of U.S. assets abroad than does Mexico. Producers involved in this trade will be reluctant to see the value of those assets eroded by a deal with Mexico.

But business is future-oriented. Even under CUFTA, labor intensive manufacturing was slipping out of Canada. With Mexico under the same umbrella, that trend would accelerate.

Already the framework for this is in place in the form of more than 1,500 assembly or "maquiladora" plants located along the 2,000 mile Mexico-U.S. border. These plants take components built in the U.S.A. and transform them into finished products, paying a labor force of half a million some \$5.00 a day (vs. \$25.00 an hour at car plants in Windsor, Ont.). Under free trade, the value of these operations would be

increased if the components, too, came from Mexico.

Even without free trade, the maquiladora plants boomed during the 1980s. Trade with the U.S. has tripled since the mid-1980s. Maquiladora plant employment has risen from 100,000 in 1980 to the current 500,000. Mexican average hourly wages including benefits in 1989 were \$1.63 compared with \$2.25 in Singapore, \$2.94 in South Korea, \$3.71 in Taiwan and \$14.32 in the U.S. And Mexico's literacy rate is 87%, one of the highest in Latin America. Companies such as Eastman Kodak and Volkswagen are moving beyond the "screwdriver plant" and transferring full scale production to Mexico. Other companies include Hewlett-Packard, IBM, Wang, Ford Nissan and nine of its suppliers.

Behind Mexico's drive to become a North American NIC (newly industrialized country) lies the administration of 42-year-old Mexican President Juan Salinas de Gortari, whose economic team is composed of U.S. trained technocrats. And behind the leadership stands a whole new generation of outward looking, entrepreneurial managers of international firms. Their vision: a new North American trading bloc from Anchorage to Acapulco with a combined GNP of \$6 trillion and a population of 346 million--a vast counterweight to Europe 1992.

So imagine you're a Canadian producer who has just spent the last few years preparing for free trade with the United States. How should you react to this? How likely is this dream to be realized? Where do you fit in to the emerging trends?

The readings in this module were selected to help students understand these developments and to formulate an appropriate response.

Country Profiles			Mutual Trade and Investment		
Pop. (Millions)	GDP(\$US Billion)	Manufacture (%GDP)	% Share by Destination	Investment Abroad	
Canada	26.0	435.8	25	72.1 to U.S.A. 0.4 to Mexico	71.2 in U.S.A. 0.3 in Mexico
Mexico	83.7	176.7	26	72.0 to U.S.A.	N.A
U.S.A.	246.	4,847.3	22	24.0 to Canada 7.0 to Mexico	19.0 in Canada 1.6 in Mexico



# *Mexico-U.S. Free Trade Talks: Why Canada Should Get Involved*

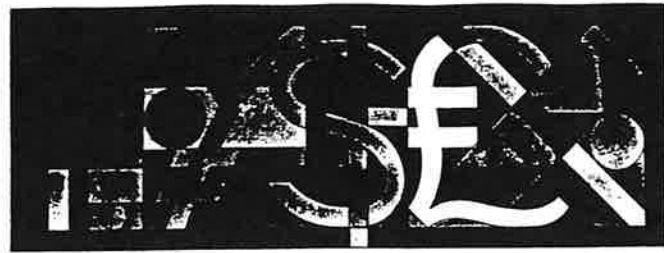
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## *Discussion Note*

Canada and Mexico have relatively little to do with each other commercially, but both countries compete with each for shares of the U.S. market. What should Canada's business community expect from trade policy with respect to a U.S.-Mexico free trade agreement? These readings suggests that Canada cannot afford to stand aloof.

But if Canada can't hold back, how will its North American neighbors respond to a request to participate in the talks? What would be the best way to organize the talks: a full, 3-way conference, or sequentially, with Canada coming in after Mexico and the U.S. negotiated one on one about bilateral issues?

From a strategic perspective, the commentary by Peter Morici argues that Mexico is increasingly a direct competitor of Canadian producers in the U.S. market. The Royal Bank selection suggests that Canadians have an advantage in knowledge-based services. What advice would you give the Canadians and why?



## OTHER VOICES

### **PETER MORICI: *Canada should be at the table when the U.S. and Mexico write their free-trade pact***

A FREE-TRADE DEAL BETWEEN the U.S. and Mexico seems inevitable. Canada has a lot at stake in any such arrangement. If Canadians are to avoid losing their collective shirt, they need to start dealing themselves in now.

A U.S.-Mexico pact that matches the breadth and depth of the Canada-U.S. free-trade agreement is unlikely. The differences between the two countries in terms of economic and social development are simply too great.

Yet each has considerable power in terms of influencing the other's security and other vital interests. One need only consider the alarm caused by the hostility of a relatively small and distant country like Nicaragua to appreciate the view from Washington in such matters. A hostile Mexico is not something that the U.S. could tolerate gladly.

Mexico, fiercely independent, jealous of its revolution and with long memories of the *yanqui gringos*, is equally sensitive in terms of relations with its northern neighbor.

As a result, free-trade negotiations between the two countries are likely

to be conducted like a poker game with very high stakes. And the question for Canada is how and when it wants to join the game.

Let's take a look at some of the major issues that are likely to emerge in bilateral talks between Washington and Mexico City.

To begin with, if negotiators were to take the issues addressed by the Canada-U.S. agreement as a starting point, the two sides would have quite different lists of items they would want withdrawn from consideration.

For example, while a U.S. goal would be to get long-term guarantees allowing U.S. interests to undertake direct investments in the Mexican economy, it would be politically difficult for Mexican President Carlos Salinas de Gortari to sell such a guarantee at home.

Similarly, the U.S. would be seeking concessions regarding energy pricing and supplies similar to what they gained in the Canadian FTA. But this would also be politically hard for the Mexicans to swallow, although they might ultimately have to in order to win access to U.S. markets for

products such as petrochemicals and primary plastics.

Turning to Mexico's agenda, the continued success of its economic reforms requires continually expanding access to U.S. markets for its manufactured goods. High on Mexico's want list will be elimination of tariffs and import restraints, the movement of labor as part of any deal on services and bilateral dispute settlement mechanisms to corral U.S. contingent protection.

Yet, given Mexico's low wage structure, unrestricted access to U.S. markets for its manufactured products could devastate a number of U.S. industries, putting strong political pressures on U.S. President George Bush to remove commodities such as textiles, footwear and basic metals from consideration. The prospects of Mexican construction workers, janitors and other service personnel freely moving across the border for short-term employment will generate fierce opposition from U.S. workers and unions normally insulated from foreign competition.

Nevertheless, both countries' leaders have strong incentives to be sufficiently flexible so as not to preclude an agreement.

For President Salinas, a free-trade

deal would offer the opportunity to ensure that his market-oriented reforms are sustained down the road by another administration. Future Mexican presidents would be in no position to revert to economic nationalism in the face of a restructured industrial sector that was oriented toward U.S. markets.

At the same time, President Bush cannot afford to let economic reforms fail in Mexico. As already suggested, the security implications for the U.S. of a political upheaval in its southern neighbor are unthinkable.

Given these mutual imperatives, negotiators for the two countries should be able to finesse difficult issues—like energy, investment and the vulnerabilities of mature U.S. industries—through managed phasing-in of harmonized policies and increased market access.

The 1987 trade framework agreement between the U.S. and Mexico that has allowed the latter to significantly increase its exports of steel and textiles, and more recent Mexican concessions to foreign investors in the automobile industry, indicate that, to use the old adage, where there's a will, there's a way.

Still, this process is likely to be both complicated and messy.

Where does Canada stand in all this?

Mexico's fastest-growing exports are precisely the kinds of products Canada has been banking on under the FTA to supplement its resource sales in the U.S.

For example, the proportion of machinery and transportation equipment in Mexico's exports to the U.S. jumped from 21% in 1979 to 43% in 1987. The latter figure was about the same for Canada.

It would appear that Mexico has been achieving its rapid export growth by bypassing many U.S. import-sensitive industries and going directly into the kinds of secondary

manufacturing that Canadian industrial policymakers have long coveted, such as power generation equipment, telecommunications equipment and electrical equipment.

In this context, Canada cannot afford to have Washington decide unilaterally which U.S.-Canadian industries will be sheltered from Mexican-based competition through transitional provisions.

Consultations between Ottawa and Washington will not be enough.

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*Canada does not  
share the U.S. sense  
of urgency  
about the need to  
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economic and  
political progress.*

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Canada must be represented at the table when the dealing begins.

Additionally, Canada has a major stake in ensuring that any deal that liberalizes U.S.-Mexico trade is consistent with FTA rules as they evolve. Comparable rules for U.S. trade with both Mexico and Canada will better ensure the ability of each to hold the U.S. to its commitments—for example, with regard to safeguard actions and countervailing duties.

In the FTA negotiations, the most significant achievement for Canada was to begin the process of subjecting U.S. actions—that might violate GATT-based norms or that rescind benefits anticipated from tariff cuts—to bilateral review. This gain could be greatly strengthened by a tripartite arrangement.

But the latter could only evolve if

the U.S. and Mexico saw their emerging arrangement through the prism of the FTA. And again, the best way for Canada to ensure this is to be at the negotiating table from the start.

It will not, however, be easy for Canadians to reserve a seat at that table. For one thing, their presence there will certainly have the effect of slowing the negotiation process; it would be much easier to achieve a bilateral agreement than a tripartite one. The U.S. is likely to favor speed; Canada does not share the U.S. sense of urgency about the need to facilitate Mexican economic and political progress.

Also, U.S. trade officials are likely to find their Mexican counterparts relatively inexperienced. They might not welcome the presence of what they came to regard (perhaps surprisingly for Canadians) as Ottawa's canny crew.

What this means is that if Canada is to be represented in the talks, it will have to bring something to the table.

The Mexicans are interested. President Salinas has said that his country wants closer commercial ties with both Canada and the U.S. But Canada must be prepared to offer Mexico the same kind of tariff cuts and privileged access to Canadian markets as would be provided by the U.S.

Undoubtedly this will provoke strong opposition from Canadian industries such as steel and textiles that could be hard hit by the elimination of protective tariffs. It will also be opposed by Canadian unions concerned about cheap Mexican labor.

Cries will be raised that the costs of cutting a deal with Mexico are too great. But the fact remains that if Canada is to maximize the benefits it receives under the FTA, this is the price that will have to be paid.

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*Mr. Morici is professor of economics and Canadian studies at the University of Maine.*



# econoscope

## Executive summary

*A North American free trade zone comprising almost 360 million inhabitants would offer Canada opportunities to specialize and expand economies of scale in production, distribution and marketing...*

■ The United States and Mexico appear poised to negotiate a free trade agreement. Canada's federal government has not formally taken a position on the issue, but it is expected to make its views public in the near future. In our judgement, Canada's position should be to seek to become a full and active participant in the negotiating process as soon as possible.

■ Clearly, negotiating a free trade deal involving Mexico will be a complex and controversial process because of the large differences in technology and labour costs between Mexico and the United States. In practice, however, very healthy trade has for many years taken place between countries with such differences simply because healthy trade depends not on absolute cost differences but rather on a country's comparative advantage in producing certain goods and services for export.

■ Canada, with its highly educated workforce, its specialized expertise in many areas and its highly developed capital markets, is ideally placed to seize the opportunities offered by a liberalized trading zone in North America.

■ A North American free trade zone comprising almost 360 million inhabitants would offer Canada opportunities to specialize and expand economies of scale in production, distribution and marketing, enhancing its international competitiveness.

■ There are several areas in which Canadian expertise could find a market in Mexico. These include agriculture, fishing, forestry and financial services. Also, Canada, with its expertise in transportation, telecommunications and civil engineering is in a good position to take advantage of Mexico's drive to modernize its economy.

■ Demand for Canadian goods and services will increase further over time as the Mexican standard of living and incomes rise as a result of the gains made from more liberalized trade.

■ It is in Canada's interest to seek enlarged access to the Mexican market. Not to do so would place Canada in a disadvantaged position. Mexican exports to the United States are bearing an increasing resemblance to those from Canada. With further trade liberalization between Mexico and the United States, the competition for market share in the United States will be increased. This competitive challenge, particularly for some labour-intensive Canadian manufactured exports to the United States, would occur whether Canada joined the new free trade group or not. However, if the Mexico-U.S. trade deal excludes Canada, then Canada could face the additional consequences of a diversion of trade and investment.

■ Furthermore, Canada has an interest in the shape of the trading relationship that will evolve between Mexico and the United States in that it could have implications for the Canada-U.S. free trade agreement.

■ It should be recognized that because of significant differences in technology and labour costs, a free trade deal between Mexico and the rest of North America would likely need a substantially longer transitional period of adjustment than in the Canada-U.S. free trade deal.

■ For all these reasons, Canada can ill afford to stand aloof while Mexico and the United States enter into bilateral negotiations that could reshape North American trade and investment flows. It is imperative for Canada to seek immediately to become a full and active participant in this far-reaching initiative.

## Mexico-U.S. free trade talks: Why Canada should get involved

In early August, President Bush took the occasion of a meeting with the U.S.-Mexican Binational Commission to announce that, if President Salinas of Mexico agrees, he expects to notify Congress formally in September of the intent of the two countries to negotiate a free trade agreement. This announcement concluded months of preliminary discussions and behind-the-scenes preparatory work on both sides.

As early as last March, the Bush Administration had revealed that the governments of both countries were initiating discussions that could lead to such an agreement and, in a meeting in early June, both presidents agreed to undertake the consultations and preparatory work

needed to initiate discussions on a comprehensive free trade deal.

A free trade agreement between Mexico and the United States would go beyond previous bilateral accords which have focused on sectoral trade issues. Both sides envision the gradual and comprehensive elimination of trade barriers between the two countries, including the full, phased elimination of import tariffs; the elimination or fullest possible reduction of non-tariff trade barriers, such as import quotas, licences and technical barriers to trade; the establishment of clear and binding protection for intellectual property rights; fair and swift dispute settlement procedures and the means to improve and expand the flow of goods, services

and investment between the two countries.

President Salinas has stated that, under Mexico's constitution, oil and electricity would be excluded from the agreement. The free movement of labour, which Mexico would have liked to include, will also be excluded from the preliminary talks.

### **Economic integration part of Mexico's modernization drive**

A move towards economic integration is a logical step given that the United States is Mexico's largest trading partner. The United States also accounts for two-thirds of the estimated US\$27 billion of total foreign direct investment in Mexico, while Mexican citizens hold assets in the United States estimated to range between US\$40 billion and US\$80 billion. However, such a development would be a radical departure from Mexico's traditional economic nationalism and protectionism.

During the 1980s, Mexico set out to achieve a gradual integration with the United States, reducing local content requirements to encourage export performance. In tandem with Mexico's accession to GATT in 1986, the previous Mexican Administration set in motion a cautious sector-by-sector approach to liberalization.

In 1987, the U.S. and Mexican governments signed the "Bilateral Understanding on Consultations Regarding Trade and Investment Relations" which aimed at settling principles and procedures to deal

### **Timetable for Mexico-U.S. negotiations**



*In spite of Mr Salinas' determination and the rapid pace of economic reforms witnessed during the past two years, there remain major differences between the two countries in inflation, investment policy, subsidies, labour costs and other issues. As a result, free trade talks between the United States and Mexico are likely to be a complex process. Nevertheless, because of U.S. trade law, the "fast-track" process will impose firm deadlines.*

*U.S. trade law requires the President to ask Congress for approval in principle before proceeding with negotiations. Members of Congress then have 60 legislative days to give the Administration authority to negotiate a treaty, a timetable that if initiated this September, as President Bush indicated he would in a statement to the U.S.-Mexican Binational Commission, would give them until late 1990 to accept or refuse.*

*If Congress does give its approval, the Administration must return with a negotiated package within two years, at which time Congress can either accept or reject, but not amend, the package's provisions. This, therefore, puts the deadline around the beginning of 1993, by which time an acceptable agreement must be concluded. On the Mexican side, President Salinas has already won approval from the Mexican Senate to open talks with the United States. A rapid completion of the negotiations is imperative given that President Salinas' non-renewable term expires in 1994.*

with contingent problems between the two countries. The 1987 trade pact also led to an easing of access to the U.S. market, allowing Mexico to increase dramatically its exports of goods, such as steel, textiles and clothing products, to the United States.

This agreement was strengthened in March 1989 with the establishment of nine working groups on various industrial sectors. In October 1989, an "Understanding on Talks to Facilitate Trade and Investment" was signed. Its aim was to transform the 1987 bilateral framework agreement into a more active forum of negotiations where access to products from both countries would be made easier. It also set up a mechanism to identify trade and investment opportunities.

Since 1987, Mexico has taken a number of energetic measures to improve the efficiency of its economy, including a stringent economic stabilization program (which has reduced inflation dramatically and set the stage for sustained growth), significant unilateral tariff reductions on a wide range of imports, wide-ranging privatizations and an opening of the country to foreign investors.

In the area of trade, the maximum rate of import duty was cut in 1987 from 45 to 20%, bringing the weighted average to about 11%. The tariff reduction exceeded Mexico's commitment under the terms of its admission to GATT. Mexico also unilaterally eliminated most import licences, its most potent form of non-tariff barrier.

In 1988, Mexico's weighted average tariffs stood at about 6%, a lower level than Canada's when it began its own trade negotiations with the United States. By the end of 1989, 16% of all Mexican imports were duty-free, while the remainder had tariffs ranging between 5% and 20%. Remaining import restrictions are to be phased out over the next few years.

On the foreign investment side, in May 1989 the government liberalized the 1973 foreign investment law. The new rules automatically allow 100% foreign ownership of Mexican companies provided that less than US\$100 million is involved and that certain other criteria are met (for example, the funds must come from abroad and the investment must not be in areas which are already industrialized).

However, certain activities continue to be reserved for Mexican investors (sea and air transportation, radio and television and most financial services are examples), while some activities remain the exclusive preserve of the state (such as oil and electricity production and rail transportation).

The move towards a free trade agreement with the United States is seen by the Mexican government as a powerful tool to modernize its economy. Such an alliance leading to a greater integration of Mexico into the North American economy could provide an anchor of stability for Mexico's monetary and fiscal policies. Enhanced export opportunities and the elimination of tariff and non-tariff barriers would encourage investment flows and could also encourage the return of Mexican flight capital.

Another reason for seeking some form of free trade is Mexico's concern that it could be passed by in a world that could be moving in the

### How the three countries compare

	United States	Canada	Mexico
<b>Population</b> (millions)	248.8	26.3	85.0
<b>Population growth</b> (%)	0.8	0.9	1.9
<b>Total area</b> (thousands/sq. km)	9373	9976	1958
<b>Literacy rate</b> (%)	95	95	89
<b>GNP/GDP*</b> (US\$ billions)	5200.8	531.6	201.4
<b>GNP/GDP*</b> (US\$ per capita)	20,904	20,214	2365
<b>Merchandise exports</b> (US\$ billions fob)	370.0	121.0	22.8
<b>Imports</b> (US\$ billions fob)	480.1	115.9	23.4
<b>Current account deficit</b> (US\$ billions)	110.0	16.6	5.4
<b>Inflation rate</b> (%)	4.8	5.0	20.0

\*GDP for Mexico; GNP for Canada and the United States; 1989

direction of large regional markets. Finally, and perhaps most importantly, Mexico is eager to have secure access to the U.S. market in light of protectionist sentiments. Many of these objectives also motivated Canada to seek a free trade agreement with the United States.

#### **Differences with Canada-U.S. free trade agreement**

A trade deal between Mexico and the United States is likely to be substantially different from the Canada-U.S. deal. Such a deal is also likely to be more controversial on both sides of the border.

Although there was strong opposition among some segments of Canada's population, the United States did not worry very much about free trade with Canada because Canada is small relative to the United States and very similar in terms of economic development and culture. Moreover, decades of relatively unhindered trade and investment between the two countries had moved both economies along the road to complementarity.

Almost two years after the implementation of the Canada-U.S. pact, and in spite of the high external value of the Canadian dollar, adjustments to Canada's economic structure appear to be proceeding smoothly. This is because of the similarity in industrial structures and because three-quarters of bilateral trade between the two countries was already conducted free from tariffs.

#### **Obstacles and opportunities**

The United States will find an agreement with Mexico very controversial because the Mexican population is large and growing rapidly, the culture is different and Mexico is at a lower level of economic development.

The large differences between wages and productivity in U.S. and Canadian manufacturing plants and those in Mexico suggest that there are very substantial efficiency gains to be obtained by freeing up trade. But these differences also mean that the transitional arrangements to integrate Mexico further in the North American economy would have to be longer than was the case with the Canada-U.S. free trade agreement.

A free trade deal that quickly removed tariffs on most of the trade between the United States and Mexico could make it difficult for some U.S. and Canadian producers to compete with cheaper Mexican goods. U.S. fruit and vegetable growers, in particular, will face greater competition with Mexican growers. Some U.S. unions are already strongly opposed to the establishment of in-bond manufacturing zones in northern Mexico which have shifted jobs from the rust belt to the south. Given that Mexico has already unilaterally lowered its tariffs substantially, the economic adjustment effort might be greater on the part of the United States.

On the plus side, the United States will find that an improved Mexican economy, particularly if it can help to reduce the flow of economic refugees into the United States, and improved co-operation on narcotics and the environment sufficiently compelling reasons to pursue free trade talks. The Mexican government's drive to privatize some of its state-owned companies will provide an added incentive.

On the Mexican side, a free trade deal promises to be a major issue in next year's mid-term elections. Several union leaders have criticized a possible Mexico-U.S. free trade deal, saying that it would flood the

### **CANADA'S POSITION**

*During his March trip to Mexico, Prime Minister Mulroney signed 10 economic and commercial agreements and, while falling short of formally backing a free trade deal between Mexico and the United States, encouraged Mexico on its trade initiative.*

*President Salinas stated in June that Mexico would first work towards a free trade agreement with the United States and that an agreement with Canada could follow at a later stage. In previous declarations, Salinas had stated that he favoured a trade relationship with both the United States and Canada. Similar declarations were made by President Bush who promised in 1988 that he would work towards the creation of a free trade zone embracing all three countries.*

*Although there has been no formal response on Canada's part to the statements made at the June meeting, the federal government has been closely monitoring developments between Mexico City and Washington and has ordered studies to assess the impact on Canada of a Mexico-U.S. deal.*

*Now that the United States and Mexico appear closer than ever to initiating formal talks, Canada's federal government is expected to decide very shortly what role it wants Canada to play in the deliberations.*

### **Benefits to Canada of a North American common market**

*For Canada, the creation of a North American free trade zone would add to the already expanded and secure Canada-U.S. trading system. With the inclusion of Mexico, the market for producers located in Canada would increase from 272 million customers to almost 360 million, almost three times the size of Japan's domestic market of 123 million customers and larger even than the EC's market of 326 million.*

*A North American common market would offer Canada further opportunities to specialize and expand economies of scale in production, distribution and marketing, all factors which in the long term should enhance its competitiveness. The benefits of freer North American trade can be summarized as follows:*

#### **Comparative advantage**

*Freer trade will provide the opportunity for producers to make business decisions based on the principle of comparative advantage rather than on the basis of tariff barriers. Each country will be able to concentrate on the goods that it can produce more efficiently. Even if a country can manufacture a good as efficiently as the other country, it will still benefit the country in question to produce the commodity it has a relative advantage in producing, since specialization will lead to greater overall production and lower costs for the three nations.*

*With its highly educated workforce, Canada is well positioned to take advantage of the growth in knowl-*

*continued...*

country with imports, create chronic unemployment and lead to the "exploitation" of Mexican workers.

Moreover, Mexico will have to confront its traditional hostility towards foreign investment, especially in natural resources and banking. Like Canada, Mexico has a number of sensitive sectors (such as energy and rail transportation) and may look for a deal that extends only to certain sectors, leaving services and other difficult issues for later. Both the United States and Mexico will eventually have to deal with the sensitive issue of immigration.

#### **Strategic issues and implications for Canada**

There are a number of reasons that argue for the creation of a North American free trade zone. One of the more compelling reasons is that, in a world which may evolve in the direction of regional trading blocs, it may be of crucial competitive and strategic importance to include a region with a comparative advantage in labour-intensive industries.

A North American grouping would resemble the European model in the size of the market and in the economic benefits derived from combining a rich, industrial north with a capital-hungry south. A North American free trade zone would be a formidable competitor to a fully integrated European Community (which will eventually include parts of Eastern Europe) and to Asia's newly industrialized countries.

The inclusion of Mexico in a North American liberalized trade zone would increase significantly the potential size of the North American market and improve the export potential of Canadian firms in many product ranges.

There are strong arguments for Canada's early involvement in the process:

☉ The failure of Canada to enter into a wider agreement with Mexico would leave soft sectors of the Canadian economy exposed to competition from Mexican producers both in the United States and domestically without the cushion provided by transitional arrangements, while depriving Canadian producers of the opportunities represented by the opening of the Mexican economy.

☉ A Mexico-U.S. free trade agreement could modify the balance of advantages reached under the Canada-U.S. free trade agreement and could perhaps dilute some of its benefits. For instance, a Mexico-U.S. agreement could affect the relative attractiveness of Canada as an investment location for production for the North American market.

☉ An agreement excluding Canada altogether would limit the economies of scale that could be achieved by the addition of a new market.

☉ A deal liberalizing trade between the U.S. and Mexico may not be consistent with some aspects of the Canada-U.S. free trade agreement.

#### **What kind of agreement?**

There are two main routes that could be followed to reach the objective of a North American free trade zone: trilateral negotiations leading to a joint deal (which could involve a re-opening of the Canada-U.S. free trade agreement to include Mexico) or a series of bilateral deals.

Because of the need for Canada to join the process as early as possible, the final outcome of either a trilateral agreement or a set of bilateral agreements is likely to be substantially the same. A continental deal remov-



ing tariff and non-tariff barriers in a consistent manner could involve a single agreement which, once finalized, would be the easiest to administer for all three parties involved. As is the case with the Canada-U.S. free trade agreement, it could include origin, procurement and technical standard rules, and dispute settlement procedures.

The main difficulty with a trilateral agreement is that, although the Canada-U.S. free trade deal could be used as a blueprint, the negotiation process would be fairly complex because it would have to allow for considerable differences in the way particular economic sectors are dealt with in the case of each country.

The second option would involve three sets of bilateral deals. It would allow each country greater flexibility in meeting their objectives. However, this could be at the cost of a lower degree of harmonization between the three countries - and consequently a greater administrative burden - a factor which could reduce the benefits offered to business by liberalized trade.

Furthermore, given the relatively small volume of trade and investment between Canada and Mexico, the economic incentive to negotiate a bilateral deal with Mexico may not be sufficiently important by itself to warrant a separate deal. However, if it chose this second option, Canada would have to seek to enter into negotiations with Mexico at a very early stage because it could be difficult for Canada to catch up after Mexico and the United States have arrived at an agreement covering key areas of interest. This would mean that, in practice, the process of bringing Mexico into the Canada-U.S. trading system through a series of bilateral deals would not be very different from a trilateral deal.

Canada should define its position and decide how it wants to use its influence as soon as possible to ensure that its interests are factored into the negotiations. Canada may not experience dramatic immediate gains from the addition of Mexico to a North American trading system, but it could nevertheless lose much by not being included.

#### **Opportunities and challenges for Canadian businesses**

In Canada, the burden of argument has often dealt with the disadvantages of a free trade agreement involving Mexico. Recent press coverage has emphasized the potential threat that low-cost Mexican labour could represent for labour-intensive sectors of Canadian industry. Such arguments were used at times during the debate surrounding the Canada-U.S. negotiations and have often been used by opponents of the entry of Mediterranean countries into the EC.

The greater competition offered by Mexican low-cost labour-intensive products has to be kept in perspective. A central tenet of international trade theory is that countries specialize in the production and export of goods according to comparative advantage rather than absolute advantage.

Many developing countries have failed to convert their advantages with respect to plentiful and cheap labour into a comparative advantage because of a number of factors impeding overall labour productivity. This in part explains why, for instance, countries such as India or Bangladesh have failed to attract substantial investment flows and to develop more rapidly in spite of very low labour costs.

Similarly for Mexico, the compara-

*edge-based services industries. Canada enjoys a particularly enviable position in areas such as transportation machinery and equipment, telecommunications equipment, and civil engineering.*

#### **Economies of scale**

*A reduction in tariffs and non-tariff barriers will offer producers further opportunities to exploit economies of scale in production. Access to larger markets will allow producers to spread the total cost of doing business over larger production runs, thereby reducing average costs per unit of output.*

#### **Higher levels of real disposable income**

*Declining trade barriers should increase competition and reduce price distortions. This should lead to price reductions and, in the process, raise the level of real disposable income. Higher disposable income should lead to higher consumer spending which should in turn, stimulate growth in production and employment.*

#### **Improved investment climate**

*Greater security of access to the various markets for foreign investors as well as the higher income of consumers should lessen the risks of doing cross-border business and attract more investment into North America.*

#### **Wider product availability**

*Freer North American trade will not only create job and investment opportunities, but will also expand the availability of goods to consumers and producers.*



tive advantage offered by low-cost labour is offset to a certain extent by the lower level of manufacturing productivity (except perhaps for the most recent manufacturing plants built in the in-bond maquiladora sector). Moreover, Mexico is faced with a number of other problems such as heavy state involvement, absenteeism and poor transportation and communication infrastructures.

Clearly, labour costs are only one of the elements in the production process. Other factors such as the economy's overall efficiency, the educational level of the labour force, the quality of management and the cost of capital have to be taken into consideration.

Canada is in a favourable position relative to Mexico on all four accounts. It has a highly skilled labour force, a highly competent and motivated managerial class, a modern economic structure and an efficient financial system which, in recent years, has experienced the benefits of financial liberalization.

There are several areas in which Canadian expertise could find a market in Mexico. These include agriculture, fishing, forestry and pollution control. Agricultural productivity in Mexico is low, thus forcing Mexico to import significant amounts of basic foodstuffs. This means that, while Canada will never be able to compete effectively with Mexico in areas such as horticulture and tropical food products, our experience in many agricultural areas represents a comparative advantage.

There are several others as well. If it is to become an important player in the international trade arena, Mexico will have to revamp substantially its transportation and communications sectors. With its world renowned expertise in sophisticated transportation and communication

equipment as well as in civil engineering, Canada is well positioned to take advantage of Mexico's economic modernization drive. Reflecting the interest of firms involved in these areas, Minister of International Trade, John Crosbie, was accompanied on an April trip to Mexico by representatives of Canadian companies, including telecommunications and engineering firms.

Substantial opportunities are also likely to open up with the privatization of government-owned industrial enterprises and financial institutions. For instance, in early May, President Salinas announced a further reversal of the 1982 nationalization of commercial banks by extending the partial privatization begun in 1987.

#### **What would happen if Canada failed to gain enlarged access to Mexico?**

If Canada failed to gain enlarged access to the Mexican market, it would then be penalized because it could not expand exports significantly to Mexico but would still face stiffer competition from Mexican producers. Canada would be confronted with a competitive challenge on at least four fronts.

⊗ There could be some diversion of U.S. trade away from Canada and towards Mexico. New investment in manufacturing in Mexico combined with low labour costs could give a competitive advantage to Mexican exports over Canadian exports in the U.S. market. Canada has a given share of the U.S. market in certain product lines. That share is currently protected by U.S. protectionist policies, primarily in the form of quotas, but also in the form of tariffs against Mexican imports. If the United States were to liberalize access, some of that market share would be lost to expanding Mexican

firms. For example, Mexican exports to the United States are bearing an increasing resemblance to those from Canada. This is particularly true in the case of the automotive industry. Those goods are currently the biggest component of merchandise trade between the United States and Canada, on the one hand, and between the United States and Mexico on the other.

Mexico is also, in varying degrees, a competitor in industrial machinery, metal fabrication, textiles, footwear, iron and steel, petrochemicals and paper products. (The above list is constructed on the basis of revealed trade data, which is not necessarily a good predictor of what would happen under a Mexico-U.S. agreement simply because free trade would create new and expanded trade flows not currently captured by the data). Thus, a Mexico-U.S. free trade agreement which excluded Canada could affect some Canadian exports to the United States.

⊗ There could be greater indirect import penetration from Mexico. The duty-free provisions of the Canada-U.S. agreement do not apply to goods purchased in the United States if they are manufactured in another country. But manufactured goods that have a sufficiently low proportion of intermediate content produced in a third country could qualify as U.S. or Canadian products for purposes of further manufacturing. As a consequence, if a Mexico-U.S. free trade agreement is successfully negotiated without Canada's participation, Canada could expect more U.S. finished products with intermediate components made in Mexico finding their way into Canada.

⊗ Greater Mexican import penetration into the United States may force producers in that country to shift

some of their output to Canadian markets.

Labour cost and locational advantages could divert investment flows from Canada to Mexico from both North American and non-North American companies seeking to develop a production base in North America. The United States could also be a preferred investment location since it would be the only country with free access to markets in all three countries.

#### **A cause for concern?**

As was the case prior to the ratification of the Canada-U.S. free trade agreement, concern has been expressed about the adjustment costs which Canada would face in the event of a North American free trade zone. In fact, Canada will not face major economic dislocations from liberalized trade. Several factors have to be taken into consideration.

First, and perhaps most importantly, Canada's comparative advantages relative to Mexico should not be neglected. With its highly educated labour force, Canada is particularly well positioned to take advantage of the expansion of knowledge-based high-technology and service industries.

Second, since the signing of the Canada-U.S. agreement, Canadian firms have had to make considerable adjustments. Even in some sectors considered to be soft, many Canadian firms have succeeded in remaining competitive by stepping up investment in anticipation of the implementation of the agreement. This has been particularly true of the high value-added segments of the leather, textile and clothing products sectors.

Such trade-induced rationalization would probably accelerate further in the event of a Mexico-U.S. deal, but

would nevertheless continue even without a free trade deal including Mexico because of the multilateral liberalization process. For instance, tariff reductions of about 35% should follow a successful resolution of the GATT Uruguay Round.

Third, Canada is already benefitting from easier access to the larger U.S. market in many sectors and should make further gains if Mexico is integrated into the North American economy.

Fourth, under a new free trade regime including Mexico, Canadian businesses will be able to obtain inputs more cheaply from Mexico which should improve Canadian export competitiveness, thereby minimizing the potentially negative economic impacts of a free trade agreement. In addition, the availability of cheaper consumer goods will increase real incomes and should provide a boost to the retail industry.

Fifth, many high value-added manufacturing industries are nowadays much more capital-intensive, thus reducing somewhat the advantages offered by low-cost labour.

The Mexican and the two other North American economies share complementary features. A free trade zone would stimulate economic activity and, therefore, should not be treated as a zero-sum game.

Most economic studies on the impact of freer trade (for instance on the Canada-U.S. free trade agreement or on the EC integration process) concur on the positive impact of such a development, if not on the magnitude. In these studies, an increase in GDP and a reduction in the price level generally occurs over the forecast horizon.

While some sectors will undeniably face difficulties in the short-term, the redeployment of capital to other

areas in which Canada has a comparative advantage means that, in the long term, the impact of North American free trade will be positive. The ultimate impact on employment will depend crucially on transitional arrangements and adequate retraining programs.

Post-war economic history has shown that trade does not lead to a reduction in standards of living or an elimination of industrial bases but, on the contrary, provides a necessary framework for growth and improvement. A good example is provided by the EC which has experienced stronger and more balanced growth since the economic integration process began in the late 1950s. The inclusion of Mexico into the North American economy should be seen as a positive step which will produce a trading system more in line with the economic realities of the 1990s.

#### **What should Canada do?**

Whether Canada participates or not, any negotiations leading to a free trade agreement between the United States and Mexico will inevitably have direct and indirect effects on Canada. An agreement between the United States and Mexico which excluded Canada could put Canada in a disadvantaged position with respect to North American trade and investment patterns.

Only by participating in a North American deal could Canada hope to influence the future course of trade and investment flows. Therefore, Canada should seek to become an active and full participant in the negotiating process. Moreover, this participation should take place as early as possible if Canada is to have an effective input in shaping the deal.

□

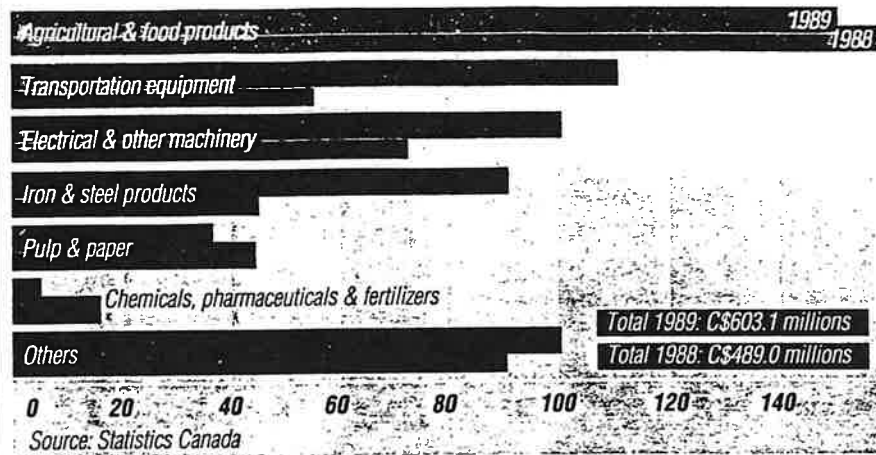
# Canada's trade with Mexico

When compared with Canada-U.S. trade of C\$185.8 billion in 1989, Mexico's trade with Canada has not been very substantial in recent years. Two-way Canada-Mexico trade amounted to C\$2.3 billion in 1989, of which imports from Mexico accounted for C\$1.7 billion. Nevertheless, Mexico is Canada's leading trading partner in Latin America, with two-way trade increasing at a rate of 17% a year since 1987. Crude oil imports from Mexico have fallen sharply since the beginning of the 1980s (when they accounted for over 80% of imports) and the bulk of Canada's imports is now made up of manufactured products (principally transportation and machinery parts, and various consumer goods).

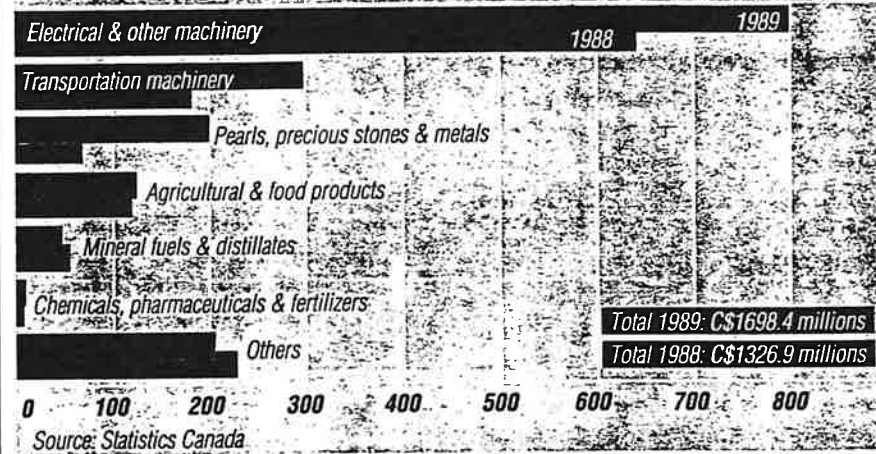
Canada's exports to Mexico are largely composed of agricultural products and transportation machinery. In the area of trade in services, Mexico and Canada's links are insignificant other than a small amount of engineering services exports from Canada to Mexico. Tourism is well-developed but unlikely to be affected by trade liberalization. There is clearly room to increase Canadian exports of goods and services to Mexico.

The level of bilateral direct investments between the two countries is very limited. Mexican holdings of Canadian productive assets are virtually non-existent, while according to the Bank of Mexico, the total value of Canadian investment in Mexican manufacturing industry amounted to US\$371 million in 1987. However, it is not sufficient only to examine current trade and investment flows. Consideration must be given to Mexico's growth potential. Improved economic prospects following Mexico's economic adjustment and debt reduction programmes, and the establishment of a North American free trade zone should create substantial investment opportunities over the coming years.

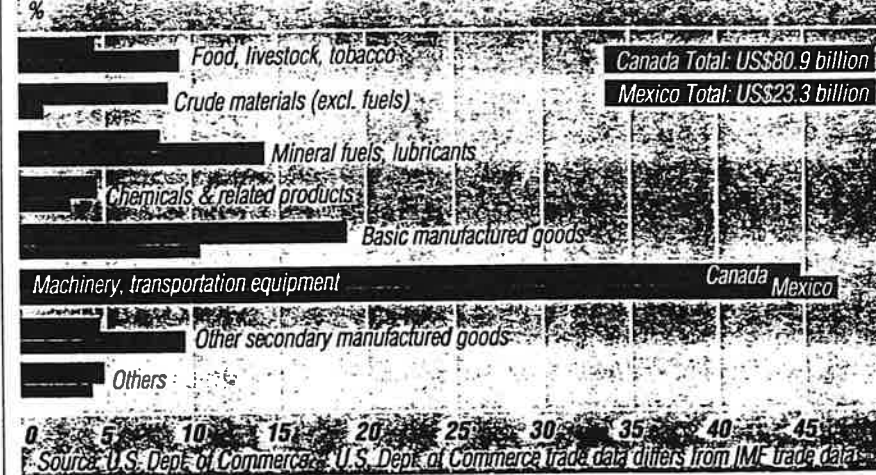
**Canada's exports to Mexico**  
C\$ millions



**Canada's imports from Mexico**  
C\$ millions



**Commodity shares of U.S. imports from Mexico and Canada**  
%



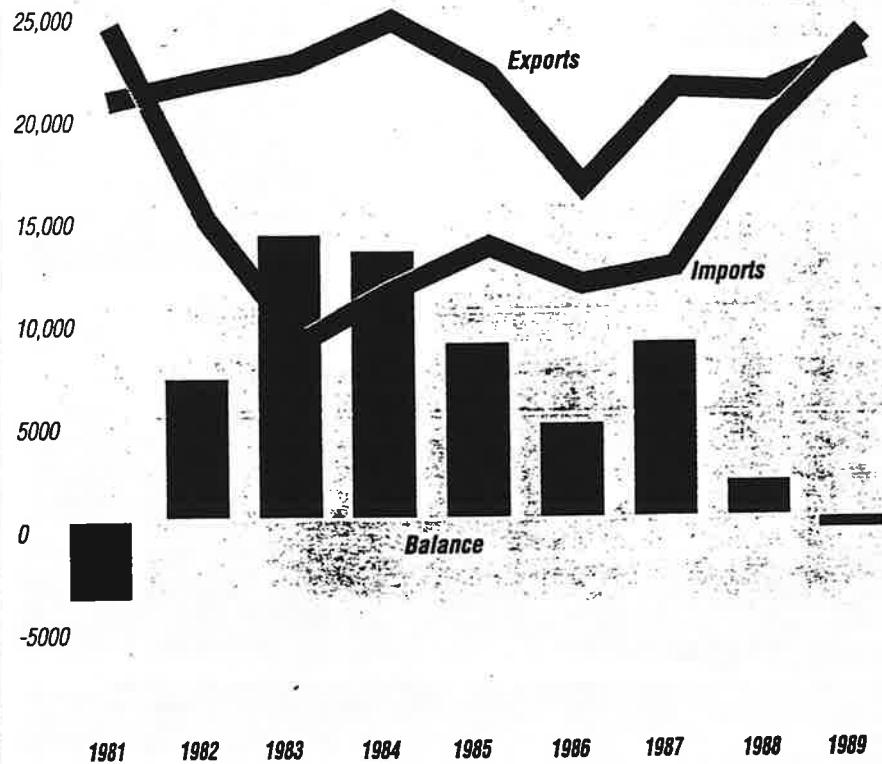
# Mexico's international trade

## TREND OF FOREIGN TRADE



Mexico's foreign trade has been stagnant in the 1980s, although expansion resumed in 1987 after a decade-long volume of exchanges reached in 1986. After the onset of the LDC debt crisis in 1982, the country succeeded in restraining import growth to generate substantial trade surpluses. However, the government's anti-inflationary strategy structured in 1987 around a reduction in tariffs and a substantial appreciation of the peso led to a surge in imports in 1988 and 1989 and a reduction in the growth of non-oil exports. The strong growth in imports was also caused by the need to import large quantities of food because of a drought in 1988. This resulted in a sharp worsening of the trade balance and a trade deficit of US\$0.6 billion in 1989 (the first since 1981). With the trade deficit expected to widen further in 1990, Mexico will have to have recourse to a greater volume of foreign investment to plug its trade gap.

**Mexico's trade flows**  
US\$ millions fob



Source: International Monetary Fund



**Mexico's principal imports**  
US\$ millions



Source: Report of the President, Mexico

## MEXICO'S IMPORTS

Manufactured good imports accounted for the bulk of Mexico's imports in 1989 (38%). A large proportion of manufactured imports has been accounted for by the processing and re-exporting activities of the maquiladora sector. Consumer good imports have made up only a small proportion of the total in recent years. However, consumer goods and agricultural imports increased rapidly in 1988 and 1989 because of trade liberalization and the need to compensate for inadequate domestic food supplies.



## MEXICO'S EXPORTS



Oil and oil derivatives are by far the most important of Mexico's merchandise exports. However, their contribution to total export earnings has fallen dramatically in recent years.

While in 1983 oil and oil-related products accounted for nearly 70% of exports, in 1989 they accounted for less than 35%. While the decline has resulted in part from the drop in oil prices in the intervening period, it was also related to the progress made by non-oil exports, particularly automobiles, auto engines and other parts, machinery and equipment, chemicals as well as electronic goods such as modular sound units, televisions and cassette recorders.

Lower wages compared to the United States have led to the growth of an in-bond assembly industry in the border areas (maquiladoras) employing almost half a million workers. It has transformed Mexico from a net importer to a substantial exporter of motor vehicles (mainly to the United States).

The automotive industry is now Mexico's second largest foreign exchange earner. In 1989, the industry earned US\$3.3 billion from overseas sales. The estimated total value of output from the maquiladora region varies between \$10 and \$15 billion out of a Mexican GDP of \$201.4 billion in 1989.



### Mexico's principal exports

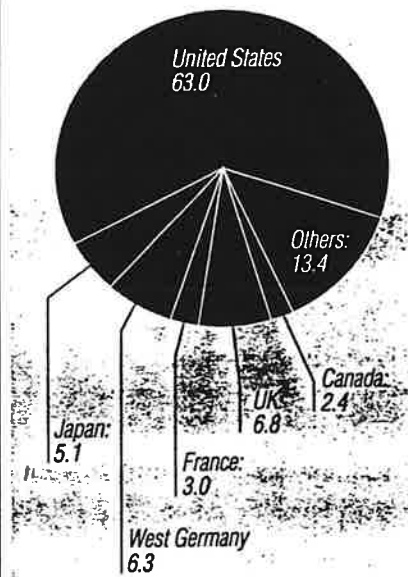
US\$ millions



Source: Report of the President, Mexico.

### Foreign direct investment in Mexico

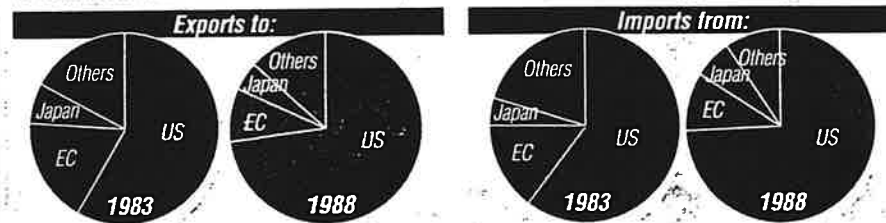
Stock as at end-1987  
% share



Source: International Institute for Finance.

### Mexico's major trading partners

% of Mexico's total trade



Source: International Monetary Fund.

### DIRECTION OF TRADE

Mexico is the United States' third most important trading partner (two-way trade of US\$43.9 billion in 1989) after Canada and Japan, while the United States is Mexico's pre-eminent trading partner. Almost three-quarters of Mexico's exports go to the United States and a slightly larger proportion of imports comes from that country. Despite efforts to diversify its international trade, Mexico's reliance on the U.S. market has increased in recent years. In spite of lower average U.S. tariffs, there remain many obstacles to an expansion of bilateral trade between the two countries such as quotas and non-tariff barriers imposed on a number of Mexican exports. The restrictions imposed by the United States are particularly high in agriculture.

# *Exploring North American Options*

This selection reprints with permission *Canada, Mexico and the United States: Pursuing Common Multilateral Interests and Exploring North American Options*, by Murray G. Smith, Director, International Economics Program, Institute for Research on Public Policy, Ottawa, to be published by the Centre for Trade Policy and Law.

## *Discussion Note*

This paper reviews the commercial policies of Canada and Mexico and sets out some options:

- o Is Canada obliged to take part in bilateral talks between Mexico and the U.S.?
- o Should Mexico Accede to the Canada-U.S. Free Trade Agreement?
- o Should the existing Canada-U.S. Free Trade Agreement be renegotiated?
- o Should Canada be prepared to explore a trilateral approach?

Each of these has different implications for the conduct of business in North America. Students can be asked to consider the strategy of such companies as BCE Inc., or Northern Telecom, or Chrysler or a leading Canadian bank, such as the Canadian Imperial Bank of Commerce, and evaluate the various options in terms of Strengths, Weaknesses, Opportunities and Threats (SWOT).



## Introduction

At first glance, it would appear that in the 1980s Mexico and Canada pursued opposite tacks in the conduct of their economic relations with the United States. After decades of pursuing a bilateral approach in its economic relations with the United States, Mexico joined the GATT and is an active participant in the Uruguay Round of GATT negotiations. At the same time, Canada, a founding member of the GATT, has negotiated a bilateral free trade agreement with the United States. It is important to consider how these three countries, and in particular Canada, deal with the Uruguay Round of GATT negotiations and examine the subsequent implications for economic relations among these three economies.

Recent developments in Europe are provoking reactions by governments and firms in North America. Concerned about increasing competition from Eastern Europe for investment dollars Mexico's President Salinas wishes to explore options to expand economic links with the United States and possibly Canada as well.

This paper considers the interactions or tensions between bilateralism and multilateralism, both in general and in particular with respect to the trade and international economic policies of Canada, Mexico and the United States.<sup>1</sup> All three countries face common challenges and have common interests in the multilateral trading system. The main focus will be on the trade and investment policies, but it is useful to take account of macroeconomic factors, which can have significant implications for trade and investment flows.

## The Macroeconomic Dimension

One remarkable similarity about these three North American economies, which otherwise are different in many ways, has recently emerged. As a result of the large U.S. trade and current account deficits of the 1980s, the United States, like Mexico and Canada, has become a substantial international debtor. In fact, all three North American countries

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<sup>1</sup> An overview of these issues is available in William Diebold (ed.), *Bilateralism, Multilateralism and Canada in U.S. Trade Policy*, (Cambridge, Mass: Ballinger, 1988). See in particular W. Diebold's introduction and Gerardo Bueno's chapter.

have enormous amounts of international debt. The United States is, at least according to official data, considered to be the largest external debtor, although, of course, there are questions about exactly how you value the US external position. Clearly, the large international liabilities of the three economies are going to have important implications over the medium term and the longer term for the real exchange rates of these three economies, and for trade flows, both within North America and between North America and the rest of the world.<sup>2</sup>

The sharp appreciation of the U.S. dollar in the mid-1980s, and the substantial U.S. trade deficit that resulted, diverted Canadian trade flows and inhibited the private sector from expanding trade and investment links with offshore economies. However, continuing pressures in financial markets resulting from the changes in national balance sheets will act to reverse the massive global trade imbalances of the 1980s during the 1990s. The realignment of exchange rates (which has sharply reduced the value of the U.S. dollar in terms of the yen and West German mark since 1985) has started the process of reversing global trade imbalances. However, the prospect for further short term improvement in the U.S. trade balance is limited in light of the continuing U.S. budget deficit and the strength of the U.S. dollar in 1989. Yet the continued rapid buildup of U.S. international liabilities and the expanding U.S. deficit on investment income will put downward pressures on the real exchange rate of the U.S. dollar through the 1990s.

The slow and irregular process of macroeconomic adjustment could make it harder to make progress in the Uruguay Round. Protectionism may be waning in the United States, albeit slowly, but the legacy of protectionist attitudes is likely to linger. At the same time, Japan and Europe (both with strong currencies) could become less willing to open their markets to competition from foreign agricultural producers and the manufacturing capabilities in developing countries if they anticipate that their currencies are likely to appreciate against North American currencies in the 1990s.

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<sup>2</sup> See Richard G. Lipsey and Murray G. Smith, Global Imbalances and U.S. Policy Responses, (Washington, D.C. and Toronto: Canadian American Committee, 1987).

Similarly the pattern of Canadian trade is affected by the exchange rate alignment among the major industrial countries. During the 1970s when the U.S. dollar was low, Canada earned all of the trade surplus required to service its substantial international liabilities from offshore trade. During the 1980s with the strong U.S. dollar, Canada obtained all of the necessary trade surplus from trade with the United States and ran a trade deficit with the rest of the world. Of course, other macroeconomic factors were also operating during this period.

There are some parallels between Mexico and Canada in the economic impact of shifts in exchange rates, interest rates and commodity prices over the last two decades. Both countries enjoyed improvements in their terms of trade during the 1970s because of rising energy prices. And with low real interest rates in global capital markets, the costs of large domestic budget and external current account deficits appeared low to Canada and Mexico. The collapse of commodity prices and high real interest rates in the early 1980s resulted in a severe contraction in both economies. In Canada's case economic growth was restored starting in 1983, while Mexico has had a much more painful adjustment process.

Although the process could be irregular, depending upon the budgetary policies which emerge from the continuing struggle between the U.S. administration and the Congress, during the 1990s the United States will be obliged by mounting foreign debt service requirements to continue to make progress in reducing its trade deficit. Thus, collectively Canada, the United States, and Mexico will need to look to offshore markets for growing export opportunities.

#### **Evolution of Commercial Policies**

Through most of the post-war period the United States was outward looking in its trade policies, while Canada was leaning outward or drifting outward. Certainly Canada participated in the GATT along with the United States, but the enthusiasm of Canadian participation in the individual rounds of tariff negotiations was variable. It was not always

as intense as is now so fondly remembered. It is interesting to observe that in 1945-1947 that US tariffs were higher than Canadian tariffs and at the end of the Tokyo Round the reverse was true — Canadian tariffs were higher than US tariffs. Mexico was inward looking for most of the postwar period, and previously as well.

The interesting thing about the 1980s is that each country switched places to some extent. Canada became more outward looking in its trade policies, Mexico started drifting outward, more along the Canadian model, and the United States became more inward looking in the conduct of its trade policy and trade relations. In recent years, Mexico has accelerated its liberalization of trade and investment policies.

The apparent contrast between Canada, which pursued a bilateral option negotiating a Free Trade Agreement with the United States, and Mexico, which shifted to a multilateral approach by joining the GATT, should not be overstated. In fact, since Mexico had a bilateral MFN treaty with the United States, Mexico received many of the benefits of the GATT system. For its part, Canada often negotiated on a bilateral basis with the United States in a GATT context and did negotiate an explicit bilateral agreement, the Canada-U.S. Automotive Agreement (Autopact) in the 1960s.

At the same time that Mexico has become a full participant in the GATT, it has also proposed a sectoral approach to North American trade liberalization. It is worth recalling that Canada proposed a sectoral approach to negotiations with the United States in 1983, which encountered two problems. First, sectoral approaches are incompatible with GATT (the United States got a waiver in 1965 to implement the Canada-U.S. Autopact, but obtaining such a waiver would be difficult today.) Second, the lists of sectors proposed by the two countries did not overlap, which made negotiations difficult. A combination of these two problems limit the prospects for the sectoral approach to bilateral or trilateral negotiations for Mexico as they did for Canada previously.

Pursuing the comprehensive approach permitted under GATT rules faces some obstacles in all three nations. Although Mexico's liberalization of its trade and payments regime has been dramatic and bold, since tariffs remain significant many Mexican industries may oppose a full FTA. Moreover, President Salinas, may discover that FREE TRADE with the United States reawakens nationalist sentiment in Mexico, just as Canadian nationalist sensitivities were stirred in Canada's 1988 Free Trade debate. Indeed, Canadian nationalists likely would view bringing Mexico into the Canada-U.S. FTA as confirming their fears of a slippery slope of continentalism. In the United States, (and also Canada), industries such as textiles and apparel and autoparts that were cautious about the Canada-U.S. Free Trade Agreement will be hostile to a Free Trade Agreement involving Mexico. Thus, U.S. opposition is likely to be more prosaic than nationalist concerns in Mexico or Canada, but could be very tough to dislodge. However, if one were to consider a full-scale common market with unrestricted immigration, then American and Canadian reactions could become more strident.

Current economic trends are toward greater intensification of regional trade and investment. The early stages of unwinding Japan's trade surplus have involved increased imports of manufactured goods from Asian economies. Implementation of the Canada-U.S. Free Trade Agreement and Mexico's significant liberalization of trade and investment policies will expand commerce among the three North American economies. West European economies will benefit from internal liberalization under the 1992 agenda and clearly are well placed to exploit emerging opportunities in Eastern Europe.

#### The Architecture of the Canada-U.S. Free Trade Agreement

Although the Canada U.S. Free Trade agreement is shaped by the many pressures and interests impinging on the world's largest bilateral commercial linkage, it is compatible with the multilateral system. Not only are the two nations implementing a classic free trade area, consistent with Article XXIV of the GATT, but the agreement is interwoven with their respective multilateral trade obligations in the GATT and interlinked with the Uruguay Round negotiations.

The Canada-U.S. Free Trade Agreement provides for the elimination over ten years of all tariffs, not only in the industrial sector but also in food and agricultural products. Thus, the agreement goes further in liberalizing agricultural trade and in avoiding sectoral exclusions than do many other free trade areas that have been reviewed under Article XXIV of the GATT. True, the United States and Canada retain quotas that serve to buttress supply management regimes and price support mechanisms for agricultural products. However, such selective exceptions are permitted under Article XXIV, if the measures conform with GATT Article XI or Article XX. Similarly only limited progress was made in resolving agricultural subsidy issues — both sides will cease export subsidies on bilateral trade — because the real problems in world agricultural trade results from the interaction of European and Japanese with U.S. and Canadian policies and can be only addressed in the Uruguay Round.

It must be stressed that the agreement creates a free trade area, not a customs union. Thus, each country retains separate commercial policies for trade and economic relations with third countries. Maintaining this commercial policy independence while at the same time preventing undesired pass-through trade or deflections of trade and production, requires the negotiation of clear and predictable rules of origin. On a technical level, the rules of origin in the Canada-U.S. Free Trade Agreement are much clearer and involve much less uncertainty than do the rules used by EFTA-EC bilateral agreements. Of course, some of the most difficult issues in balancing conflicting sectoral interests required special rules of origin for textiles, apparel, and automotive trade.

The obligations in the Canada-U.S. Free Trade Agreement regarding technical barriers to trade and government procurement build on the GATT codes negotiated in the Tokyo Round. The procurement and technical barriers provisions of the agreement are not sweeping and revolutionary changes, but they are further steps to liberalize trade and to make more transparent the impediments that remain. The limited scope of the procurement provisions is one area where the Canada-U.S negotiations fell short.



Drafting general rules of competition to deal with subsidies, dumping, and other allegations of unfair trade practices, and rules to liberalize trade in services and investment, were the major challenges in the Canada-U.S. talks. The two models that provide the most relevant basis for comparison are the rules of competition that are contained in the Stockholm Convention, which created the European Free Trade Association, and the Treaty of Rome, which created the European Community. Neither of these models provides a perfectly appropriate analogy for Canada and the United States. Instead, the bilateral talks have produced a hybrid, which shares elements of the EFTA system, the EC system, and includes some unique and distinctive elements, not found in any other free trade area.

Other bilateral free trade areas, such as between Switzerland, Austria or Sweden and the European Community, or the U.S.-Israel Agreement, do not have such formal dispute settlement processes. The principal mechanism for resolving disputes in these other bilateral agreements is a joint committee of the two governments. The Canada-U.S. Trade Commission is a similar type of joint committee, but there are some important and unique innovations in the dispute settlement process in the Canada-U.S. Free Trade Agreement. The general dispute settlement mechanism under Chapter 18 is analogous to the GATT but incorporates some procedural reforms.<sup>3</sup>

The Canada-U.S. Free Trade Agreement also institutes under Chapter 19 an expeditious binding binational appeal process for antidumping and countervailing duty cases and a binational review process governing changes in the trade laws. Furthermore, the potential recourse to judicial review should have a sobering effect on the administrative processes. Thus, the agreement seeks to stop the protectionist drift in each country's trade laws and to buffer the administration of those laws from political influences.

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<sup>3</sup> The dispute settlement mechanisms are examined by G. Horlick, G. Oliver, and Debra Steger and comments by Robert Hudec and Frank Stone in J. Schott and M. Smith in *The Canada-United States Free Trade Agreement: The Global Impact*, (Washington, D.C. and Halifax: Institute for International Economics and Institute for Research on Public Policy, 1988).

In the services and investment areas as well, the Canada-U.S. Free Trade Agreement goes further than the existing EFTA-EC bilateral agreements, but falls well short of the full commitment to national treatment that applies within the European Community. (The EFTA-EC negotiations of European Economic Space can be expected to deal with services and investment issues). Many existing laws and measures that derogate from national treatment are grandfathered on both sides of the Canada-U.S. border.

The cultural and transportation sectors were exempted from the provisions of the agreement regarding services and investment, because of Canadian concerns about the vulnerability of the cultural industries in light of heavy penetration by U.S. media, and because of lobbying pressures from U.S. maritime interests to permit new cargo preference legislation in addition to existing Jones Act and related restrictions. For Canada, the most sensitive national concerns involve issues of cultural sovereignty and identity; while, in the United States, national security goals are the rationale for special consideration.

#### Bilateralism versus Multilateralism

The tension between bilateralism and multilateralism in terms of the evolution of the trade policy can be characterized in terms of two criteria. The first criteria is whether those various trade agreements or negotiations deal with trade disputes and trade conflicts in a way that can be characterized as rules-based or a power-based system.<sup>4</sup> The second question is, apart from that question of management of economic relations, is whether there is genuine liberalization or whether the arrangements reinforce a drift towards managed trade in the world trading system.

The Canada-U.S. Free Trade Agreement contains some significant institutional innovations and does provide a very useful basis for managing economic relations between

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<sup>4</sup> See John H. Jackson, "Governmental Disputes in International Trade Relations: A Proposal in the Context of GATT", *Journal of World Trade Law*, vol. 13, (1979), pp. 1-29.

Canada and the United States.<sup>5</sup> In general, the FTA is much closer to the rule-based system of resolving trade issues and trade disputes than the power-based system. Indeed it is closer in that regard than the GATT at the present time, although hopefully the GATT dispute settlement procedures and institutions will be strengthened in the Uruguay Round.<sup>6</sup> I also think that the Canada-U.S. agreement is very useful in introducing more competition in the North American market between the two countries, and in that sense it is likely to reinforce the multilateral system.

There are two basic questions we have to ask about regional trade arrangements, such as the Canada-U.S. Free Trade Agreement or other free trade arrangements around the world. The first question you have to ask is the question economists have always asked, is the agreement upon its formation, going to lead to trade creation or trade diversion? The second question, which is asked much less often, is, what would be the longer term impact on the trading system in terms of both the management of trade relations and subsequent conduct of those countries in trade negotiations.

There is a dearth of empirical estimates measuring the trade creation or trade diversion effects on Mexico of the Canada-U.S. Free Trade Agreement. However, I presume that if one were to analyze the effects on Mexico with a general equilibrium model — such as the Harris-Cox model —, embodying significant economies of scale than the trade creation effects will dominate the trade diversion effects for Mexico. It is worth noting that third country barriers are not increased in the Canada-U.S. FTA and either country is free to lower their barriers on third country commerce. Of course, to the extent

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<sup>5</sup> A fuller discussion is available in Jeffrey Schott, "The Free Trade Agreement: A US Assessment" and Murray Smith, "The Free Trade Agreement in Context: A Canadian Perspective" in J.Schott and M.Smith(ed.), *The Canada-United States Free Trade Agreement: The Global Impact*, (Wash, D.C. and Halifax: Institute for International Economics and Institute for Research on Public Policy, 1988).

<sup>6</sup> See papers by Leonard Legault, Robert Hudec, Julius Katz, and Debra Steger, in D. Macrae and D. Steger, *Understanding the Free Trade Agreement*, (Halifax: Institute for Research on Public Policy, 1988).

that there are trade diversion effects adversely affecting Canadian economic welfare, it is largely the result of Canada's own import policy.

The much more important question in my view is the dynamic of subsequent trade liberalization. For the purposes of this discussion, I will focus on tariffs. Some Canadian industries may feel that digesting the reductions in tariffs that are resulting from the Canada-U.S. Free Trade Agreement is really a sufficient challenge, both in terms of the competitive opportunities and competitive threats. Those industries might prefer to coast through the Uruguay Round and not really place a high priority on improved access to offshore markets. Yet other industries however, are likely to be concerned about their input costs and will be concerned that they are paying higher Canadian tariffs on their inputs when they are now competing with US firms so, they are likely to lobby for reduction in Canadian tariffs in the context of the Uruguay Round. A third set of industries may feel that the rationalization for the North American marketplace improves their competitiveness and as a result, may in fact attach higher priority to improved access to offshore markets. At least on the Canadian side, there is going to be continued interest in liberalization of trade in the Uruguay Round and negotiating significant improvements in access to offshore markets including obtaining tariff reductions.

#### **Pursuing Common Interests in the Uruguay Round**

Canada, Mexico and the United States have very strong interests in a successful outcome of the Uruguay Round. As debtor economies, they will be obliged to look to offshore markets for growth opportunities in the 1990s. Moreover, strengthening the multilateral GATT system will facilitate harmonious economic relations among the three economies, just as strengthening the GATT will buttress the Canada-U.S. FTA.

One of the most difficult issues in the Uruguay Round is the negotiation of significant reductions in domestic support and trade protection for agriculture.<sup>7</sup> As was

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<sup>7</sup> For a fuller discussion of agricultural trade issues in the Uruguay Round, see W. Miner and D. Hathaway, (eds.) *World Agricultural Trade: Building A Consensus*,

noted above, Canada and the United States could not agree on elimination of third country export subsidies, reduction of domestic farm support, or liberalization of quantitative restrictions on agricultural trade bilaterally, because of concern about the subsidies and trade barriers maintained by the European Community and Japan. Thus, the Uruguay Round of multilateral negotiations appears to be the only possible vehicle for liberalization of trade in this sector.

Mexico has had some experience with U.S. antidumping and countervailing duty laws in the 1980s. As a result, Mexico may support Canada in efforts to revise GATT rules for antidumping and countervailing duties in the Uruguay Round. This interest is likely to be shared by some of the Asia-Pacific economies who have experienced particular difficulties with EC antidumping procedures. Certainly Mexico should share some of Canada's concerns about various attempts in the United States to redefine resource management policies and practices as countervailable subsidies.

Turning to the offshore challenges, some have expressed concern about fortress Europe. Yet, the 1992 agenda items that may have adverse impacts on third countries are concentrated in agriculture, technical barriers, safeguards and antidumping duties, public procurement practices and rules for services. Those are areas where the existing GATT rules are either inadequate, incomplete or non-existent. Thus, the outcome of the Uruguay Round could be very significant in dealing with potential external consequences of Europe's 1992 agenda as well as the emerging links between Western and Eastern Europe.

The consequences for third countries of the efforts of the European Community to complete its internal market by 1992 are uncertain and it remains to be seen how that process will interact with the Uruguay Round. There may be much about those EC internal mechanisms and liberalization proposals that are genuinely trade creating, but given the past behaviour of the European Community, one has some grounds for concern that they

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(Washington, D.C. and Halifax: Institute for International Economics and Institute for Research on Public Policy, 1988).

will not structure those arrangements in such a way as to link them closely with what happens in the multilateral system, or to make the internal European Community market more open to the rest of the world. Again, this is a case for urgency, since early progress in the Uruguay Round before the EC completes its internal process, would be highly desirable. Stronger multilateral rules increase the likelihood that it will be possible to structure the EC internal arrangements so that they are more open to the rest of the world.

Although trade and investment links are expanding among the Western Pacific economies, there is no reason to fear the emergence of a Japan-centered trade bloc. The United States and Canada are full participants in the new Asia-Pacific Economic Cooperation (APEC) process and they might encourage Mexican participation in the APEC process. In any event, APEC nations have stressed the high priority they attach to achieving substantial progress in the Uruguay Round and their overall goal of strengthening the multilateral system.

When Canada and the United States entered into the Free Trade Agreement, both countries expressed their intention to negotiate the fullest possible liberalization of trade in the Uruguay Round. Although cries of fortress Europe may be exaggerated, the implications for trade with, and investment by, third countries of the Europe 1992 agenda remain uncertain. The real test of whether a regional trading arrangement is trade expanding is if the members are prepared to engage in reciprocal multilateral reduction of trade barriers.

It must be acknowledged that we face some very deep existential problems of the in the multilateral trading system. On the one hand, developing countries have been deeply attached to their rights to special and differential treatment and they want credit for some of their "unilateral" trade liberalization steps implemented under the IMF/World Bank programs. Granting advance credit for these liberalization measures makes sense but only if they would prepare not only to bind their specific tariff policies and their rights under Article XVIII of the GATT, where they are permitted to impose quotas and other



restrictive arrangements for balance of payments or development purposes.<sup>8</sup> Unfortunately, it is going to be very difficult to engage the developing countries in a constructive dialogue in the system, in terms of taking a slightly different stance on these traditional issues of special and differential treatment. However, if a few of the major developing countries such as Mexico, Korea, Thailand and one or two others were to take some significant steps in that regard, that would have a major impact on the whole dynamic of the Uruguay Round and the development of the trading system.

The other problem, on the other side of the equation, is that the major players, particularly the United States and the European Community, are interested primarily in high technology and services issues, which are not issues that have much appeal to the developing countries to say the least. And, the major industrial countries are not predisposed to significant liberalization in sectors such as textiles and apparel. The asymmetries of interest between industrial and developing economies put us in a difficult situation. We need significant liberalization in the Uruguay Round if we are going to make real progress in strengthening the multilateral system. Perhaps the best parallel that is sometimes used in the context of the Canada-U.S. negotiations is that the only deal that is feasible is a big deal. Put it this way, you either have a big deal that deals with a lot of the issues permitting cross-issue and cross-sectoral trade-offs, or you unravel down to a very small deal. Michael Aho has termed this package paradox, and it may well be the most credible basis for achieving a broad-based liberalization of trade and a strengthening of the system in the Uruguay Round.<sup>9</sup>

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<sup>8</sup> See Robert Hudec, *Developing Countries in the GATT Legal System*, (London: Gower for the Trade Policy Research Centre, 1987).

<sup>9</sup> See C. Michael Aho and Jonathan Aronson, *Trade Talks: America Better Listen*, (New York: Council on Foreign Relations, 1985), pp. 133-164, and Gary Hufbauer and Jeff Schott, *Trading For Growth: The Next Round of Trade Negotiations*, (Washington, D.C.: Institute for International Economics, 1985), pp. 82-85.

Will Canada's proposal for a strengthened dispute settlement mechanism for the GATT and the development of an institutional framework which could evolve into a World Trade Organization deflect attention from the real issues in the Uruguay Round?

To the contrary, progress on strengthening the trading system is inextricably linked to achieving significant trade liberalization. Agreements on services and intellectual property issues are vital to obtaining support for the Uruguay Round package in the United States and Europe. Second, other countries wish to constrain unilateral trade retaliation by the United States. The United States will not accept limits on unilateral retaliation without agreements on these new issues, yet other smaller nations will be unwilling to participate without restraints on unilateral actions. The negotiation of effective trade rules and trade liberalization requires a strengthened institutional framework and dispute settlement process.

Smaller countries are playing a much more vigorous and effective role in the Uruguay Round. Canada is playing its traditional role as a middle power in the GATT, and now that Mexico has become an effective participant in the GATT, there is greater scope for common strategies to overcome some of the obstacles that confront us in the Uruguay Round. For that matter, all three North American countries have a significant interest in trade liberalization and strengthening of the GATT system in the Uruguay Round. The trading system right now is very fluid and fragile, but this presents some creative opportunities. Certainly, there is more ferment about the institutions and the inter-relationship among the Bretton Woods institutions than there has been since the beginning of the Cold War. There must be both significant liberalization of trade in the Uruguay Round and a further strengthening of the trading system.

### Exploring North American Options

Either of the North American options for Mexico of a bilateral free trade area agreement with the United States, or a trilateral arrangement involving some form of Mexican accession to the Canada-U.S. Free Trade Agreement, raises political, economic and technical issues for Canada.

Is Canada obliged to participate in Mexico-U.S. bilateral negotiations?

The answer to the question of whether there are constraints on the commercial policies of either of the partners in the Canada-U.S. Free Trade Agreement for their relations with third countries seems obvious. It is of the essence of a Free Trade Agreement that either partner is at liberty to lower its trade barriers against third countries either through multilateral negotiations through the GATT or through plurilateral or bilateral trade arrangements such as free trade areas.

Some in Canada argue that the United States could complain under the "nullification and impairment" provisions of the dispute settlement mechanism in the Canada-U.S. agreement if Canada lowered its trade barriers against third countries. This argument makes a mockery of the concept of nullification and impairment as it is developed in the GATT jurisprudence and it is one that we reject for the purposes of this paper. Neither country has a formal property right in the preferences which are incidentally created by the removal of bilateral trade barriers by the Canada-U.S. Free Trade Agreement. Each country simply has claims on maintaining the degree of access to the other market achieved through the Free Trade Agreement. It is evident that Canada and the United States are each pursuing their own objectives and negotiating approaches in the Uruguay Round of multilateral negotiations.

Nonetheless, exporting interests in the partner country are likely to be disappointed if the other country concludes an FTA with a country that eliminates all trade preferences. It must be remembered, however, that the partner country would have been disadvantaged to an even greater extent by the other country entering into an FTA with a third country,

if there were no Canada-U.S. Free Trade Agreement. Thus, it may be in Canada's interest to participate in trilateral negotiations, but there is no obligation to do so. The question that must be considered first is, What are the implications of various bilateral or trilateral options?

#### Should Mexico accede to the Canada-U.S. Free Trade Agreement?

Including other countries in the Agreement poses a number of more or less technical problems, concerning such things as the phase out period for third-country tariffs, and the rules of origin for the wider FTA. It also raises a number of questions concerning those aspects of the Agreement which were designed to respond to bilateral concerns. These are considered in the following paragraphs.

**Energy:** The provisions of the Agreement's energy chapter are controversial on both sides of the border. Canadians worry about the prohibition of export taxes (which is customary in FTAs) and about the specific allocation rules governing supply cut-backs and rationing in time of government-declared shortages. Concern on the U.S. side relates to the exemption of the energy sector from the provisions liberalising investment and the lack of untrammelled access to Canadian energy resource development. The careful balancing of conflicting concerns over energy that characterises the Canada-U.S. Agreement may or may not be appropriate for a trilateral trade agreement including Mexico.

**Auto trade:** The automotive provisions of the Agreement give some preferential treatment to Canadian and U.S. auto manufacturers over foreign-owned firms located in the U.S. and Canada by grandfathering existing autopact provisions (there are a few foreign firms whose existing preferential treatment is also grandfathered). The provisions also give protection to Canadian and U.S. parts producers by increasing the restrictiveness of the rules of origin. Extending these provisions to the automobile industries operating in Mexico will raise complicated questions for the North American and foreign-based firms. In particular if the

result is more restrictive rules of origin for third country manufacturers then this would raise serious issues.

**Institutional Arrangements:** All of the dispute settlement mechanisms in the Agreement are formal with carefully delineated time limits and with a preselected roster of panellists to adjudicate the process. The general dispute settlement mechanism could be generalized to include third countries fairly readily and trilateralization might serve to depoliticize some issues.

It appears more difficult to generalize the review mechanisms governing the trade laws under Chapter 19. Although there are technical differences, Canadian and U.S trade laws are remarkably similar. It would be more difficult to apply the Agreement's review mechanism for decisions involving anti-dumping and countervailing duties to third countries whose domestic trade laws and administrative procedures differed substantially from those of the United States and Canada. It may be difficult to involve Mexico in this type of judicial review.

The Agreement's trade law review mechanism is in any case intended as an interim arrangement pending the outcome of negotiations on a new set of rules with respect to such trade remedy laws. Introduction of a third country into this negotiation process could make reaching an agreement on the thorny issues that are involved even more difficult than it already will be. No one knows the outcome of the negotiations, but it will undoubtedly reflect a careful balancing act of different national sensibilities. Furthermore, it would seem unlikely that Mexico — with different sensibilities of its own and invoking different sensibilities on the part of Canadians and Americans — could easily be accommodated into the completed agreement for a new code covering unfair trade practices.

**Services:** Extension of the principle of national treatment and right of establishment to service industries in acceding countries should pose no serious problems. Indeed, either country can extend these provisions to third countries at its own discretion now, but the

partner country is not obliged to extend such treatment. Furthermore, Canada would receive the benefits if the United States removed restrictions on services trade with third countries because of the commitment to national treatment.

At the same time, since the Canada-U.S. agreement grandfathers existing derogations from both national treatment and the right of establishment, reciprocity considerations may influence the attitudes of both countries to extension of the services provisions. It would probably be necessary to negotiate with Mexico the specific coverage of the services arrangements and some rollback of restrictions on establishment by third countries to achieve more symmetry in the barriers to services trade (and related investment issues) with the situation prevailing between the United States and Canada today.

Should the existing Canada-U.S. Free Trade Agreement be Renegotiated if one partner enters into an FTA with a third country?

Assume that the United States and Mexico negotiate a bilateral free trade agreement. This could occur because Canada was not interested in a trilateral FTA with that country (or was not invited to join the negotiations). Problems could arise if the Mexico was given more favourable treatment by the United States than Canada receives under its agreement with the U.S. This could not be an issue with tariffs, because no country can gain more than the complete elimination of tariffs that the Canada-U.S. Agreement provides. On certain non-tariff measures, however, there are potential problems whenever there are derogations from national treatment. For example, Mexico might get access to a share of the U.S. procurement market that is larger than the small share that Canada obtains under its FTA with the United States.

There are at least two issues, that would require a reopening of the Canada-U.S. Agreement. First, a general case can be made that the rules of origin for duty free treatment within a FTA should be made more liberal as the external tariffs of the parties are reduced either on an MFN basis or through negotiations of further regional FTAs. The

purpose of rules of origin is to prevent deflections of trade and protection that can arise due to disparities in the external trade barriers of the FTA partners. For example, the United States textile and apparel industries were concerned that the Canadian apparel industry would expand exports to the United States utilizing low cost textiles from third countries and circumvent United States barriers to textile imports. To meet the United States industry concerns, the Canada-U.S. FTA provides for elimination of apparel tariffs for apparel produced from textiles manufactured in either country as well as a quota for apparel produced using third country textiles. If however, the United States concludes an FTA with Mexico introducing a low cost supplier into the U.S. market, then the restrictive rules of origin for textiles and apparel in the Canada-U.S. Agreement should be liberalized to allow more Canadian sourcing of textiles from third countries.

Second, the new bilateral FTA agreement might allow for a faster phased reduction of tariffs than the ten year period (with exceptions for faster reductions) under the Canada-U.S. Agreement. The temporary distortions of competitive positions that would be implied by the different phase-in periods could be removed by renegotiating the Canada-U.S. phase-ins.

#### Should Canada be prepared to explore a trilateral approach?

Although, as the above discussion suggests, the process of negotiating third country accession would be difficult for all parties, such an accession would have several virtues, when compared with possible separate bilateral agreements. First, accession to the Agreement would ensure the two present contracting parties more balanced treatment with respect to the new partner. Second, resolving some of the technical issues associated with accession, such as phasing of reductions in trade barriers and rules of origin among the three countries would provide more stable and orderly framework for private sector planning and investment decisions than if there were separate bilateral agreements. Third, compared with a situation in which the U.S. made a separate agreement with a third



country, accession to the Agreement would avoid the problem of Canada finding itself less favoured in the US market than Mexico.

#### **Conclusion**

As debtor economies, Canada, the United States, and Mexico face common challenges in expanding their exports of goods and services to offshore markets in the 1990s. The liberalization of trade and investment that has occurred on a bilateral basis under the Canada-U.S. Free Trade Agreement and through Mexico's liberalization will stimulate the expansion of trade and investment links among the three North American economies. All three economies have a strong interest in promoting a broad-based liberalization of trade in the Uruguay Round that will deepen the liberalization of commerce among the North American economies and provide enhanced and more stable access to offshore markets.

Although achieving a successful outcome in the Uruguay Round should be the immediate priority for all three countries, a willingness to explore North American free trade areas could help stimulate multilateral progress. It is clear, however, that whether or not Canada wishes to participate in trilateral negotiations with Mexico, the Mexican initiative will raise interesting questions for the future evolution of the Canada-U.S. Free Trade Agreement, particularly with respect to the prospective negotiations of rules governing subsidies and anti-dumping and countervailing duties.

**TABLE 1: CANADIAN EXPORTS TO MEXICO**  
(1989)

	Amount (\$million)	Percentage of Total Exports (%)
Vehicles, parts and accessories	71	11.8
Iron and Steel	71	11.8
Oil seed	60	9.9
Dairy products	46	7.6
Sulphur and asbestos	41	6.8
Others	314	52.1
<b>Total</b>	<b>603</b>	<b>100.0</b>

Source: Statistics Canada, Catalogue 65003.

TABLE 2:

## CANADIAN IMPORTS FROM MEXICO

(1989)

	Amount (\$million)	Percentage of Total Imports (%)
Machinery and Mechanical Appliances	466	27.4
Electrical Machinery	335	19.7
Vehicles, parts and accessories	299	17.6
Precious Stones and Metals	199	11.7
Mineral Fuels	49	2.9
Others	350	20.7
<b>Total</b>	<b>1,698</b>	<b>100.0</b>

Source: Statistics Canada, Catalogue 65006.

TABLE 3:

CANADIAN EXPORTS  
1989

	Amount (\$million)	Percentage of Total (%)
<b>Total</b>	<b>138,934</b>	<b>100.0</b>
United States	103,732	74.7
EC countries	11,466	8.2
Japan	8,472	6.1
Other OECD countries	11,857	8.5
South Korea	1,592	1.1
China	1,120	0.8
Hong Kong	1,049	0.7
Taiwan	882	0.6
USSR	685	0.5
Mexico	602	0.4

Sources: Bank of Canada Review, May 1990  
 Statistics Canada, Exports by Country, January-December 1989, Catalogue  
 65003

TABLE 4:

CANADIAN IMPORTS  
1989

	Amount (\$million)	Percentage of Total (%)
Total	134,255	100.0
United States	93,322	69.5
EC countries	14,485	10.8
Japan	8,262	6.1
Other OECD countries	4,030	3.0
South Korea	2,441	1.8
Taiwan	2,351	1.7
Mexico	1,698	1.3
China	1,182	0.9
Hong Kong	1,161	0.9
Brazil	1,130	0.8

Sources: Bank of Canada Review, May 1990  
Statistics Canada, Imports by Country, January-December 1989, Catalogue  
65006

## *Contexts and Impacts of a Mexico-Canada-US FTA*

This selection reprints with permission Annex 1 and Annex 2 of *A Mexico-Canada-United States Free Trade Agreement: The Strategic Implications for Canada*, by Michael Hart, Director, Centre for Trade Policy and Law, Carleton University and University of Ottawa (forthcoming).

### *Discussion Note*

Michael Hart was a principal Canadian drafter of the Canada-U.S. Free Trade Agreement and is one of that country's most experienced trade negotiators. The first of these annexes to a wider paper focuses on the shortcomings in U.S. and international trade rules that Mexico hopes to overcome with an agreement with the U.S.

Of particular interest to U.S. students will be Mr. Hart's controversial view of U.S. trade policy "Evolution of U.S. Trade Policy - The Riderless Horse." This charts the opening and closing of the post-war liberal window on trade and the emergence of a U.S. strategy that promotes regional blocs as a viable second best to an increasingly unsatisfactory GATT.

The second annex provides a valuable analysis of the Canada-U.S. FTA and the impact of an opening to Mexico. This is virtually a clause by clause analysis and will be of particular interest to those wishing to advise companies and businesses as developments unfold.

## Annex 1 The Context of a Mexico-Canada-US Free Trade Agreement

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Mexican interest in negotiating a free-trade agreement with the United States or in acceding to the Canada-US FTA has not arisen in a vacuum. It reflects a pragmatic response by Mexico to profound changes in the multilateral trading system, the place of the United States in it and Mexico's perception of how it can best pursue a strategy to integrate its economy into the global economy. This annex reviews the nature of some of these developments and their implications for Mexico and for the question of Mexican accession to the FTA. The same considerations, of course, were fundamental to Canada's decision to negotiate its FTA with the United States.

### The Changing Multilateral Trading Order

For forty years, the General Agreement on Tariffs and Trade (GATT) has served as the main vehicle for promoting order in world trade. Its ability to continue in this capacity, however, has become less clear over the years. The GATT process has become increasingly slow and considerably more complex. The GATT is in urgent need of reform. Not only are the rules that deal with trade in goods beginning to show their age, but there are virtually no rules to deal with trade in services, with trade-related investment measures and with intellectual property protection. In short, the GATT rules dealing with the industries of the past are proving inadequate, and the rules for the industries of the future are non-existent. The rules dealing with trade in agriculture have always been inadequate.

British economist Martin Wolf has characterized trade as an economic war and the GATT as a peace treaty among mercantilist states. It is an apt metaphor. While the mercantilist states have agreed to peace, they have not fully disarmed nor are they averse to the odd skirmish. They have, for example, kept tariffs in place that serve no useful economic purpose except as payment for future trade concessions. They have imposed new barriers in order to increase their bar-

gaining leverage or to force concessions from weaker states. And they have appeased protectionist pressures, so we are told, in order to safeguard the system and provide scope for future improvement.

Enthusiasm for the idea of commercial disarmament was at its highest in the immediate post-war years when the survivors of fifteen years of depression and war agreed that there had to be a better way. That enthusiasm led to the Bretton Woods institutions (the International Monetary Fund and the World Bank) to promote international financial cooperation but was already waning when these same post-war leaders established the International Trade Organization (ITO) whose rump, the GATT, remains as the only part actually implemented. Enthusiasm for commercial disarmament has continued to decline ever since.

Over the years, the system has become increasingly complex in order to compensate for the failure of the more ambitious ITO to come into being, to address new problems and, most importantly, to take account of the continuing decline in enthusiasm for commercial disarmament and the principles embodied in the original peace treaty. The 35 original articles of the GATT have become encrusted with a range of ancillary or supporting arrangements, including codes, protocols, understandings, derogations, regional agreements and ad hoc institutional arrangements. Few of these have been universally accepted or applied. Many qualified and changed the original bargain and undermined progress toward the fundamental GATT objectives of freer and less discriminatory trade. Additionally, GATT has become a multi-layered instrument with various members accepting different degrees of rights and obligations. GATT legal scholar John Jackson warns that GATT law, because of its studied ambiguity, backed up by an inadequate constitutional structure and flawed dispute settlement provisions, tends to be very slippery and can be bent and abused with relative impunity by its more powerful members.

Despite these difficulties, GATT can lay claim to many achievements. Trade has been liberalized; tariffs have been cut; old-fashioned discriminatory quantitative restrictions have been virtually eliminated; and many potentially harmful practices have been restrained by its rules. At the same time, GATT has been unable to curb the crisis in agricultural trade, to come to grips with the new protectionism, or to address new and urgent problems arising out of the globalization of business. In many ways, therefore, the arguments about whether the GATT has been beneficial are about whether the glass is half full or half empty. The challenge is to come to grips with the realities of the new trade relations system and with the demands of a rapidly globalizing economy.

The heart of the modern trade relations system is no longer the tariff and related customs administration but administered protection through such devices as antidumping and antisubsidy duties, safeguard measures and domestic policies such as supply management and subsidies. The main focus of international business is less trade in goods and more international capital transactions and trade in industrial property. Thus two gaps have emerged: between the rules of the government-to-government trade relations system and the domestic regimes of member countries and between the GATT-based trading order and the reality of international business.

For the business sector, the frustration lies in the growing gap between business reality and the trading system. In Mexico, Canada and the United States, developments in the Uruguay Round of trade negotiations seem hardly to be visible on business radar screens. Whereas the Canada-US negotiations were regarded with intense and immediate concern, the Uruguay Round appears to most Canadian, American and Mexican business leaders to be a remote and stylized event only barely touching their vital interests. What will be decided over the next six months in Geneva and major capitals may be critical to the future evolution of the world trading system but appears remote to those making decisions in the boardrooms of private corporations.

For the private sector, it is less a question of rules than the proliferation of barriers old and new that stand in the way of rational economic decisions. Business craves stability and predictability and if the old trading order will not provide these virtues, they will be found in other ways. Those ways increasingly marginalize the old trading order. They are being found in inter-corporate networking - in the negotiation of licensing and distribution agreements, in research consortia and technical joint ventures, in cross investments and joint production agreements. In a recent article in the *Wall Street Journal*, Kenichi Ohmae, managing director of McKinsey and Company in Japan, writes;

... the most fundamental truth of today's economic world is this: Man's ability to create and consume will not be denied by those politicians and bureaucrats who try to restrict the flows of capital, technology and information. This is a lesson not only for Eastern European communists but also for Japanese and American nationalists. (April 27, 1990)

One of the basic premises of the old trading order is that goods and services have a nationality. That is increasingly not the case, particularly for the products of global corporations. Modern cars and airplanes, to take but two examples, incorporate parts sourced all over the world, involve design and engineering work by nationals of many countries, are assembled in plants on every continent, are financed by capital from a wide range of sources, and are marketed on a global basis. The Ford Probe is manufactured by Mazda and the Dodge Colt by Mitsubishi. These are neither North American nor Japanese products but global products and the companies that market them have found ingenious means of hedging against the uncertainties caused by the nationalist and mercantilist preoccupations of governments. While one group of specialists in these corporations seeks to find advantage in various national regulatory schemes, others seek to ensure there are ways to neutralize them. Their apparent success should humble any politician or trade negotiator who thinks that their efforts are critical to future business decisions.



Business people have long concluded that doing business in a smaller economy such as Canada or Mexico is a gamble and that the prudent course is to hedge one's bets by expanding in the larger market and serving the smaller market from there. Thus for Canada and Mexico, the challenge is finding a policy framework that will make investment in Canada or Mexico more attractive and less of a gamble.

Efforts to modernize the GATT system to reflect the changing trade relations system, to take account of changing global business practices and to rekindle interest in liberalization have met strong resistance. The 1982 ministerial meeting failed to reach consensus on any substantive issue. The Uruguay Round was finally launched in 1986 not because there was enthusiasm about the agenda and approach but because there was agreement that a new round would stand as a symbol of continued commitment to multilateral trade. The intervening four years have been used to develop consensus on the agenda and the negotiating parameters. Progress has been slow because the major players have approached the negotiations less as a means to advance trade liberalization and international rule-making and more as a management tool to dampen domestic protectionist pressures and reduce bilateral trade frictions.

The United States has traditionally provided leadership in maintaining momentum toward liberalization. Today, the United States substitutes rhetoric for leadership. Much of this rhetoric has a strong moral overtone, expressing anxiety about "fairness", "level playing fields" and the need for "disciplines". The US approaches international negotiations with an agenda built up from individual irritants and brings no comprehensive vision or substantive leadership to the table. It has yet to come to grips with the challenge to its economic leadership from Europe and Japan and with the profound changes that have taken place in the trade relations system. Until American officials adjust to these new realities, the United States will continue to have difficulty galvanizing other GATT members into forward-looking commitments that tackle the trade policy problems of today and tomorrow rather than those of yesterday.

The European Community continues to be preoccupied with consolidating its own market. Since the Dillon Round (1961-62) confirmed the legitimacy of the Community, it has approached multilateral negotiations defensively, ensuring that they in no way erode movement toward a unified European market supported by economic satellites in Europe, Africa and the Caribbean. Its Common Agricultural Policy (CAP) and Common External Tariff (CET), as essential building blocks holding the Community together, are jealously guarded against inroads from multilateral negotiations. It has bound the economies of its former colonies to that of Europe in a trade and aid agreement (the Lomé Convention) that stands outside GATT. It has entered into free-trade agreements with its Western European trading partners and used accession agreements to deny full GATT status to its Eastern European trading partners, a decision that is now being rectified. GATT has become a marginal agreement which provides international legal cover for its network of special arrangements and a framework for conducting trade relations with the United States, Canada and Japan. The EC has adopted the US-inspired trade remedy system but without the saving grace of US attachment to transparency and due process, in effect running a Star Chamber trade law system wholly at odds with the principles of non-discrimination. Today its primary energy is directed toward the magic date of 1992 when all of Western Europe is to function as one integrated market. There are worrisome signs that many Europeans view the post-1992 integrated market as reserved for Europeans and that the Community may adopt policies to change this fear into reality. The rapidly evolving situation in Eastern Europe is sapping remaining European energy, as European governments and businesses find ways to integrate the markets and productive capacities of these countries into the European system. European participation in the Uruguay Round reflects this defensive approach to GATT bargaining. Whatever creative juices exist in Europe, there is no sign that they are being used to strengthen the multilateral system.

Japan continues to prefer bilateral accommodation to genuine international rule-making and liberalization. It has never come to terms with

the essential nature of multilateralism. Its products enjoy phenomenal success on world markets while foreign exporters continue to find its market impenetrable for all but essential imports or except pursuant to bilateral arrangements. While nominally following GATT principles, Japan uses the ingenious device of administrative guidance to deny in reality what it may accept formally. Its competition laws condone oligopolistic practices and reinforce the protectionist mindset of government officials. Its goal in multilateral bargaining is to ensure that the United States and the EC do not adopt policies harmful to Japanese interests. In short, its approach is wholly dictated by export considerations. Domestic issues raised by its trading partners are, wherever possible, pursued bilaterally and dealt with in bilateral agreements that avoid most-favoured-nation or general non-discriminatory commitments.

All three of the major players have shown a continued willingness to resolve their bilateral problems outside the parameters of the GATT. The United States resolved its problem with Japan over the production of semi-conductors without reference to GATT. Their Structural Impediments negotiations took place parallel to the Uruguay Round. Conflict between the United States and the European Community over trade in beef and other farm products, including threats of retaliation and counter-retaliation, was pursued largely outside the GATT. Thus both in attitude and through unilateral action and cooperative measures, the major players have undermined faith in the GATT system.

None of these problems, even if they may be somewhat overdrawn and simplistic, augur well for solid progress in the Uruguay Round. The old order has broken down; progress toward a new order appears to be tentative and unsure. Against this background of a faltering multilateral trading order, it is easy to understand why Canada and Mexico, dependent on the United States for some 70 percent of their trade, are examining how to redefine their relationship with their giant neighbour. That examination began with a searching look at the evolution of American policies and practices and their implications for bilateral and regional trade.

#### Evolution of US Trade Policy – The Riderless Horse

In the immediate post-war years, American officials took pride in the assertion that the United States was the most open market in the world. One administration after another took steps to make the world trading system increasingly more open. The rhetoric has remained, even though the reality has changed. The United States has returned to its historic protectionist stance, but with the added dimension of a cacophony of voices calling for a variety of incompatible approaches to the problems of US and world trade.

Protectionism has deep and enduring roots in the United States. From the Continental Congress to the Smoot-Hawley tariff of 1930, US legislators have shielded US producers from world competition. The costs of this protectionism were easily borne by an expanding continental economy. For a brief period, from the *Reciprocal Trade Agreements Act* of 1934 until the Nixon economic measures of 1971 (ushering in a surtax and devaluing the US dollar), the US adopted a liberal, outward-looking trade policy to advance its broad, world-wide economic and political interests. The combined effect of the excesses of the depression and of US economic and political hegemony had convinced a skeptical Congress to accept this direction. Congress, less out of conviction favouring multilateral freer trade and more in an effort to shield itself from the pleading of special interests, was prepared to adopt four complementary techniques that allowed the administration to chart a new direction for US trade policy:

- delegation of first its tariff and later of its non-tariff negotiating authority to the President, giving the administration the capacity to negotiate reciprocal tariff-reducing and rule-making agreements;
- development of a quasi-judicial trade remedy system that allowed US industries to seek relief from injurious imports through administrative tribunals rather than as a result of industry-specific legislation;
- occasional special deals for politically potent sectors such as agriculture, textiles and clothing and steel that stood outside the interna-

tional and national rules but allowed those rules to continue to operate for the rest of the economy; and

- creation of a special office in the White House, the special trade representative (now United States Trade Representative) to act as a broker among competing interests at arms' length from the Congress and armed with the political clout of the presidency.

These four techniques allowed the congressional leadership to acquiesce in relatively liberal trade policies without having to accept political responsibility for them. It also allowed the administration to pursue complementary trade and foreign policies. The whole system was run by technocrats and effectively removed trade policy from the agenda of high policy.

But by the 1970s the conditions that had allowed a liberal trade policy had lost force and relevance and US trade policy began to revert to its fundamental protectionist habits. Flagship sectors such as autos, consumer electronics, textiles and steel wilted before significant import penetration. Burgeoning trade deficits and the re-emergence of Europe and Japan as major industrial powers deprived the United States of unquestioned trade and economic dominance and revived the mercantilist proposition that imports constitute strategic weakness and exports represent strength. The traditional private sector supporters of a liberal trade policy, such as export-oriented resource and grains producers and competitive capital-intensive manufacturers, found their ability to compete both at home and abroad less sure than a generation earlier. There were now many more competitors; the subsidy practices of the Europeans and developing countries undercut US producers; and, in the early 1980s, the high value of the dollar further undermined their position on world markets.

The decline in support for a liberal trade policy was paralleled by the steadily growing exposure of the US economy to world trade. In 1950, exports constituted only six percent of US GNP. By the 1980s, that figure had risen to twenty percent. At the same time, the US began to experience an almost continuous deficit in its merchandise trade surplus; since 1970, the US has run a merchandise

trade deficit in every year but two. Throughout the Reagan years, the United States ran not only a merchandise trade deficit but also a current account deficit as rising imports of consumer goods far outstripped service receipts and, by the middle of the decade, a devalued US dollar fuelled by US budgetary deficits began to suck in foreign capital.

Congress thus found an increasing number of dissatisfied industrial groups on its doorstep, complaining that the administration was insensitive to their concerns and the trade remedy laws inadequate to their needs. In response, Congress began steadily to reassert its constitutional authority over US trade policy. Rather than reverting to the ancient technique of tariffs and quotas, Congress now used four new techniques to goad the administration into a more accommodating (i.e., less liberal) approach to trade policy:

- omnibus legislation facilitating access by private interests to US trade remedy law. The *Trade Expansion Act* of 1962, setting out authority for the Kennedy Round, was the last act under the old regime. The *Trade Act* of 1974 ushered in the new regime, with Congress trading authority for the Tokyo Round for revisions in trade remedy legislation. Subsequent acts further revised the laws to broaden their scope and coverage and reduce administrative discretion so that US industries would be more likely to qualify for import relief. The 1988 *Trade and Competitiveness Act* represented the latest unilateral redefinition of existing trade rules, although the final version did not include some of the more egregious efforts of earlier drafts to rewrite US international trade obligations.
- product-specific legislation imposing new barriers to imports. From the *Agriculture Adjustment Act* of 1933 through the *Trade and Competitiveness Act* of 1988, Congress has been prepared to legislate protection for favoured sectors, even where such protection has run counter to US international obligations. In the mid-1950s, the US needed a waiver from its GATT obligations to accommodate agricultural protectionism and has steadily sought new derogations from international rules to satisfy the political clout of the textile indus-

try. More recently, Congress has pressured the administration into pursuing voluntary export restraints on shoes, automobiles, steel and semi-conductors, suggesting that without such GATT-illegal measures, worse restrictions on imports would be legislated.

- more aggressive use of existing legislation and administrative discretion. The introduction of section 301 in the *Trade Act* of 1974 gave US producers a potent weapon for forcing the administration to pursue their complaints; that provision was strengthened in 1988. One of the favourite techniques is the voluntary import obligation which, for example, has forced Japan to open its semi-conductor, tobacco and leather markets to American producers on a bilateral rather than on an MFN basis. Since 1980, the number of countervailing, antidumping, unfair trade (section 337) and safeguard cases has steadily mounted, now averaging over 200 a year, as the administration, under congressional pressure, has methodically lowered its standard for acceptance of petitions. The scope of cases has been resolutely expanded to cover insignificant volumes of trade with devastating psychological effect – if small amounts of trade can be caught in the web, what could happen to significant trade volumes?
- steadily increased the ambit and depth of Buy America procurement preferences by adding riders to defence appropriations and federal funding programs, thus effectively shielding a huge volume of US production from foreign competition.

The favourite justification for these departures from the letter and spirit of GATT used by US policy-makers is two-fold and interrelated: the first is the deeply held conviction that the US market is the most open in the world and only the US plays by the rules – other countries openly flout the rules and are taking advantage of US generosity. Thus any US departures are but minor imperfections in a world of much greater sinners. The second argument is that “small” doses of protectionism are required to satisfy the real protectionists and prevent much worse – the unfair trade laws and the escape clauses are thus portrayed as a kind of inoculation against a full-scale outbreak of protectionism.

As the United States enters the 1990s, three forces contend for the direction of American trade policy. One represents the traditional multilateral orthodoxy which fuelled US leadership in the erection and maintenance of the multilateral trading system and drives the US position in the Uruguay Round. The second is a resurgence of unilateralism and protectionism in US trade policy, disdainful and distrustful of the multilateral trading system. The third contender favours the negotiation of regional or bilateral agreements with selected countries notably Canada, Mexico and those of the Pacific Rim, either on their own merits or as a complement to the Uruguay Round of multilateral trade negotiations.

It is, of course, possible for a superpower like the United States to ride off in several directions at once for a considerable period of time. Consistency is a virtue much honoured in the breach in the practice of trade policy by both great and small powers. Indeed, both current US trade policy and the debate about its direction in the Administration, the Congress and the US business community blur the distinctions.

Nevertheless, the multilateralists are trading in debased coin; the geopolitical impulses that, until recently, successfully subordinated trade policy to US foreign policy have little force left. The unilateralists, while paying lip service to the multilateral ideal, appeal to deeply-embedded US mercantilism and strike an emotionally powerful chord in the American psyche. For their part, the regionalists and bilateralists are struggling to find a patch of secure ground by marrying the liberal virtues of the traditional multilateral approach to a recognition that the future may lie in tailor-made trade agreements with particular countries and regions.

There is a scent of change in the air, a change as significant as that which led the United States in the 1930s to embrace a multilateral, liberal trade policy to replace 150 years of protectionism. Canada sensed that change in the mid-1980s and used it to forge an agreement that responded to its own frustration with the changing multilateral trading order. Mexico is now sensing the need to address the same changes in direction. Its analysis has added a third dimension. It has become even

more acutely aware than Canada five years ago that the world trading order is breaking up into three major regional trading blocs and that it needs to be part of its regional bloc in order to underwrite restructuring of its own domestic economic and political reform. Its analysis has in part been fuelled by events in Eastern Europe and the emergence of that region as the potential main focus of attention for the next few years. Mexican business and political leaders reason that there is only so much energy available to craft creative solutions to the world's many problems and that much of that energy will be devoted to Eastern Europe for the next decade. Meanwhile, they want to make sure that some has been diverted to a solution to their problems. They see that solution to be a North American free-trade accord.

Increasing political resistance to adjustment as well as greater economic disparity at the multilateral level appears to be ruling out comprehensive multilateral agreements on such sensitive domestic issues as industrial policy, subsidies, investment, performance requirements, product stan-

dards and government procurement. As a result, the increased range of issues in modern negotiations are being addressed both regionally and multilaterally, leading to an increasingly tiered international trade relations system. The multilateral system, at least for the time being, appears to be stretched as far as it can go. In the Canada-US FTA there is a commitment to address these issues bilaterally. Mexico has now expressed an interest to accede to the agreement or reach a similar arrangement with the United States. In Europe, the combined effect of the Treaties of Rome and Stockholm and the free trade agreements that link the two groups together amount to a similar commitment. Efforts to address these issues multilaterally have so far come up short. These regional arrangements and their more far-reaching commitments effect greater policy uniformity and less discrimination than has so far been possible under GATT. While the ultimate goal should be universal rather than regional rules, progress and experience at a regional level may be the only way to get there.

Annex 2  
A Chapter-by-Chapter Analysis of the Canada-US FTA:  
Implication of Mexican Accession

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Conventional wisdom maintains that the Canada-US FTA is an extremely complex document, the product of intense and difficult negotiations. There is some truth to this assertion but it is a truth that can be easily exaggerated. In point of fact, the FTA is based on more than fifty years of experience in negotiating international trade treaties. Many of the chapters in the agreement follow well trodden paths. Many articles relating to trade in goods, for example, are taken directly from the GATT or provide a particular interpretation of GATT rules. Those that break new ground, do so cautiously. Finally, the changes in domestic law and practice required by the rights and obligations in the agreement are incremental, i.e., established laws and practices, conforming to the requirements of GATT and other trade treaties, needed incremental adjustments to bring them into conformity with the new, more stringent requirements. Agreement was not reached on the most difficult issues, such as subsidies and countervailing duties, antidumping duties, procurement preferences, supply management, and the protection of intellectual property. It is these issues which would have required more extensive legislative changes and would have broken more new ground.

From this perspective, the task of extending the FTA to Mexico looks somewhat less formidable than would at first appear to be the case. For both Canada and the United States, the trade policy arithmetic will be whether the inclusion of Mexico will be of net benefit, i.e., whether the increased competition from low-cost Mexican manufactures will be more than offset by increased and more secure access to the Mexican market for Canadian and US goods and services. Both governments, as well as directly affected interest groups, will need to be convinced that the inclusion of Mexico in the agreement will maintain the agreement's status as a trade creating rather than trade diverting agreement.

This kind of arithmetic would have been virtually impossible prior to Mexico's unilateral in-

roduction of a wholesale reform of its trade regime in 1985 and its accession to GATT the following year. The combined effect of these two decisions has made the Mexican trade regime sufficiently similar to those of Canada and the United States to allow an assessment of the extent to which it would need to be further adjusted to meet the obligations in the FTA, or the extent to which Canada and the United States would have to tolerate deviations from those obligations.

Negotiating difficulties will arise less from trade and economic concerns and more from subtle psychological and political perceptions. In Canada and the United States, there will be fears about the deleterious effects of low-cost Mexican labour and about the ability of an economy at a much lower stage of development to compete fairly with two industrialized economies. Mexicans will worry about the threat of enhanced American influence and dominance. An economic analysis based on classic international trade theory should demonstrate the short-term adjustment costs and long-term economic benefits flowing from a more integrated North American economy. But such an analysis cannot deal adequately with deep-seated fears and long-held prejudices. In crafting a basis for Mexican accession, therefore, the three governments will have to be sensitive to these non-economic concerns without letting them overwhelm their trade policy judgments.

Neither Canada nor the United States is likely to be prepared to make major adjustments in the text of the FTA, although there are some areas which could benefit from the wisdom of several years' experience. Having laboured two years to negotiate the agreement, they will not regard the renegotiation of the text as an attractive option. The traditional route of negotiating a protocol of accession is the more attractive and likely scenario. We need not, however, let the mechanics of Mexican accession stand in the way of the analysis, which is valid whichever method is chosen.



A major issue will be whether, given Mexico's less advanced stage of economic development, there is a case for asymmetry, e.g., a longer phase-in of obligations for Mexico than for Canada and the United States. In the case of the US-Israel FTA, the United States was prepared to phase in various provisions of the agreement on a differential basis recognizing Israel's status as a developing country. Mexico is likely to press for similar treatment and will be able to mount a good political case. Not only will it be able to plead its case as a developing country, but it will also be in a good position to argue that its unilateral reforms should be recognized and compensated through differential treatment. Mexico's accession to the GATT stressed its status as a developing country and its ability, under the terms of article XVIII, part IV and the 1979 Decision on Safeguard Action for Development Purposes, to maintain measures otherwise inconsistent with the GATT. While Mexico's unilateral reform program has gone well beyond the commitments it made upon acceding to the GATT in 1986, these are not contractual and Mexico might well resist making all of them contractual.

Any efforts by Mexico to seek permanent differential treatment for more than a few specific instances should be treated as a non-starter. While not likely, should domestic pressures dispose Mexico to seek such treatment, a North American FTA is not the right vehicle to underwrite further economic reform. The GATT provides for such treatment and Mexico would have to be encouraged to limit its obligations to those contained in GATT. A permanent differential regime would undermine the desired economic effects of a trilateral accord and eventually erode support for it in Canada and the United States.

The major challenge will thus be to Mexico whose trade and investment regime has long been out of step with international practice. While the unilateral reform program as well as Mexico's decision to join GATT in 1986 have already forced a major realignment in its trade laws and practices, it still has a way to go. As noted above, as a developing country there are various aspects of GATT with which it did not need to conform. Additionally, it is able to justify various practices under the terms of its protocol of accession.

Entering into the FTA, therefore, would require it to build upon these adjustments and go much further in bringing its regime into line with those of Canada and the United States.

The following pages look at the Canada-US FTA on a chapter-by-chapter basis and isolate those issues that would appear to be the most difficult for Canada, the United States or Mexico. At the same time, the analysis suggests that there are many areas where negotiations should be relatively straightforward or where the hurdles are largely of a technical rather than political nature.

#### **The Canada-US FTA: An Overview**

The Free-Trade Agreement required Canada and the United States to eliminate the tariff and remove a wide variety of other import barriers and domestic practices or bring them under codes of conduct based on the principle of national treatment. The trade liberalizing elements of the agreement are being phased in over a period of up to ten years to provide industry with the time to adjust to more competitive conditions. The agreement is thus exposing Canadian and American farmers, producers, manufacturers and service providers to greater competition but within a predictable framework of rules that assure them greater and more secure access to a larger market. The reward for accepting greater competition is the opportunity of exploiting a much larger market.

The preamble and first chapter set out the basic objectives of the two governments and provide the philosophical framework within which the whole agreement must be viewed. The heart of the agreement can be found in chapters 3 to 13. These establish a sound but conventional free-trade agreement. They provide a sensible set of rules fully consistent with GATT article XXIV. The link to GATT cannot be overemphasized. Many of the clauses of the agreement are drawn directly out of the GATT or provide agreed interpretations of GATT provisions. In effect, the FTA takes a set of good rules and makes them better. Where either side was not prepared to go as far as the other, provision was made to continue negotia-

tions, but within a new and more secure framework.

Chapters 14 to 17 make a cautious start on the so-called new issues of services, business travel, investment and financial services. They recognize that international commerce is more than a matter of shipping goods to one another. The two governments decided to freeze the status quo and to promise that any future laws and regulations would be based on the premise that Canada and the United States will treat each other's service providers and investors and business travellers as they treat their own.

Thirdly, chapters 18 and 19 achieve a Canadian quest of long standing – a contractual, institutional basis for managing the trade and economic relationship. Chapter 18 takes well-established GATT practice, commits it to a clear body of rules and procedures, and applies these to the rights and obligations of the agreement as a whole – to the enhanced and improved GATT-like rules dealing with trade in goods as well as the new rules dealing with services, investment and business travel. For the first time, there is a clear mechanism that places Canada and the United States on an equal, one-on-one footing. The agreement as a whole provides the rules; chapter 18 provides a neutral referee to enforce those rules.

Chapter 19 deals with the thorny issues of trade remedies. Here the United States recognizes for the first time that disputes arising out of the application of trade remedy laws are not a matter for the application of domestic law and unilateral decisions alone, but should also be subject to bilateral dispute settlement. The chapter provides an important beginning. While both countries will continue to rely on their respective trade remedy laws, they have agreed to replace judicial review of domestic decisions by bilateral review, to subject amendments of their laws to bilateral challenge and to continue negotiations toward a replacement regime.

The provisions of the agreement as a whole are a significant improvement in the security and stability of Canadian access to the United States market. For example:

- changes in antidumping and countervailing duty laws have to name Canada specifically and are subject to a declaratory judgment as to their conformity with US GATT obligations and the object and purpose of the agreement;
- binding dispute settlement will substantially inhibit political fixes from distorting the application of antidumping and countervailing duties and should impede the launch and acceptance of frivolous suits;
- escape clause action against Canadian exports can only be taken where these exports alone are the cause of serious injury to US industry or where such exports are above ten percent of total US imports of the product in question and undermine the effectiveness of global US restrictions;
- national treatment in services will prevent new trade restrictive action against Canadian exports in the service sectors designated in the agreement; and
- national treatment in investment will prevent the addition of new discriminatory barriers to Canadian investors and assure them of equitable treatment once established.

Finally, the agreement provides a framework for the negotiations of the future. At least ten articles throughout the agreement anticipate continued negotiations. The most important of these relate to subsidies, anticompetitive pricing practices, intellectual property and government procurement.

The FTA catches up to the economic and business realities of the Canada-US trade and investment relationship. By guaranteeing more open and more secure access to businesses on both sides of the border, it should allow both countries to plan and grow with increased confidence. Early evidence that the FTA is meeting this economic objective can be seen in the changed attitudes among Canadian entrepreneurs. Canada may be dependent on exports for 30 per cent of its GNP, but traditionally exports have been confined to a narrow range of products. Additionally, many Canadian companies did not view their business as international or take the steps necessary to become successful on a worldwide basis. Over the past few years, however, the business pages of Canada's

newspapers have shown a remarkable change in these attitudes, changes directly attributable to the debate over the Canada-US negotiations and their positive result. An increasing number of Canadian companies, including those already involved in exporting, now acknowledge the need to become more internationally competitive, to rationalize their production and to produce products for the world market rather than only for the Canadian or North American markets. They have accepted the challenge to diversify, establish joint ventures, enter into licensing arrangements and distribution networks and establish branch plants or subsidiaries to an unprecedented extent. They now view the US market as only an intermediate step to the world market.

The Agreement is stimulating greater rationalization and specialization which in turn should lead to an increase in intra-industry trade and even intra-firm trade. This level of success will be evident if Canadian trading patterns diversify – not as a result of a reduction in trade with the United States but because of an increase in trade across the Atlantic and Pacific due to greater competitiveness and specialization. The ultimate economic success of the Agreement, therefore, will require the successful implementation of outward-looking, international business attitudes. The dynamism resulting from these changed attitudes will lead to much more wealth creation than the mere removal of tariffs.

Canadian and US interest in a bilateral agreement, while not identical, proved compatible and negotiable. The result is a workmanlike agreement that satisfies many of the basic objectives of both Canadians and Americans as well as a framework for further improving the agreement. Mexican interests and objectives are not fundamentally different from those of Canada and the United States. Mexico is similarly seeking secure access to a large enough market to further underwrite domestic economic reform. It has made sufficient progress unilaterally to be convinced that it is on the right track and that the short-term political costs are worth the long-term economic benefits. What needs to be determined now is whether these broad objectives can be translated into specific rights and obligations that fit within the framework of rights and obligations contained

in the FTA. The chapter-by-chapter analysis that follows suggests that such an approach is feasible.

#### **Preamble and Chapter One: Objectives**

In most agreements, the preamble and statement of objectives do little more than provide the political framework within which the rest of the agreement must be considered. In the Canada-US FTA, however, chapter nineteen provides that any changes in domestic antidumping and countervailing duty laws are subject to challenge on the basis of the "object and purpose" of the agreement, giving the preamble and chapter added significance. Additionally, chapter one includes a stronger version of the GATT federal-state clause and provisions on the order of precedence of this agreement as compared to other bilateral and multilateral agreements.

A close examination of the contents of the preamble and chapter one discloses no major difficulty that might arise if these rights and obligations were extended to Mexico. While there might be need for one or two additional preambular phrases to satisfy Mexican political imperatives, there are none there now that should trouble any of the three governments if they were adjusted to include Mexico.

A more difficult problem, however, will arise if Mexico insists on a preambular clause emphasizing its development status and uses that as a basis for building a case that it deserves special and differential treatment on a permanent basis. While a case for asymmetry may be robust, it should be circumscribed and time limited. Otherwise, the integrity of the whole agreement will be brought into question.

Article 101, which contains a bold assertion of GATT consistency, might well have been tested by the time any trilateral negotiations are joined. A GATT Working Party is now seized of the Canada-US FTA and should decide by the end of 1990 whether the FTA complies with the requirements of GATT. In keeping with past GATT practice, the Working Party is likely to prepare an inconclusive report, which the parties to an

FTA have traditionally taken to mean that their agreement meets the requirements of GATT.

Articles 102-105 are all straightforward and should be adaptable to Mexican accession without any significant difficulty. Article 102, objectives, establishes the broad parameters of the agreement and is unexceptional. While Mexico has a federal state structure similar to that of Canada and the United States, the division of powers is such that it is unlikely to face the kind of challenges to federal authority that can be launched in Canada. Article 103 (extent of obligations), therefore, should present no challenge to Mexico. Article 104 (affirmation and precedence) is largely of a technical nature and non-controversial and article 105 (national treatment) establishes no specific rights or obligations other than those spelled out in more detail in the rest of the agreement.

#### Chapter Two: Definitions

The general definitions chapter of the agreement will need some adjustment to incorporate Mexican practice. The idea of defining terms precisely as they are used in the agreement as a whole, and in each chapter as they are used within that chapter, an innovation in this international trade agreement borrowed from domestic legal practice, has proven prudent. Negotiating the accession of Mexico might well provide scope to strengthen this chapter. Given the pressure of time that attended the legal drafting of the agreement, it was not possible to isolate all those words that required definition. Expanding the list of defined terms, however, is largely a technical task of legal drafting and should not excite much controversy nor have any substantive impact on existing rights and obligations.

#### Chapter Three: Rules of Origin

In many ways, chapter three, which establishes the rules of origin for the Agreement, may be the most difficult and the most important chapter that will have to be tackled in negotiating Mexican accession. In effect, the chapter contains hundreds if not thousands of product-specific rules of origin. While Article 301 sets out the general rule and Article 304 the all-important definitions,

the real rules are contained in Annex 301.2 which sets out how the general rules will be applied on a product-specific basis. It requires that individual producers know precisely how the rules apply to the products that they wish to trade on a duty-free basis and it means that the rules can be readily adjusted to meet specific and changing circumstances. The advantage of what appears at first to be a highly complex system is that, once the basic rule and its application is understood by individual manufacturers, it becomes a predictable and unchanging rule. It will not, for example, be subjected to the vagaries of changing interpretation as has been the case for the more widely applied US substantial transformation rule. In effect, the FTA specifies what substantial transformation means in every instance and limits the application of a 50 per cent value added rule to the situations where it makes economic sense or was politically necessary.

The rules of origin are based on the new Harmonized System (HS) of tariff classification. The HS is based on the long established and widely used Brussels Tariff Nomenclature and its successor, the Customs Cooperation Council Tariff Nomenclature, but its concepts are new to Canada and the United States. Canada introduced the HS in 1988 and the United States in 1989. Inevitably, therefore, the two customs administrations are experiencing some growing pains in applying the new system and these are influencing their experience with the application of the rules of origin.

Negotiating Mexican accession will involve a detailed assessment, on a product-by-product basis, of the impact of extending the rules to include products wholly or partially manufactured in Mexico. This will require detailed consultations and will excite some concerns. Those companies in Canada, for example, which expressed anxiety about US goods incorporating goods benefitting from the Mexican Maquiladora program will be even more anxious if such goods qualify for duty-free treatment. Similarly, there will be companies concerned that Mexico will become a conduit for Japanese, Brazilian or other third-country goods. As a result, it can be expected that there will be manufacturers in Canada and the United States who will seek more stringent rules. For example, there will be requests to extend the fifty

percent FTA content provision to more products or to require chapter to chapter transformation rather than heading to heading transformation. The rules as they now stand reflect an assessment of Canadian and US industrial structures and how they would be affected by the FTA. The addition of Mexico will change that assessment and require detailed adjustment.

Such adjustment will be facilitated by the fact that Mexico uses the HS tariff nomenclature and used the Brussels and CCC systems before that. Unlike the original Canada-US negotiations, therefore, all three parties will be proceeding on the basis of a common tariff structure.

Given the increasingly integrated structure of industry in North America and the rationalization that is taking place to take advantage of global markets, it is not realistic to consider a permanent separate set of rules of origin for Mexico, as might be suggested by some manufacturers worried about competing with Mexico. In effect, demands for separate or tougher rules amount to demands to use the rules of origin to deny the benefits of tariff elimination. They indicate the extent to which in a free-trade negotiation producer concerns can be met through artful drafting of the rules of origin rather than through tariff exemption.

While the eventual goal should be a single rule of origin based on North American content, i.e., products wholly of Canadian, US and Mexican origin in any combination always qualify while products that incorporate some non-North American content qualify depending on the degree of transformation and/or value added in any of the three countries, there may be need for a transitional rule. From a Canadian perspective, such a rule would treat goods of Mexican or mixed US-Mexican origin differently from goods that meet the current FTA rules. Such a rule would recognize the fact that Canada and the United States maintain different tariffs to third countries and would thus be eliminating a different tariff structure. The challenge would be to construct a transitional rule in such a way as not to become a major disincentive to firms wishing to take advantage of improved access to the integrated market.

Even without Mexican accession, we are likely to see some significant lobbying in Canada (and, to a lesser extent, the United States) to adjust the rules of origin to changing business reality. Not all businesses are happy with the rules and some have found them to be a significant barrier to taking advantage of the tariff provisions of the FTA. Some companies have concluded that the cost of meeting the rules of origin exceed the benefits of duty-free or lower tariff treatment and are continuing to do business under the MFN tariff regime.

The numbing complexity and tedium of rules of origin should not lull government and business analysts into complacency about this chapter. Failure to negotiate a workable and politically acceptable set of rules is critical to the success of any free-trade agreement. Insufficient attention was paid to this fact by Canadian business and government during the FTA negotiations. The accession of Mexico might well be viewed, therefore, as a convenient opportunity to rectify this situation.

On a related note, efforts in the Uruguay Round to develop uniform rules of origin are unlikely to lead to substantive agreement. Nonetheless, these discussions have clearly identified the need for model rules of origin that can be applied in the various circumstances in which such rules are required. The FTA rules of origin, for example, are limited in their application to determining appropriate tariff treatment. They do not apply to the operation of trade remedy law, government procurement or other border measures. Additionally, there are different rules applied by Canada and the United States to goods of non-FTA origin (e.g., for GSP treatment). In recognition of the difficulties for traders raised by a multiplicity of complex and incompatible rules, GATT and the Customs Cooperation Council have initiated efforts to develop a uniform or model code. While agreement in the Uruguay Round is not likely to go beyond the development of a work program leading toward harmonization, these discussions should also help to create a more constructive atmosphere within which to consider the development of rules of origin for a North American free-trade accord.

#### Chapter Four: Border Measures

If the problems of chapter three can be successfully resolved, the issues raised by chapter four may prove relatively benign. The issues here can be divided into two groups: those related to the tariff and those arising from other border measures.

The main tariff question is the speed with which the tariff will be eliminated for trade between Canada and Mexico and the United States and Mexico. In the FTA, Canada and the United States agreed to eliminate the tariff on the basis of three formulas: immediate elimination; elimination in five annual steps; and elimination in ten annual steps. The decision where to place individual tariff items followed from intense industry consultations.

A similar approach could be adopted in negotiating Mexican accession. Given the lower cost structure of Mexican industry, however, there are likely to be many more requests for extended rather than accelerated tariff elimination. At the same time Mexico, which has already adjusted to a significant reduction in tariff protection over the last few years, may be reluctant to eliminate the remainder too quickly. A realistic negotiating scenario, therefore, might involve the elimination of most tariffs over a period of ten, twelve or even fifteen years with provision for faster elimination for those industries that believe they are ready.

There is no compelling reason for Canada and the United States to offer a common approach to tariff elimination other than that of business simplicity. As long as the three countries work out a relatively straightforward set of formulas, the individual tariff schedules would then set out who will eliminate what tariffs at what pace.

Mexico bound its tariff in GATT at 50 percent ad valorem but its maximum applied rate is 20 percent with many tariff positions attracting rates of 5, 10 and 15 percent. The overall incidence of the tariff on a trade-weighted basis now falls about halfway between that of Canada and the United States for MFN trade, i.e., about 8 percent, a drop from close to 30 percent prior to the 1985 unilateral reforms. The major adjustment resulting

from tariff elimination, therefore, has already been undertaken and the issue of tariff elimination should not be exaggerated for any of the three countries.

For Canada and the United States, remaining high tariffs affecting imports from Mexico are in labour intensive sectors such as textiles, clothing and footwear where Mexico's labour-cost advantage is such as to be able to jump over high tariffs. Penetration by Mexico of the Canadian market for these products, however, for a variety of institutional reasons, is not very high. These are not export-oriented sectors in Mexico nor those where new investment is taking place. Rather, Mexican manufacturers are concentrating their export activities in other sectors, particularly machinery and transportation equipment, where tariffs are not very high. Additionally, the whole issue of "cheap" Mexican labour should be examined much more critically than has been done heretofore. Wages are lower because the productivity of a largely unskilled or semi-skilled labour force remains low. As productivity improves, so will labour costs. Furthermore, labour is only one cost component and, in many industries, a decreasing component.

Most Mexican products benefit from preferential tariff treatment in Canada and the United States, narrowing the amount of remaining tariff protection that would be eliminated by an FTA. Mexico is the ninth largest beneficiary of the Canadian GPT; as a result, 82 percent of Mexico's exports to Canada in 1989 were duty-free, either on an MFN basis or as a result of the GPT. Similarly, a high proportion of Mexico's exports to the United States benefit from duty-free or lower GSP-duty treatment. In short, it is not the tariff that is responsible for the low level of Canada-Mexico trade and the elimination of the tariff alone would not greatly increase two-way trade. Rather, the elimination of the tariff on a three-way basis should encourage greater rationalization throughout North American and thus stimulate greater economic activity in all three countries.

As noted, Mexico uses the Harmonized System of tariff nomenclature, a fact which should greatly facilitate tariff negotiations since all



three countries will be operating on the basis of roughly equivalent tariff systems. Mexico is also a party to the GATT Customs Valuation Code, eliminating possible controversy about valuation. Since acceding to GATT, Mexico has virtually eliminated its former practice of official prices for customs purposes.

Most of the rest of chapter four reflects some of the peculiarities of Canadian and US customs practice. Most of it involves an affirmation or clarification of GATT rights and obligations. It will need, however, some provisions to reflect Mexican practices as well as a judgment that its provisions can be extended by Canada and the United States to Mexico.

For Canada, this will involve a decision whether it is prepared to make the same concessions to Mexico regarding its duty drawback and remission programs as it did to the United States.

The United States will have to decide whether it is prepared to eliminate its customs user fees for Mexico, a measure it is already under pressure to bring into conformity with GATT, and adjust its program for duty-free zones. Mexico has equivalent practices which would need to be brought into conformity. The fact that the US and Mexico both impose customs' user fees may provide a basis for trading equivalent concessions.

For Mexico, the main issue will involve addressing the remaining vestiges of its old import substitution regime, including its prior import licensing scheme, the extent to which the Maquiladora program will have to be adjusted to bring it into conformity with the obligations in article 404 relating to drawbacks and free-trade zones, other drawback schemes, export licenses and duties, import and export subsidies, dual exchange rates and customs user fees. While Mexico has made great strides in reforming its trade regime, there remains room for reform. As well, many of the reforms have been implemented on the basis of administrative decrees rather than legislation. An accord would provide the security of legislation. If given enough time to phase in changes with assurance of secure access to the US and Canadian markets, Mexico should be able to make those adjustments.

The obligations in article 406 and its annex are similar to a recent agreement on customs cooperation between Canada and Mexico and similar arrangements between the United States and Mexico and present no particular difficulties. While these agreements were largely motivated by efforts to control illicit drugs, they are equally applicable to normal trade.

Finally, Mexico will have to consider whether it is prepared to accept the obligations in article 407 relating to exports to and imports from third countries that affect trade with either Canada or the United States; the obligation in article 408 prohibiting export taxes; and the obligations relating to access in article 409. All three build upon but expand GATT obligations. The last two will prove particularly difficult in the context of energy trade and are discussed further in the energy chapter. More generally, however, the United States is unlikely to be prepared to make any significant changes in these articles, arguing that in return for open and more secure access to its large market, Mexico should be prepared to commit itself to being a reliable supplier, if not immediately, then within a reasonable period of time.

Neither Canada nor the United States should face difficulty extending the obligations of articles 407-409 to Mexico.

Generally speaking, therefore, the provisions of chapter four, while requiring some hard bargaining and tedious technical work, do not appear to raise insuperable obstacles to the trilateralization of the FTA.

#### **Chapter Five: National Treatment**

This should not be a controversial chapter. Article 501 amounts to a straightforward incorporation of GATT article III (national treatment) into the FTA. Article 502 extends these obligations to the states and provinces in a recognition of evolving practice and of GATT jurisprudence arising out of GATT article XXIV:12 (the federal state clause). Given Mexico's accession to GATT, there should be no problem for any of the three governments involved. The GATT Working Party examining Mexican accession in 1986 raised no problems relating to article III.

Nevertheless, some careful research will have to be undertaken to catalogue those Mexican practices that are incompatible with GATT article III and justified on the basis of its protocol of accession. The United States, for example, continues to justify discriminatory marking requirements on the basis that its 1933 law requiring marks of origin predates the GATT and is thus exempted under the Protocol of Provisional Application. Any such laws and practices that are so identified for Mexico should be brought into conformity either immediately or eventually or specifically exempted.

Given that there may be an unknown number of residual discriminatory practices, the United States may be more willing to consider a "saving" clause such as was proposed but rejected during the FTA negotiations. Such a clause would prescribe that all restrictions and discriminatory practices are illegal except as specifically provided in the agreement.

#### Chapter Six: Technical Standards

This is also not a particularly controversial chapter. Technical regulations for health, safety, sanitary and consumer protection reasons can constitute severe barriers to trade if they are applied in a discriminatory or arbitrary manner, but the right to maintain regulations to protect human, animal and plant life, the environment or for a variety of other purposes is a sovereign issue for each country to decide. The ability to make such decisions is fully protected in both the GATT and the FTA. The challenge is to ensure that such rules are not abused and become disguised protectionist trade measures.

In this chapter, Canada and the United States affirm their obligations under the GATT Agreement on Technical Barriers to Trade to avoid the use of standards-related measures as unnecessary obstacles to trade. The Agreement establishes the general principle of national treatment. It requires that the two governments treat goods originating in the other country identical to goods of domestic origin once they have satisfied all customs formalities, including any standards. The two governments will also endeavour to make their respective standards-related measures and

procedures more compatible and thus reduce the obstacles to trade and the costs of exporting which arise from having to meet different standards. Since many standards-related measures are developed by private organizations in Canada and the United States (such as the Canadian Standards Association or the Underwriters Laboratory), and they have already made much progress in developing compatible standards, all that the two governments can do is encourage these organizations to continue to work toward greater compatibility.

The issue, therefore, is whether Mexico is prepared to accelerate the process of bringing its technical standards and standards setting procedures into greater conformity with those of Canada and the United States. The practical exigencies of modern trade are already proving a powerful inducement to meet this requirement, but there are political concerns, as we saw in Canada, about "harmonizing" to the US standard. Mexico joined the GATT Standards Code in 1988 and is taking steps to bring its standards and standards-setting procedures into conformity with the code. Standardization is one of the principal issues being pursued under the 1989 US-Mexico Understanding Regarding Trade and Investment Talks. Thus, on a bilateral basis, the US has already made a good beginning in educating Mexican officials in what is involved in moving toward trade-neutral product standards, testing, packaging, certification and related regulations.

#### Chapter Seven: Agriculture

Chapter seven marks the first substantially controversial chapter in the agreement, but less for Canada than for the United States. Generally, the agriculture discussion will be controversial less because of the rights and obligations in the agreement than because of their absence. While the FTA contains relatively greater obligations in the agricultural sector than other free-trade agreements, they are significantly less onerous than obligations for trade in industrial goods. As it stands, the FTA eliminates all agricultural tariffs and a number of specific non-tariff barriers. Some of the most important barriers to trade in agriculture are not addressed. The various price support mechanisms used in Canada and the

United States, such as deficiency payments, import quotas and supply management, are not covered. Provision is made, however, for continued negotiations, both multilaterally and bilaterally. Thus the degree of difficulty in extending this chapter to Mexico depends in part on the extent to which Canada and the United States are prepared to go further bilaterally at the conclusion of the Uruguay Round which in turn depends on what is achieved in the Uruguay Round.

A major breakthrough at the Uruguay Round of multilateral trade negotiations remains hard to predict. The United States and the EC have long been locked in a battle of nerves as to who will disarm first in the expensive game of subsidizing farm production. While Canada also subsidizes agricultural production, albeit for a different mix of products than does the United States, progress will only come when the EC decides to dismantle the main machinery of its Common Agricultural Policy and the United States retreats from the policies enshrined in the Agricultural Adjustment Act of 1933 and subsequent Farm Bills. While both governments are convinced that the other's programs are unacceptable, there is real reluctance to recognize that real reform has to start at home. Thus the results of the Round may be as much cosmetic as real.

Agriculture will also be an extremely difficult issue for Mexico. While Mexico may want more open and secure access for its exports of seasonal fruits and vegetables, its agricultural sector remains extremely sensitive. The unilateral program of reforms barely touch the agricultural sector. Much of the Mexican economy remains rural and near-subsistence peasant farming still plays a central role in many states. Some thirty percent of Mexican GDP is still generated in agriculture, involving forty percent of the population.

Although agricultural negotiations between the US and Mexico will be extremely difficult. The impact on Canada's agriculture sector should be modest. The US supplies 85 percent of Mexico's food imports - between \$1 and \$1.5 billion annually. During critical marketing periods, many Mexican agricultural products compete with identical produce from the southern US - worth about

\$2 billion annually. In contrast, Canada-Mexico agricultural trade is generally complementary: Canada is deficient in most of the Mexican-produced fruits and vegetables for nine months of the year - worth about \$100 million annually - while Mexico buys Canada's grains, oilseeds and skim milk powder. Less than 10 percent (pork, dried beans) of Canada's \$150 million agricultural exports to Mexico currently attracts a duty.

Discussion between the United States and Mexico of the provisions of article 702 (special provisions for fresh fruits and vegetables) should prove particularly interesting. Canada should be able to play largely a bystander role here, taking quiet satisfaction in seeing a reversal in US attitudes and concerns. The issues are of vital interest to Mexico, and Canada may be able to take some pleasure in watching an uncomfortable United States raise some familiar arguments.

Articles 704 - 707, providing specific commitments regarding market access for meat, grain and grain products, poultry and eggs, and sugar-containing products reflect the peculiarities of Canadian and US agricultural regulation and could not be directly adapted to Mexico. Rather, in the light of the results of the Uruguay Round, the three countries would either have to negotiate more generic rights and obligations or negotiate specific commitments that take into account the peculiarities of Mexican agriculture. As noted, the latter would be much more difficult for the United States and Mexico while the former would pose a major challenge to all three. Given the historic difficulty of negotiating agricultural trade agreements, specific commitments are more likely and could involve a fair degree of asymmetry.

In the case of phytosanitary regulations (health and safety regulations relating to agricultural commodities), there is a detailed program for consultation laid out in an annex to Article 708. It establishes a contractual framework within which the respective agricultural authorities will work to eliminate unnecessary differences in their health regulations. This work program could ostensibly be extended to include Mexico, but not without some difficulty. Again, bilateral US-Mexico discussions may already be smoothing the path toward more uniform standards.

#### Chapter Eight: Alcoholic Beverages

Chapter eight addresses a specific irritant in Canada-US relations and as presently conceived should excite little controversy in trilateral discussion. The results of the 1987 GATT panel examining European complaints about Canadian liquor board practices as well as bilateral discussions with the Americans and Europeans during and after the implementation of the FTA and the panel report should make what was once a very controversial issue increasingly easy to address.

Mexico and the United States have already reached a bilateral accord on beer and wine. As part of the 1987 sectoral accords, Mexico agreed to eliminate import quotas and licensing requirements for beer and wine. As a result, the United States has largely achieved its major objectives for this sector in both markets. The US maintains no major restrictions on imports of alcoholic beverages.

Mexico is not a major producer of either wines or distilled spirits. Mexico produces some very fine beers for which it might seek enhanced access to the Canadian market. The United States might well return to this issue in the context of a trilateral discussion, especially in light of American industry pressure under section 301 to force greater access for US beer to the Canadian market. Should that be the case, Canada might have to be prepared to bite the bullet and deal with its quaint beer production and marketing practices. This will be a politically difficult issue that may have to be resolved through some creative technical processes. Time, however, is on the side of a more rational system. The beer companies themselves are moving rapidly to diversifying their production into other agri-food sectors and to rationalize beer production to the extent Canada's regulations allow.

#### Chapter Nine: Energy

The energy chapter is potentially the most difficult issue for Mexico for the same reason that this chapter proved controversial in Canada. Mexico is a major producer of oil and, after Canada, the most important foreign supplier to the US market. The development of oil resources in the 1970s

raised many expectations about the future of Mexico and the fall in prices exacerbated many of Mexico's economic woes. Oil and oil-based products constituted some three-quarters of Mexico's exports in the early 1980s. The proportion is now down to about 35 percent, due to the combined effect of a rise in exports of manufactures, falling oil prices and mismanagement of Mexican oil exploration and exploitation. Canada imports about 10,000 barrels of Mexican crude. Mexico probably could not increase revenue from its energy sector today without significant outside capital and technical aid. Nevertheless, the energy sector remains critical for Mexico and makes the acceptance of market disciplines and export obligations politically difficult.

Despite similar interests as energy producers, Canada and Mexico do not compete directly in the United States market. Crude quality, distribution networks and other factors have resulted in regional oil and gas markets in North America.

To a much greater extent than in Canada, there is heavy state involvement in the energy sector. PEMEX, the state oil company, is a powerful organ of government policy and one of the most influential players in the Mexican economy. The obligations in chapter nine, which in effect would require Mexico to move toward a much more market-oriented oil policy, would therefore involve major and controversial changes in Mexican policy. They would only become acceptable if they included the guarantee of major investment to make the sector more economically reliable.

In the course of Mexico's GATT accession negotiations, it signalled that energy was one of the sectors where it could not move as far and as fast as in other sectors and it has maintained that position.

The issue is largely one between the United States and Mexico, although the Canadian petrochemical sector also has a keen interest in nurturing a more market-oriented Mexican industry. Heavy investment in petrochemical production in Alberta predicated on free access to the US market would be undercut if Mexico gained equivalent access but continued to allow Mexican producers to

gain access to feedstock at below-market prices. Thus the Canadian interest may be less direct but nonetheless real. Nevertheless, given the strongly held views of American interests in moving Mexico toward a more market-oriented approach, Canada can afford to let the US take the lead on this potentially explosive issue and save its negotiating leverage for issues where Canada is less likely to be able to count on US negotiating clout.

#### **Chapter Ten: Automotive Products**

At first blush, the automotive chapter would seem to be a difficult chapter. Further examination, however, suggests that the controversy is more likely to be symbolic than real. The Rubicon has been crossed and Mexican production is already being integrated into the North American auto economy.

The Big Three auto assemblers have invested heavily in Mexico in the past few years, sourcing parts and major components there. As a result, Canadian and US parts suppliers are under intense pressure to enter into joint ventures with Mexican parts producers or invest directly in Mexico in order to maintain their contracts with the Big Three. In effect, Big Three investment in Mexico has created a de facto trilateral trading block in the North American automotive sector: Canadian companies either source parts duty-free from Mexico under the terms of the autopact or pay the GPT rate of 6 percent. In addition, US and Japanese parts producers have invested heavily in Maquiladora plants – some 200 automotive-related Maquiladora plants are operating in northern Mexico – which limits duty liability into the United States to the value added in Mexico.

Mexico introduced an Automotive Decree in 1989 to raise the Mexican auto parts industry to world-class standards. The decree lowered import and investment barriers to attract capital-intensive, high-quality manufacturing operations to Mexico. Although the transfer of Canadian jobs to date has been minimal, a free-trade environment between the US and Mexico would make Mexican investments more attractive for Canadian parts manufacturers.

Given these developments, a more rational, integrated trade policy environment for the automotive sector would make sense and would not be all that difficult to negotiate. Nevertheless, the Canadian Auto Workers and their political supporters can be expected to use the negotiations to vent their frustration at the potential erosion of Canadian participation in automotive production being brought about by market forces.

#### **Chapter Eleven: Safeguards**

The safeguards chapter should not be a difficult chapter for Canada. Canada's principal concern was that it gain assurance that its products would not be sideswiped by US safeguard actions while retaining ability to take effective temporary action during the transitional period. Those objectives were met. Mexico will seek similar assurances from the United States. Given the structure of North American trade, Canada should not need enhanced safeguard procedures to guard against surges of imports from Mexico other than during the transition period and that is fully provided for. The United States, on the other hand, may not be prepared to extend the same provisions to Mexico as it did to Canada. That will be an issue for the United States to work out, however, and will only involve Canadian interests peripherally.

#### **Chapter Twelve: Exceptions for Trade In Goods**

Chapter twelve will have to be adjusted to meet specific Mexican concerns and may well lead to the addition of some Canadian and US exceptions that apply to Mexico. The specific issues that will need to be addressed, however, will not be clear until well into the negotiations after a much more detailed appreciation of the peculiarities of the Mexican trade regime. This chapter, in effect, provides the basis for dealing with difficult residual issues requiring either permanent or transitional exemption.

#### **Chapter Thirteen: Government Procurement**

The extension of chapter thirteen to Mexico as it stands poses little difficulty for Canada, some



difficulty for the United States and major difficulty for Mexico. The chapter builds on the GATT Government Procurement Code, to which the United States and Canada are signatories but Mexico is not. In its accession to GATT, Mexico made no commitments to open up its public sector.

Negotiations on government procurement would thus involve a three-step approach. First Mexico would have to accede to the GATT Code or accept equivalent obligations to Canada and the United States. Secondly, Mexico would have to be prepared to undertake the slightly more onerous obligations of the FTA, particularly as regards transparency. Finally, the difficult negotiations foreseen in the FTA to expand government procurement obligations beyond what is achieved in the Uruguay Round will have to be taken up.

Given the size and extent of the public sector in Mexico, opening it up to full competition would be a major step. While the combination of unilateral reforms and GATT accession have generally brought the Mexican import regime into greater conformity with those of Canada and the United States, it has not yet taken similar steps to open up its public sector. Failure to take this step, however, would not be a major obstacle to Mexican accession to the FTA. Canada and the United States have also not gone very far in opening up their public sectors. The GATT Code applies to less than five percent of federal government procurement in the two countries and chapter thirteen only increases that percentage marginally. The challenge of opening up procurement markets, therefore, remains a three-way challenge.

Negotiators in the Uruguay Round are seeking to increase the application and extent of the GATT Code. Canada and the United States are committed to continue negotiations on opening up procurement markets further in the light of the GATT results. The addition of Mexico to those discussions will make them significantly more difficult and will probably increase US intransigence. US politicians have over the years found government procurement preferences an important pork-barrel and are loathe to give them up for anything other than a very steep price. US officials consider improved access to the Canadian market nowhere nearly sufficient and are unlikely to re-

gard the Mexican market as making up the difference.

Given this state of affairs, it would be in Canada's interest to convince Mexico to delay accession to chapter thirteen of the FTA until such time as it is prepared to accede to the GATT Code.

#### Chapter Fourteen: Services

It is possible that obligations similar to those in chapter fourteen may soon be developed on a multilateral basis in the Uruguay Round of GATT negotiations. The chapter, of course, provides a cautious set of obligations requiring that governments in their future regulation of specified service sectors will not discriminate between each other's providers of those services. Particularly if similar obligations are concluded under the Uruguay Round, Mexico should have no difficulty accepting these obligations nor should Canada or the US have difficulty extending these rights to Mexico. The Mexican service sector is not as developed as those of Canada and the United States and the comparative advantage clearly lies with US and American service industries. In the Uruguay Round, Mexico has advanced a generally positive approach in this negotiating group.

The challenge in trilateral negotiations, therefore, will be whether the anticipated extension of the obligations to existing regulations in specific sectors is of interest to Mexico. Mexico may well feel that it wants its service sector to grow somewhat before opening it any further to foreign competition. While the economic arguments for such a development are not very robust, the political case is strong and, as a result, this may well be an area where Mexico will seek temporary differential treatment. In the Uruguay Round, Mexico tabled proposals favouring the negotiation of a broad framework to govern trade in services but allowing for differential treatment on a sector-by-sector basis.

Thus the first challenge of this chapter is to broaden its coverage between Canada and the United States and determine whether Mexico is prepared to go as far. Transportation services, for example, are not now covered. There is no contractual obligation on either government preventing it

from establishing rules discriminating in favour of local suppliers of transportation services. The second challenge will be to identify those areas where government regulations and programs in the services area currently do discriminate in favour of local suppliers and to negotiate the reduction or elimination of such barriers. This will be done on a sectoral basis and can also be done on a bilateral basis within the framework established by the chapter in a manner similar to tariff negotiations under GATT. This is an area where it would be relatively easy to provide temporary differential treatment.

#### **Chapter Fifteen: Business Travel**

This may prove the most politically controversial of all the chapters. Within a Canada-US context, this chapter has provided one of the more welcome and unanticipated benefits of the agreement. In the case of Mexico, however, given the long history of illegal immigration, any relaxation of border crossing requirements, even when confined to business and professional travel, will elicit strong opposition in the United States. At the same time, from a Mexican perspective, a better regime for business travel will be essential. As Canada discovered in the 1980s, the zealous enforcement of US immigration rules can severely handicap legitimate cross-border trade and investment activity. Indeed, Mexico may well regard the criteria defining business and professional travel unnecessarily restrictive and seek more relaxed criteria.

This issue will be largely one for the United States to work out with Mexico. Given the distance between Canada and Mexico, the pressure of migrant and illegal labour from Mexico is at worst a minor issue for Canadians. Implementation of chapter fifteen required few substantive changes in Canadian law and practice and its extension to Mexico, therefore, should elicit little controversy in Canada. Additionally, Canada and Mexico have an existing arrangement on migrant labour that could be used as a model for the movement of seasonal labour between the US and Mexico.

#### **Chapter Sixteen: Investment**

Over the past four years, Mexico has significantly relaxed its restrictions affecting foreign direct in-

vestment and may be prepared to go further. Whole sectors of the economy are now completely accessible to foreign investors while others are open in partnership with Mexican interests. Nevertheless, Mexico may want to guard jealously its right to regulate foreign direct investment and resist US demands that it not only translate its current laws and practices into treaty rights but extend these further. Again, this is an issue that is controversial largely between the United States and Mexico. Canada and Mexico will bring similar sensitivities about foreign investment to the bargaining table, with the major exception being that Canada in 1987 agreed to freeze its current regime and roll back some restrictions.

The difficult issues raised by this chapter may be somewhat ameliorated if there is a breakthrough in the Uruguay Round discussion of trade-related investment measures and Mexico joins any code to emerge from the GATT talks. Mexico has taken a fairly forward position on the TRIMs issue in GATT, putting forward some innovative proposals and suggesting that it may have more room for maneuver than has been accepted by conventional wisdom. At this stage, however, it is too early to make any firm predictions about the outcome of the GATT negotiations.

#### **Chapter Seventeen: Financial Services**

Despite recent reforms, the Mexican banking sector remains heavily protected and Mexico may not accede readily to any requests to open it any further. Mexico recently announced gradual denationalization and relaxation of restrictions on foreign participation in its financial sector which, when in place, will permit foreign ownership in any one bank up to a maximum of 34 percent of non-voting shares, and in insurance, up to 49 percent foreign participation. The United States is likely to seek a more open regime but is not in a good negotiating position given the fragmented nature of its own banking system and the wide range of restrictive regulations at the state and federal levels.

No Canadian bank, securities firm or insurance company currently operates in Mexico on either a branch or subsidiary basis or is expected to take an



immediate interest in establishing a presence in Mexico. Over time, the stimulus to Mexico's economy under either a bilateral or trilateral free trade arrangement should improve the likelihood of loan recoveries and lead to a higher volume of trade financing (Mexico is EDC's fifth largest market in terms of total world exposure) and greater confidence. Canadian financial institutions might then take a greater interest. As a result of this current low profile, however, Canada need not play an active role in extending this chapter to Mexico.

The provisions of chapter seventeen as written cannot readily be extended to Mexico. Canada and the United States accepted very specific obligations to reform certain laws and practices and committed themselves to future negotiations. Again, should the US insist that it wants to negotiate concessions from Mexico which, as in the case of Canada, it will be largely unable to reciprocate, the issues will be largely between the US and Mexico and excite little interest in Canada.

For consideration, however, will be whether the United States is prepared, in the light of the changing international financial system, to entertain more extensive generic obligations and integrate this chapter more completely into the FTA. As it stands, the chapter has at best a tenuous connection to the rest of the agreement, both in style and substance. The institutional provisions of chapter eighteen, for example, do not apply to the financial services sector. Canada may well wish to consider whether such an approach might usefully be pursued in the context of a trilateral negotiation, particularly if the results of the Uruguay Round are relatively meagre. Generic obligations would require a major revamping of US banking laws and open that sector to Canadian competition.

#### Chapter Eighteen: Institutional Provisions

The provisions of chapter eighteen as written are unlikely to generate any controversy should they be extended to Mexico, particularly in light of the reforms adopted in 1989 for the GATT dispute settlement provisions. The FTA provisions are very GATT-like and unexceptional.

Nevertheless, the extension of the agreement to Mexico provides an opportunity to make the provisions of this chapter more robust and closer to the original proposals advanced by Canada. Experience in the first two years suggests that the United States may be prepared to overcome its traditional reluctance to enter into more rigorous institutional obligations. Canada and Mexico may well find that they have very similar interests and goals in strengthening this chapter. Additionally, there exists the possibility of significant advances in reforming the GATT institutional structure, a development that may help to reduce US opposition to stronger institutional provisions.

Some changes will have to be contemplated. The addition of a third party to the agreement may require some adjustment to the procedures for the selection of panelists. For example, the agreement could be amended to require that the chairman of any panel comes from the country that is not a party to the dispute. More radically, the idea of a permanent tribunal may well prove negotiable. Both Canadian and US officials have been handicapped by the lack of independent support services for the agreement and the United States may now be prepared to consider the establishment of a modest permanent secretariat.

#### Chapter Nineteen: Dispute Settlement for Countervailing and Antidumping Duty Cases

Mexico brings an attitude very similar to that of Canada to the growing US penchant to rely on countervailing and antidumping duties to protect its industries. Like Canada, it finds US laws and attitudes offensive and its procedures too easily abused by US competitors. Its 1985 bilateral agreement with the United States, making its cases eligible for the injury test, has made very little practical difference. Partly as a counteroffensive, it has now equipped itself with countervailing and antidumping duty laws, a move of questionable merit. No Canadian products have so far been effected but in the past three years, 15 Mexican cases have involved US products. As a result, US traders have begun to worry about the potential impact of these laws. The Mexican law, for example, allows preliminary duties to be applied within five days of receipt of a complaint. Similarly, the determination of material injury

appears to be rather easily influenced by political factors. The dubious quality of the Mexican regime may prove to be a hidden negotiating asset.

The extension of the existing provisions of chapter nineteen to Mexico will be viewed as a *sine qua non* by Mexico but is likely to excite suspicion and opposition in the United States. It is one thing to allow Canadians to participate in panels that will determine whether US law has been properly applied; it is another to extend that right to Mexicans who have little equivalent experience and attitudes. These temporary provisions were ultimately considered acceptable because they were viewed as unique to the Canada-US FTA. Their extension to Mexico will bring into question this important selling point and raise questions about how far the US is prepared to see its trade remedy laws eroded by international obligations.

Even more controversial, in Mexico and the United States, will be the addition of Mexico to the Working Group charged with negotiating a subsidies code and a substitute regime for countervailing and antidumping duties. If American producers believe that Canadian goods are tainted as a result of a raft of subsidy and intervention programs, they will have even stronger views about Mexican products, where subsidization truly has been a way of life. At the same time, Mexico is unlikely to be able to take on the kinds of further reforms which would make the US more amenable to Mexican participation.

#### Chapter Twenty: Other Provisions

This chapter provides a grab bag of miscellaneous provisions, some of which address unique Canada-US issues and some of which are susceptible of broader application. In the first category fall articles 2005 (cultural industries), 2006 (retransmission rights), 2007 (print-in-Canada requirement), 2008 (plywood standards) and 2009 (softwood lumber). Articles 2001 (tax convention), 2002 (balance of payments), 2003 (national security), 2010 (monopolies) and 2011 (nullification and impairment) fall in the second. Article 2004, requiring cooperation on intellectual property discussions in the Uruguay Round, will have become a moot point but may provide a point of departure

for a renewed effort by the United States to negotiate a substantive intellectual property chapter.

In the first category, Mexico is likely to seek an article equivalent to that of 2005 while the United States will wish to see an equivalent provision to article 2006. Neither issue touches Canadian interests.

The extension of articles 2001, 2002 and 2003 to Mexico is unexceptional. On the other hand, Mexico may balk at accepting the obligations in articles 2010 and 2011. While these articles build on provisions in GATT (article 2010 reformulates article XVII on state trading and article 2011 borrows from GATT article XXIII), Mexico may believe that these articles address issues that are covered by its protocol of accession and its development status. Mexico continues to have a very large public sector and may not be able to go much further in its privatization drive. The obligations in these articles, therefore, could be onerous. Its anxiety about these articles will in part be based on the assertion that it is not clear what the obligations in these articles entail. The only answer to this charge would be the development of much more concrete rights and obligations which take Mexican interests into account. Canadian interests could also be advanced in such a context.

The most controversial issue raised by this chapter, however, might well be US desire to include a substantive chapter on intellectual property. Such a chapter eluded the United States in the FTA negotiations. The United States could indicate that the price for Canadian participation in the negotiations would be such a chapter.

The difficult issue for Canada would be US demands regarding compulsory licensing and a North American patent system, i.e., an end to the national treatment regime that now applies and its replacement by the extension of US standards to Canada and Mexico. Mexico's position on such demands are difficult to divine. In current bilateral discussions, intellectual property protection issues have figured prominently and Mexico has been prepared to make concessions to American demands. Canada may, therefore, find itself isolated on this issue. On the other hand, the original *quid pro quo*, greater discipline on US section

337 procedures, may have been achieved as a result of the recent US-EC panel and developments in the Uruguay Round discussions on trade-related intellectual property protection.

#### Chapter Twenty-One: Final Provisions

The final provisions of the agreement are unexceptional technical requirements and can be readily adapted to include Mexico.

#### Conclusions

Based on the foregoing analysis, it would appear that the most difficult technical issue involves rules of origin where vital Canadian interests are involved. Other areas that will require some ingenuity include some aspects of the chapter on border measures and the agriculture chapter. The more substantively difficult chapters include agriculture, energy, government procurement, business travel, investment, financial services and dispute settlement in the case of antidumping and countervailing duties. These are all much more difficult between Mexico and the United States than between Mexico and Canada. Three of these

chapters – agriculture, government procurement and financial services – lend themselves very well to differential treatment or outright exemption for Mexico without harming the integrity of the agreement. In addition, the automotive chapter will be symbolically difficult for Canada and Canada may have to be prepared for further pressure from the United States on its regulatory regime for beer and compulsory licensing of pharmaceuticals.

The eventual success or failure of the negotiations, therefore, will depend largely on the degree of flexibility the United States and Mexico bring to the table on energy, business travel, investment, and antidumping and countervailing duties. These are also areas of priority importance for the United States and Mexico. The United States must be satisfied that the Mexican investment regime is both open and guaranteed by treaty and that the energy sector is regulated by market forces while Mexico will not be able to sell an agreement domestically that does not provide it with more secure access to the US market and gives its nationals more open access to the US market.

# *What About the Workers?*

This selection reprints with permission "A Potential Free Trade Agreement with Mexico and the Impact on Labor," by Sidney Weintraub, *Looking Ahead*, Vol XII, No. 1, pp. 9-13

## *Discussion Note*

Can you have a comprehensive free trade agreement that includes services but does not liberalize movement of labor?

This article examines the likely shape and impact of such a pact between the U.S. and Mexico, drawing on economic theory for its analysis.

The article is therefore cause for review of some familiar concepts such as comparative advantage theory, especially Heckscher-Ohlin theory.

Another important part of the discussion concerns the effect of extreme labor market segmentation on wage rates. In this connection, the role of the maquiladora factories have to be considered carefully. This examination should also lead to a discussion of whether the use of low wage workers to assemble U.S.-made components kills or creates jobs in the U.S. and how the answer to this question will affect the handling of the "rules of origin" issue during trade talks.

Note also that Mexico's development strategy now broadly parallels that of Canada's and its exports increasingly involve the same kinds of specialization in intermediate product manufacturing. Would a NAFTA increase the competitive pressure on Canadian goods in U.S. markets? How should Professor Weintraub's discussion be extended to cover Canada? Another theme, not explored in the article, but a subject of concern to organized labor, is the role of a "social contract" in a North American trade area, similar to that adopted by the European Community (although not ratified by all member-countries.)

# A Potential Free Trade Agreement with Mexico and the Impact on Labor

by Sidney Weintraub

**T**he analysis presented here assumes that Mexico and the United States enter into a free trade agreement (FTA) covering essentially all merchandise trade and most services originating in each country. The analysis also assumes that most foreign direct investment between the two countries is free of restrictions or prior scrutiny. By contrast, free movement of labor is not assumed. This has been referred to as a "primitive" form of economic integration and will be discussed later.<sup>1</sup>

The analysis is not based on a value judgment that the two countries should conclude an FTA. The case for or against such an agreement is the subject of considerable debate in both countries.<sup>2</sup> The focus of discussion in this article is much narrower: what would be the consequences for labor, particularly Mexican labor, under an FTA? The discussion will cover what theory can tell us—theory that is rooted in features unique to Mexico and the bilateral relationship.

## WHAT TO EXPECT FROM THEORY

We would expect the answer to the question to be reasonably straightforward—free trade should lead to a narrowing of wage and total compensation levels between the two countries, primarily by raising wages in Mexico. A narrowing of wage differentials among regions—with some significant caveats that will be noted later—occurs under free trade within nations. But a major difference exists within a single country—factor movements are also free. Furthermore, the tendency toward wage equalization may come as much from labor migration as from product flows.<sup>3</sup>

Mundell argued some years ago that an increase in trade barriers will stimulate factor movements and that restrictions of factor movements will stimulate trade.<sup>4</sup> This is an econo-

This article has been excerpted from a presentation to the 42nd annual meeting of the Industrial Relations Research Association, December 28-30, 1989, in Atlanta, Georgia. For further analysis of U.S.-Mexico relations, see Dr. Weintraub's recently published study, *Transforming the Mexican Economy: The Salinas Sexenio* (Washington, D.C.: National Planning Association, 1990).



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mist's way of saying what many Mexican policymakers have asserted—that the United States can take either Mexico's goods or its people.<sup>7</sup> However, Markusen later noted that trade and labor movements can be complements, particularly when technology requires trained professionals.<sup>8</sup> The question posed here, however, is whether increased trade, even if not accompanied by increased movement of labor, would lower wage differentials between the two countries. If free trade is a substantial substitute for free factor movement, as economists have long argued, the expected answer is "yes."

Balassa noted that trade within a customs union (and, by extension, in a free trade area) will reduce differences in factor prices, but only if conditions of production are not markedly different in the participating countries.<sup>7</sup> This caution begs the question. Production conditions in Mexico and the United States generally do differ, as the *maquiladora* plants in Mexico demonstrate. These plants, established by U.S. and other foreign companies, use relatively cheap labor to add value to products shipped to Mexico for later re-export to the United States. This is close to pure Heckscher-Ohlin theory, which states that the abundant factor is exploited in each country; increasing the demand for Mexican labor in the process. The only way that such a production pattern can continue is for Mexican labor to remain perpetually cheap, which is unlikely. Over time, therefore, even if production conditions are different when free trade is introduced, they almost certainly will converge with the advent of increased trade.

**T**heory, as it relates to the U.S.-Mexico wage relationship, must ask another question: will the extreme labor market segmentation that exists in modern Mexican society overwhelm other wage equalization tendencies? The *maquiladora* demonstrate this tendency. They combine low skill, assembly-line labor with sophisticated management personnel. Within Mexico, a considerable amount of the production of large manufacturing plants is shifted to what are essentially small workshops. This is a common pattern in shoe and clothing production in the Guadalajara area. Piore and Sabel have argued that past U.S. permissiveness in allowing the entry of undocumented workers from Mexico was designed to increase the U.S. labor force without raising wage rates at the bottom of the scale.<sup>8</sup> In a similar argument, Martin and Richards suggested that guest worker programs that encourage labor market dualism may negate the wage and welfare equalizing effects of increased trade and migration.<sup>9</sup>

This argument is that the extreme labor market segmentation in Mexico which is encouraged by the immigration of low skilled workers into the United States can nullify the wage equalizing effects of trade and migration. Indeed, the position is often put even more strongly—that labor market dualism is promoted precisely to avoid wage equalizing outcomes. However, it is clearly questionable whether this pattern of labor recruitment could endure indefinitely under a full-fledged free trade agreement. The agreement would last only if benefits were shared between the two countries, which would require that Mexico substantially increase its exports. This, in turn, would require increased productive capacity and growth in labor demand, which would have a wage raising effect in Mexico.

The other side of the labor coin relates to the impact of U.S.-Mexico free trade on the U.S. labor market. We have already witnessed some effects, such as the establishment of 1,500 *maquiladora* plants generating about \$2.5 billion of value added in Mexico, premised on differences in national factor endowments. Roughly 50 percent of the value of U.S. imports from the *maquiladora* comes from U.S. inputs and the other half from value added in Mexico, mostly labor.<sup>10</sup> Does this situation deprive U.S. workers of jobs, or does it create jobs by permitting the use of U.S. inputs for goods that might otherwise be produced wholly in foreign countries?<sup>11</sup> The answer is not self-evident. Low skill, low wage U.S. labor may well lose out; but it may lose out in any event unless there is U.S. trade protection. U.S. labor as a whole presumably gains from the greater competitiveness that results from production sharing using the least-cost mix of production sources.

The purpose of free trade is to expand trade by fostering cross-country specialization. The customs union literature distinguishes between trade creation, which augments welfare, and trade diversion (from a lower cost third party to the customs union or free trade partner), which reduces welfare.<sup>12</sup> It is an empirical question whether trade creation or trade diversion would dominate in the short term from a U.S.-Mexico FTA. The literature and the experience under the European Community (EC) make clear that the trade creation-trade diversion analysis is most relevant over time when the dynamic effects swamp the static. This, then, is the empirical question: would free trade between the two countries increase their economic growth beyond what it otherwise would be? If so, would the binational specialization have a tendency to exploit Mexico's abundant factor (labor) sufficiently to raise its price?

The answer would come only in practice. However, if the free trade agreement were to survive—if both parties benefited—then the expectation would be that the FTA would raise Mexican wages more than those in the United States as a consequence of relative factor exploitation.

#### THE MEXICAN-U.S. LABOR SITUATION

Some background is necessary for readers not familiar with recent Mexican economic policy. Since the collapse in its economy in late 1981-82—precipitated by an inability to service its external debt, but having much deeper roots—Mexico has been engaged in a dramatic shift in development policy. The main features of the new policy have been to open the economy to imports (generally to discard an import licensing system in favor of modest tariffs), to emphasize the growth of manufactured exports as a major engine of expansion (made necessary by the collapse of oil prices in 1981), and to alter relative prices (particularly the exchange rate) to make this policy package viable. An anti-inflation program has also been instituted.

Manufactured exports have in fact increased dramatically, and by 1988 and 1989 they far exceeded petroleum as a foreign exchange earner. Manufactures constituted 15 percent of total Mexican merchandise exports in 1980 and rose to more than 50 percent of the total in 1989.<sup>13</sup> More than 80 percent of manufactured exports go to the United States. This policy shift—lower import tariffs and a stress on manufactured exports—has made possible the discussion of free trade with the United States.

Much of the trade with the United States is in intermediate goods shipped within the same or related companies. Unger estimates that as much as half of Mexico's manufactured exports to the United States are in this category.<sup>14</sup> This is similar to the pattern of U.S.-Canada trade in manufactures. Intrafirm or related-party trade of this nature signifies specialization in different entities of the same multinational corporation. It is precisely this type of specialization that has occurred in the EC and is anticipated under the U.S.-Canada FTA. Under a U.S.-Mexico FTA, therefore, we would expect substantial product mandating by large companies, focusing as much on parts of products as on finished goods. Based on the current distribution of factor endowments, we would further expect the relatively labor-intensive production to be allocated to Mexico and the research- or technology-intensive production to be concentrated in the United States. This allocation would not be absolute nor would it be fixed, but over the short to medium term would be apt to increase demand for Mexican labor.

Another underlying reason for expecting Mexican wages to rise in a free trade agreement with the United States is that more labor is used in Mexican firms producing for export than in those producing for the domestic market. De la Fuente Deschamps, in a detailed econometric study of 49 industrial branches over 1984-87 (the period of expansion of manufactured exports), found that exporting industries increased their capital, generated more employment and paid higher salaries than nonexporting industries.<sup>15</sup> The study also found that Mexican exports were sensitive to income growth in the United States. These would be the expected outcomes; the value of de la Fuente Deschamps' study is its confirmation of these expectations for the period studied.

There is considerable literature on whether economic integration, within and between countries, is more likely to lead to economic convergence or polarization. The evidence is that industrialization tends to make developed societies more similar to each other than to developing societies.<sup>16</sup> However, the United States and Mexico are quite dissimilar in their levels of development. As Tables 1 and 2 show, hourly compen-

TABLE 1  
Hourly Compensation Costs for Production  
Workers in Manufacturing  
Industries in the United States and Mexico,  
1985-87  
(U.S. \$)

	1985	1986	1987
United States	12.96	13.21	13.46
Mexico	2.09	1.50	1.57

Source: U.S. Department of Labor, Bureau of Labor Statistics (BLS), Office of Productivity and Technology, unpublished data, 1988 and 1989.

sation costs for production workers in manufacturing are extremely disparate,<sup>17</sup> leaving convergence to equality in compensation in the two countries a far distant possibility. The issue under an FTA thus concerns direction—toward convergence or toward greater polarity.

The outcome will depend on economic growth in Mexico and on comparative economic growth in the two countries. The decline in the ratio of Mexican to U.S. wages in manufacturing industries evident in Table 2 reflects the economic decline



and rising unemployment in Mexico during the years shown. The expectation of wage convergence in an FTA must therefore be based on the

**TABLE 2**  
**Indexes of Hourly Compensation Costs for**  
**Production Workers in Manufacturing**  
**Industries in the United States and Mexico,**  
**1985-87**

	1985	1986	1987
United States	100	100	100
Mexico	16	11	12

Source: BLS, "International Comparisons of Hourly Compensation Costs for Production Workers in Manufacturing, 1975-88," report 771, August 1989, p. 6.

point made earlier, that free trade would lead to some incremental growth in Mexico's economy over what would take place without free trade. Without this growth, the free trade agreement would not endure.

Within Mexico, as within most countries, there is a combination of economic convergence and polarity. Setting average national per capita GDP in 1980 at 100, those Mexican states well above the average include: Tabasco (from oil) at 250; the Federal District (where much of Mexican industry is concentrated) at 191; Nuevo Leon (which contains the industrial city of Monterrey) at 157; and Baja California (which benefits from proximity to the United States and the growth of the *maquiladora* industry) at 127. By contrast, states well below the average include Oaxaca at 40 and Zacatecas at 47.<sup>18</sup>

Although economic disparities within Mexico are substantial, they are not generally as large as those between Mexico and the United States. It is here that the labor immobility assumption made at the outset of this article comes into play. The large regional income differences within Mexico now affect fewer people than before because of internal migration. Rural areas of Mexico have consistently lost population to urban areas, precisely those locations with wages above the average for the nation. Wage disparities between Mexico and the United States would also presumably narrow more rapidly if there were free migration from Mexico to the United States.

It is these wage disparities, plus the excess labor supply in Mexico, that make free labor movement between the two countries unlikely. Yet, there is considerable labor movement, stimulated by the combination of excess labor demand in the United

States (in activities such as hand-harvested agricultural crops, low skill services and low wage manufacturing) and excess labor supply in Mexico. As noted above, free labor movement is apt to come about only as U.S. and Mexican wages become more or less equal, a still remote development.

Data deficiencies make it hard to calculate how long it would take Mexico to eliminate its excess labor supply. Estimates of open unemployment in Mexico range from 5 to 13 percent, or from 1.2 million to 3.2 million people. There is no satisfactory way to calculate the degree of underemployment. Additions to the labor force over the next 15 years are expected to be about 1 million people a year. What will it take to employ the currently unemployed and the new entrants in Mexico? Employment elasticities (the ratio of change in employment to change in GDP) vary among sectors—0.09 in agriculture, 0.78 in industry and 1.15 in services (this high figure may entail underemployment as the sector serves as a residual source of employment). The overall employment/GDP elasticity has been estimated at 0.64.<sup>19</sup> One calculation by Hobbs (looking just at unemployment and labor force entries and not at underemployment) is that with steady 5 percent a year growth in GDP, Mexico could eliminate its excess labor supply by 2000. In a comparable calculation, Mexico could eliminate its excess labor supply by 2010 based on steady 6 percent a year growth starting in 1985.<sup>20</sup>

These calculations are based on uncertain data and narrowly defined assumptions and are not predictions. They do show, however, that Mexico's excess labor supply can be eliminated under certain assumptions. The main requirement is a sustained high level of GDP growth. This, in turn, confirms the expectation that wage convergence in a Mexico-U.S. free trade area would help Mexico achieve sustained economic growth.

## CONCLUSION

The main assumptions on which this analysis is based are that Mexico and the United States enter into a free trade agreement covering substantially all goods and most services originating in the other country, but that free labor movement is excluded. In actuality, traditional negotiations are focusing on increasing mutual entry for particular goods and perhaps freer entry encompassing whole manufacturing sectors, and the easing of nontariff barriers in industrial standards, intellectual property and other cross-sectoral areas. The two countries are

moving toward free trade with each other in goods and services, but the negotiations are likely to be arduous. This implies that free trade, if it comes about, will be delayed.

If free trade does occur, it will endure only if each country benefits from the arrangement, with growth in GDP greater under free trade than without it. In these circumstances, demand for labor will increase, particularly in Mexico whose manufactur-

ing structure will likely be more labor intensive for some time than that of the United States. If Mexico can maintain high economic growth for 10 to 15 years, the country may even be able to absorb its excess labor. We would expect that, with the combination of sustained high GDP growth in Mexico and freer U.S.-Mexico trade, Mexican wages would increase more than U.S. wages, setting in motion a slow process of wage convergence.

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