FRBSF WEEKLY LETTER

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Notice to our readers: The *Weekly Letter* will appear on an abbreviated schedule during June, July, August, and December. To help you keep track of your subscription: • issues now contain a running index of the most current articles • issues are now both dated and numbered.

Free Trade with Mexico?

The U.S., Mexico, and Canada are planning negotiations on a regional North American Free Trade Agreement (FTA) this summer. The proposed FTA would join the U.S. with its first- and third- largest trading partners, which account for roughly 25 percent of total U.S. trade. The North American market would have a combined output similar to that of the European Community (over $6 trillion) but a larger population (365 million, compared to 330 million in Europe).

The rationale for free trade between the U.S. and Canada has been discussed in an earlier *Weekly Letter* (February 10, 1989). This *Letter* examines why the U.S. and Mexico are pursuing an FTA, its potential scope, the expected effects on the U.S. economy, and some concerns expressed on the U.S. side.

Why an FTA with Mexico?

The U.S. is pursuing trade liberalization on several fronts. Although the latest round of global trade negotiations did not achieve an accord last year, efforts are underway to revive these talks. At the same time, the U.S. is pursuing a broad strategy of liberalizing trade in the Americas, and an FTA with Mexico is an important element of this effort. In addition to the 1989 U.S.-Canada Free Trade Agreement, other U.S. efforts include the 1983 Caribbean Basin Initiative (CBI), which exempts certain exports of Caribbean economies from U.S. trade barriers, and the proposed "Andean Trade Preferences Act of 1990" which would grant Colombia, Peru, Ecuador and Bolivia benefits similar to those of CBI. More generally, President Bush's "Enterprise for the Americas Initiative" of June 1990 called for the long-run establishment of a free trade zone in the Americas. An FTA between the U.S. and Mexico is a natural step in the direction of regional free trade because of already low tariffs and the extensive trade links between the two economies.

From the Mexican perspective, an FTA with the U.S. would consolidate the extensive economic reforms (trade liberalization, privatization, reduction of budget deficits) Mexico has undertaken since the mid-1980s. It also would help Mexico achieve two economic objectives. First, an FTA could offset a disturbing increase in Mexican trade deficits apparent since 1989, which resulted from booming imports and lagging export revenues. Improvements in Mexico's external balance are needed to cope with its still substantial external debt of about $80 billion. Second, it could stimulate large increases in direct foreign investment in Mexico, which, in the short run, would also help Mexico service its external debt. But there are important long-run effects as well. At present foreign investment in Mexico is concentrated in the export enclaves (maquiladoras) along the U.S.-Mexican border, which are relatively isolated from the rest of the Mexican economy. By encouraging investment elsewhere in Mexico, the FTA would deepen Mexico's industrial infrastructure and increase its efficiency.

Scope

The U.S.-Mexico FTA negotiations are likely to extend well beyond the liberalization of trade barriers (though not nearly so far as the economic integration envisioned for Europe in 1992). In particular, a number of outstanding topics that have been the subject of recent trade negotiations between the U.S. and Mexico may be discussed. Some of these outstanding topics are examined in the latest report of the U.S. Trade Representative (1991).

Tariff barriers. Tariff barriers between the two economies are relatively low. The overall U.S. weighted average tariff rate on Mexican products is about 3.8 percent. As a result of extensive tariff reforms in the 1980s, Mexican tariffs on U.S. products are estimated to average 6.2 percent (lower than Canadian tariffs at the start of the U.S.-Canada free-trade negotiations). An FTA could reduce U.S. and Mexican tariffs on certain agricultural and manufactured goods which are currently much higher than these averages (tariff rates on some of these products are as a high as 20 percent).

Nontariff barriers. An FTA could reduce or eliminate U.S. nontariff barriers on imports of textiles and apparel, agricultural products, and steel. Mexico's import licensing scheme could be further liberalized (this scheme still covered 210 product categories in late 1990 compared to 820 items in 1986). Particular attention may be given to easing Mexican import restrictions on automobiles and some agricultural products (such as apples, grapes, peaches, raisins, poultry, corn, and wheat). The Mexican government may also be called on to end discriminatory procurement practices that limit the import content of government purchases.

Foreign investment. An FTA could result in reforms to Mexico's foreign investment policies so that U.S. investors in Mexico would operate under the same set of rules governing Mexican nationals. This would greatly benefit U.S. investors, who account for nearly two-thirds of the authorized foreign investment in Mexico. More specifically, FTA negotiations may seek to relax prohibitions or restrictions on foreign ownership in 141 Mexican economic sectors. The opening of the Mexican energy sector, which badly needs infusions of capital and technology, would be of particular interest to U.S. investors. Foreign investment in Mexico's energy sector is banned by the Mexican constitution, however, which makes liberalization in this area particularly difficult. Other areas include mining, transportation equipment, auto parts, transportation, and most financial activities. Mexican performance requirements for U.S. investments may also be reduced or eliminated (they are banned in the U.S.-Canada pact). For example, U.S. investors in the Mexican automobile sector traditionally had to meet strict local content requirements as a condition for producing in Mexico. U.S. investors also had to ensure that the foreign currency revenues of their automobile production facilities were sufficiently large to cover import costs.

Intellectual property. FTA negotiations may seek to enhance the intellectual property protection offered in Mexico. Mexican patent protection is not planned for chemicals, pharmaceuticals, alloys, and foods until 1997, and no patent protection at all is being considered for biotechnologies. The U.S. is seeking 20-year terms of protection (compared to 14 years at present), broader product coverage, protection for trade secrets and trademarks, improved enforcement of trade secret protection, and a shift in the burden of proof to the alleged infringer in process patent cases.

Effects on the U.S.

The welfare effects of an FTA with Mexico are difficult to estimate for both theoretical and practical reasons. On the one hand, the reduction in tariff and nontariff barriers that may result from an FTA with Mexico is expected to increase the efficiency of U.S. producers by encouraging them to specialize in those sectors where they enjoy a comparative advantage. An FTA with Mexico also may permit U.S. firms to reap the benefits of economies of scale that are likely to be associated with a larger combined market. These gains would enhance the ability of U.S. firms to compete with firms based in an integrated European market as well as to meet the continuing competitive challenge of producers in Asia and the developing world. On the other hand, lowering trade barriers with Mexico under an FTA, while leaving trade barriers against the rest of the world unchanged, may encourage the U.S. to import from Mexico even if Mexico is a higher-cost producer.

Several recent studies have attempted to resolve some of the uncertainty about the FTA's impact by developing models that estimate the aggregate and sectoral effects of bilateral trade liberalization on the U.S. and Mexican economies. At the aggregate level, these studies suggest that an FTA with Mexico will raise U.S. real income, wages or employment, and returns on capital. While no definitive conclusions can be drawn about the effects on U.S. welfare, these results suggest that an FTA with Mexico may, on balance, benefit the U.S. However, the estimated benefits are very small, for two reasons. First, the U.S. economy is about 27 times the size of the Mexican economy. Second, the studies focus mainly on the effects of the reduction of trade barriers that are already quite low between the two economies.

Although aggregate effects may be small, an FTA with Mexico is likely to have significant effects on certain sectors of the U.S. economy.

In agriculture and related industries, U.S. farmers who grow grain and oilseeds, such as soybeans, could see increases in output. These crops are relatively capital-intensive, and Mexico's producers cannot meet their own domestic demand. Other U.S. agriculture-related production may be adversely affected, notably sugar refining, fruits and vegetables, tobacco manufactures, lumber, and wood. These are sectors where Mexico may enjoy a comparative advantage due to lower labor costs or greater resource endowments. The most detailed study (KPMG Peat Marwick 1991) estimates declines ranging from 0.1 to 3.9 percent.

In manufacturing, output gains are likely in U.S. industries that are technology-intensive or capital-intensive, such as optical instruments and miscellaneous manufactures, machinery and equipment, chemicals, plastics, and iron and steel. Output declines are expected in more labor-intensive U.S. industries, such as electronic components, textiles and apparel, and furniture and fixtures. In all these cases, the estimated effect is small, 1.2 percent or less for gainers, 1.0 percent or less for losers. The impact of an FTA on the automobile sector, of great concern both in the U.S. and Mexico, is uncertain. On the one hand, current Mexican trade restrictions have led to overinvestment in Mexican automobile manufacturing capacity, which suggests that trade liberalization may increase U.S. auto production and exports to Mexico. On the other hand, the International Trade Commission reports that late last year, U.S. automakers estimated that they could increase profit margins by 4 to 10 percent by producing in Mexico if an FTA leads to liberalized investment rules south of the border.

Concerns

The major concern on the U.S. side is that U.S. manufacturing will migrate to Mexico because of lower wages and lower environmental standards, at the expense of U.S. workers. Unskilled workers in the U.S. are seen as being particularly at risk, as labor costs in Mexico are estimated to be about 10 percent of those in the United States.

In response, supporters of the FTA point out that less efficient manufacturing facilities will move out of the U.S. anyway, and that it is better for the U.S. that they move to Mexico than to other developing economies. Mexico spends a much larger proportion of its export revenue in the U.S. than do many other economies (the U.S. accounts for nearly 70 percent of Mexican imports), and economic stability in Mexico resulting from U.S. investment may stem the tide of illegal Mexican immigration into the U.S.

FTA supporters also argue that the U.S. will not necessarily "lose jobs" from its trade with Mexico, as the expansion of U.S.-Mexican trade will stimulate U.S. exports, as well as employment. Some recent studies estimate that an FTA with Mexico either would have no discernible effects on aggregate U.S. employment or may even *increase* U.S. employment by a limited amount. While these results are encouraging, they should be interpreted with some caution, as studies to date have focused mainly on the effects of lowering trade barriers under an FTA. More research is needed to determine the potential effects on U.S. manufacturing of a comprehensive liberalization in Mexico's foreign investment policy. Aside from providing better estimates of aggregate effects, such research might also clarify the effects of a U.S.-Mexico FTA in certain key sectors, like automobile production.

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