NAFTA – A Model Running Out of Breath?

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'Marriage of convenience' or 'default choice' (Weintraub 1990; Brunelle and Deblock 1989)? In any case, turning to the United States and embracing free trade, Canada and Mexico abandoned economic nationalism that reached its limits in the 1980s and made a bet that securing a broadened, safe and preferential access to their main market, they would take advantage of North American integration. First, it would stimulate their stalled economies and restore growth on new foundations. It would allow them to use the US market as a springboard for successful and competitive insertion into the global economy and it would attract foreign investments looking for a gateway to the US market. Other arguments were also important. In the case of Canada, for example, fear of losing the advantages gained from the free trade agreement (FTA) signed with the United States in 1987, and, in the case of Mexico, NAFTA was an opportunity to lock in economic reforms. The United States had more ambitious goals. The first was to establish a large open market to enable US businesses to take advantage of deep integration *de jure* with their first and third largest trading partners; the second was to build on this agreement and accelerate multilateral negotiations and other negotiations; the third was to meet the challenges of relentless globalization, the revival of European integration and the rise of Asia as an economic power. North America was to become also a model that would pave the way for the creation of other regional groupings (APEC, FTAA, transatlantic FTA and AGOA) (Deblock and Turcotte 2003).

The debate on NAFTA had political, legal, economic, cultural and social dimensions. In Canada and Mexico, it was seen as a direct threat to national sovereignty, social programs and developmental policies. In the United States fear of deindustrialization, or by mass relocations to Mexico were dangers shaping public opinion and debates. Yet, most pessimistic scenarios did not materialize and the US economy experienced strong growth throughout the 1990s, stimulated by globalization, inflows of foreign investments and development of new technologies, and this had positive impacts on growth in Canada and Mexico. NAFTA, nonetheless, continues to spark debates for different reasons. First, it has lost much of its appeal as a model of regionalism, as other models now compete with it, and second, NAFTA has become far less interesting to investors, and trade inside NAFTA are dwindling. Third, increasing pressure of international competition is accompanied in Canada and Mexico with another economic concern: sluggish productivity. We will examine these three points in the following pages, and conclude by asking a most important question: "is NAFTA running out of breath as a model of regionalism, and if so, what should be done about it?"

NAFTA as a model

NAFTA is associated with the emergence of a model of 'new regionalism', referred to as 'open' regionalism as opposed to the previous models of 'closed'.

Table 1

Growth of real GDP and GDP per capita in Canada, Mexico and the United States

Period	Average annual GDP growth rate (%)		
	Canada	Mexico	United States
1980–89	3.0	2.4	3.1
1990–99	2.4	3.4	3.2
2000–09	2.1	1.9	1.8
Period	Average annual growth rate of GDP per capita (%)		
	Canada	Mexico	United States
1980–89	1.9	– 0.5	2.5
1990–99	1.3	1.7	1.9
2000–09	1.1	0.9	0.8

Source: IMF World Economic Outlook Database.

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The formula is well conceived but does not accurately reflect the reality as any RTA (Regional Trade Agreement) is preferential and exclusive. The difference distinguishing new and old ones is, on the one hand, their institutional characteristics: generally, they are trade agreements aiming to liberalize trade, and they are mostly bilateral and they are characterized by a contractual approach. On the other hand, they are directed toward international markets, i.e. towards the promotion of trade in the broadest sense. They are also negative, yet in-depth integration agreements. 'Negative' in that they aim to remove barriers to trade and competition. And 'deep' because they also tend to harmonize rules and policies in different areas of trade and investment without involving the elaboration of common policies (Lawrence 1996).[1]

NAFTA is a very comprehensive agreement covering not just trade in goods (including agriculture and services) but also investment, telecommunications, government procurement contracting, intellectual property, standards and the movement of business people. In other words, it seeks as much to open up markets as to establish common market rules, while avoiding the negotiation of common policies. NAFTA resembles the European model but it does not go as far as for example, setting a common competition policy. Where NAFTA radically differs from the European model because it is essentially a 'contractual' agreement aiming at the sole objectives (Preamble and Art. 102) of establishing a free trade zone subject to a system of fair competition, resolving disputes effectively and promoting trilateral cooperation in various areas related to the agreement.

NAFTA binds parties to respect the principle of equal treatment (national treatment and most favored nation clause, MFN), with exceptions and other clauses clearly identified. Also, as with any contract, parties must comply with the commitments made and must submit, in cases of dispute, to procedures of arbitrage and, where applicable, to a binding dispute settlement system. Its institutions are declined on four levels: *ministerial* (a commission on free trade and commissions in the areas of environment and labor cooperation), *administrative* (coordinators and three secretariats), *legal* (dispute settlement) and *technical* (groups and working committees). The agreement is intended only to create an institutional and legal environment conducive to free movement of goods and services, capital and business people. One important aspect to mention is that, contrary to the ongoing integration process in Europe, the agreement is not upgradeable. Some proposals were made to improve the agreement, notably by President Zedillo who proposed to establish a regional development fund, and to transform it into a customs union or common currency union, but these proposals were not pursued and neither seriously considered.[2]

NAFTA might not have lead to as much debate if the United States had not sought to use it for purposes. The United States' objectives, however, went far beyond the North American framework. In the first place, the agreement was meant to create precedents and to serve as leverage to advance multilateral negotiations in areas as contentious as investment and intellectual property rights. Firstly, for example, Chapter 11 on Investment (Part V) served as a model for negotiations, which ultimately failed, of a multilateral agreement on investment (MAI) (Gagné 2001). Secondly, Mexico was to serve as an example, demonstrating that trade liberalization coupled with continued reforms could lead to vigorous growth and development creating jobs and wealth, and this, in return, would contribute to reinforce democracy, greater respect for individual rights, greater economic security and control of migration flows. And thirdly, a strong signal had to be sent to all countries willing to launch bilateral negotiations with the United States, in the Americas but also elsewhere in the international community. In this regard, NAFTA symbolized the way forward in trade liberalization.

These expectations were obviously exaggerated, if not unfounded, as in the case of the reduction of migration flows. Moreover, if negotiations in North America did in fact have direct impacts on the Uruguay Round and its results, the US trade agenda quickly encountered strong resistance – beginning in the Americas where negotiations were finally dropped because of a lack of consensus (Summit of Mar del Plata), but also in the case of APEC and at the WTO (Deblock 2007). Worse, by engaging in a bilateral path, the United States somehow freed everyone the obligation to favor multilateralism, thus opening a true Pandora's box. In this regard, the disastrous Ministerial Conferences in Seattle (1999) and Cancun (2003) were turning points. Apart from the fact that they revealed the gap

[1] Integration is said to be positive when it is oriented towards common goals and shallow when it is limited to trade.

[2] The Security and Prosperity Partnership , established in 2005, helped open discussions on new areas including energy, transport and certain regulations, but its primary intention was to strengthen security at the borders and facilitate passage thereof.

between US positions and those of emerging countries, they demonstrated the impossibility of a multilateral consensus inevitably leads to a multiplication of bilateral and regional channels as the default solution. The United States is not solely responsible for the proliferation of the spaghetti bowl of trade agreements, but the doctrine of 'competitive liberalization', which, under the presidency of George W. Bush, replaced regional blocks and their disinterest in multilateralism, only added fuel to the fire. What is striking today is not so much the race towards trade agreements but rather the new form they take. We have entered a third wave of regionalism, marked both by the proliferation of agreements in Asia, a region that long remained outside this trend, and by the emergence of a different model that we call a 'partnership' model, initiated mainly by China, a new player that every day affirms and reaffirms its ambitions to shape the world economy (Beeson 2007).

Table 3
Growth of US merchandise trade with Canada and Mexico 1980–2009 (average annual growth rate in %)

Period	Exports to	
	Canada	Mexico
1985–89	8.7	16.6
1990–94	7.6	15.7
1995–99	7.9	12.1
2000–04	2.9	5.8
2005–09	2.4	3.7
Period	Imports from	
	Canada	Mexico
1985–89	6.0	8.9
1990–94	8.0	13.2
1995–99	9.0	17.3
2000–04	5.6	7.9
2005–09	– 0.9	3.3

Source: Bureau of Economic Analysis (BEA), US International Transactions Accounts Data.

The two periods of NAFTA

NAFTA is often criticized, often severe when it comes to jobs and working conditions (Faux, Salas and Schott 2006), but its overall record clearly remains positive, far more so in fact than was initially anticipated (Courchene 2003; Hufbauer 2008; Pacheco-López 2008). First, it established an institutional framework conducive to trade, to the great satisfaction of the business world. Some disputes – timber, transportation and sugar for instance – regularly reappear, but they remain few given the magnitude of trade. Similarly with disputes relating to investment: they remain isolated cases and arbitration decisions are too uncertain to allow strong conclusions to be drawn from them. Furthermore, trade between the three countries experienced a sharp rise. Between 1992 and 2008, exports from Canada and Mexico to the United States were multiplied respectively by 3 and 4.5, while their imports from the United States have been multiplied by 2.5 and 3. As for trade between Canada and Mexico, it has been multiplied by 6. Finally, even if NAFTA did not begin auspiciously (Zapatista uprising on 1 January 1994 and the peso crisis by the end of that year), Mexico recuperated quickly from the crisis, and experienced strong growth led by exports and a booming *maquilas* industry. Thus, the number of jobs in these industries doubled between 1995 and 2000 from 648,263 to 1,291,232.[3] Another compelling fact is that the share of the manufacturing sector in total exports went from less than half the total before NAFTA to more than 80 percent in the early 2000s (Waldkirch 2008).

Table 2
Exports and imports of goods and services 1970–2009 (% of GDP)

Period	Exports		
	Canada	Mexico	United States
1970–79	23.3	8.1	7.5
1980–89	27.0	17.1	8.5
1990–99	34.2	21.5	10.5
2000–09	39.0	26.9	10.9
Period	Imports		
	Canada	Mexico	United States
1970–79	22.8	10.7	7.7
1980–89	25.2	13.6	10.3
1990–99	32.7	23.1	11.9
2000–09	35.2	28.6	15.7

Source: United Nations Statistics Division.

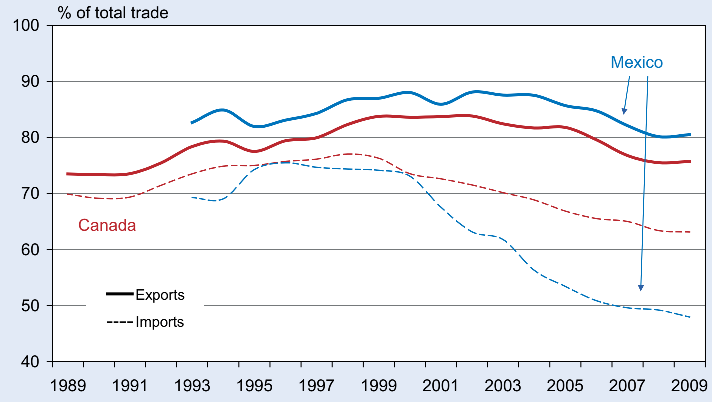
One of NAFTA's most noteworthy effects was to significantly strengthen the trade links

[3] Source: INEGI.

between the three countries. It is necessary, however, to distinguish between the period prior to and after 2000. Before 2000, trade grew rapidly. Thus, the share of intra-NAFTA trade between 1994 and 2000 went from 45 percent to 56 percent for exports and from 37 percent to 40 percent for imports.[4] Thereafter, the share of intra-NAFTA exports remained stable until 2005, but then began to recede slowly before dropping to 48 percent since the 2008 crisis. The decline is felt even more acutely in the import sector. From 40 percent, the share of intra-NAFTA imports dropped to 38 percent in 2005 and then to 33 percent in 2009. Clearly, trade is slackening and three reasons explain this. First, Canada and Mexico benefited from two advantages during the 1990s: strong growth in the United States and weak currencies. These have disappeared as the US economy has lost momentum and the crisis of 2008–2009 has sharply driven down bilateral trade while the Canadian dollar achieved near-parity with the US dollar and the peso's real value rose sharply. Both Canada and Mexico have lost competitiveness, at least in terms of prices (Morales 2010).

Figure 1

CANADA AND MEXICO MERCHANDISE TRADE WITH THE US 1989–2009

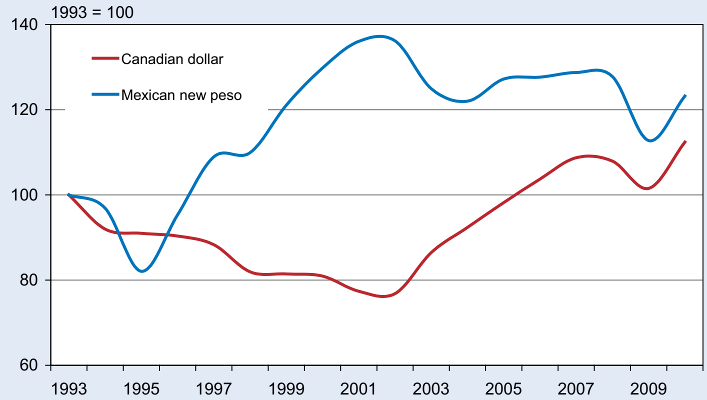


Sources: Statistics Canada, Canada's Balance of International Payments, Catalogue 67-001; Mexico, Ministry of Economy, Underministry of Foreign Trade.

Figure 2

REAL EXCHANGE RATES

Mexican new pesos and Canadian dollars to one US dollar



Source: Federal Reserve Bank of St Louis.

Furthermore, trade conditions have dramatically changed since China's accession to the WTO. Chinese competition is felt at two levels: both within the United States (the main market for Canada and Mexico), and in these two countries as well where Chinese products are challenging local industries and imports from the United States. Thus, between 1996 and 2008, we have witnessed the share of imports from China growing from 2.1 percent to 10.1 percent of total imports in Canada, from 0.8 percent to 10.7 percent in Mexico and from 6.6 percent to 16.5 percent in the United States.[5] Conversely, while US exports to China rose from 1.9 percent to 6.5 percent between 1996 and 2008, this was not the case for Canada and Mexico: Canada's exports to China rose only from 1.1 percent to 2.5 percent and Mexico's, from 0.2 percent to 0.7 percent. But what do we have to offer to China? While Canada has natural resources and cutting-edge industries in certain sectors, Mexico does not have the advantage of natural resources, with the exception of petroleum, and its industries are still very fragile and dependent on integration with the United States while it is especially exposed to Chinese competition, with the exception of the automobile industry (Meza and Salvador 2009; Rosales and Kuwayama 2007; Arès 2005).

Finally, the third source of concern is the changes in the direction of direct investments. In Canada, this phenomenon was observed long ago: in 1994, two thirds of direct investments (FDI) came from the

[4] Source: WTO.
[5] Source: United Nations, ComTrade.

Table 4

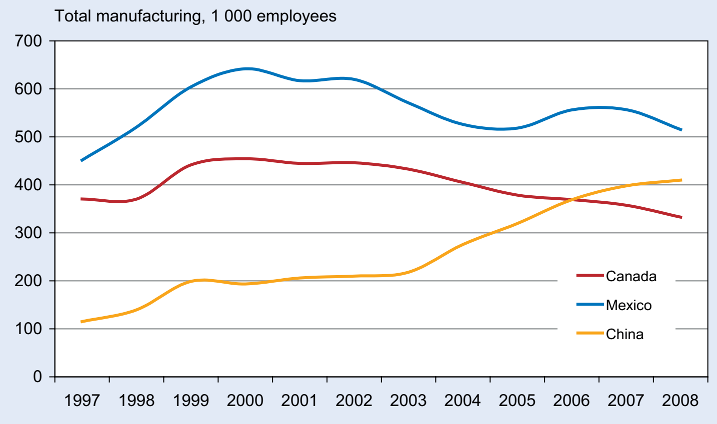
US merchandise trade with major partners 1980–2009 (average share of total trade in %)

Period	Exports to			
	Canada	Mexico	Japan	China
1980–89	22.4	6.2	10.8	1.5
1990–99	22.3	9.8	10.1	1.8
2000–09	21.9	12.9	6.2	4.6
Period	Imports from			
	Canada	Mexico	Japan	China
1980–89	19.1	5.4	18.4	1.4
1990–99	19.3	8.6	15.6	6.2
2000–09	16.9	10.9	8.5	13.9

Source: Bureau of Economic Analysis (BEA), US International Transactions Accounts Data.

Figure 3

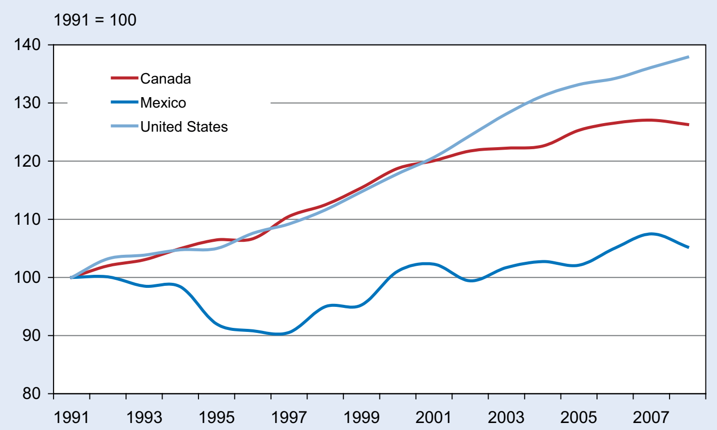
US MAJORITY-OWNED FOREIGN AFFILIATES, EMPLOYMENT 1997–2008



Source: US Bureau of Economic Analysis.

Figure 4

LABOUR PRODUCTIVITY GROWTH 1991–2008



Source: OECD Factbook 2010: Economic, Environmental and Social Statistics.

United States. By 2009, only half did, while Canadian FDI in the United States went from 53 percent to 44 percent of total Canadian FDI abroad. But it is on the US side that the changes are most notable. China and Asia generally attract few Canadian companies, but this is not the case for US companies which have long been established in this part of the world. Figure 3 is very revealing, giving us the number of jobs in US subsidiaries (affiliates) in Canada, Mexico and China for the manufacturing sector. It clearly shows that although NAFTA originally stimulated job creation in both Canada and Mexico, that trend has since been reversed (Blecker 2009).

These contrasting trends reveal two things. First, NAFTA has given new impetus to economic growth in Canada and Mexico but it has also had the perverse effect of reinforcing their natural dependence on the United States. Second, changes in the international economic environment have forced both countries to rethink their economic strategies, so far much too focused on the United States (Goldfarg 2006).

Productivity – the weak link

Did NAFTA divert the attention of Canadian and Mexican authorities from considering other markets and partners? One can think so. On the one hand, the agreement was most satisfactory as trade was extremely favorable to Canada and Mexico that benefitted from large trade surpluses year after year. On the other hand, even when both countries sought to diversify their trade, their efforts did not yield the expected results since companies did not really responded, and because the failure of the FTAA project revealing the failure of their economic diplomacy on the continent. This being said, times have changed. The United States, increasingly tied up with

China, shows little interest in the Americas while China has become a major player in the Americas in only a decade. Both Canada and Mexico are now up against a wall: how can they preserve their market shares within North America while gaining shares in other markets, if not through innovation and investment in the future?

Low productivity has indeed become a major concern in Canada and Mexico; no doubt does it also explain to a large extent the problems of competitiveness that both countries are faced with today. In this regard, Figure 4 and Table 5 are most revealing about three things. First, the hopes for convergence have not been realized by NAFTA: Mexico has not reduced its productivity gap with the United States and, since 2000, Canada has seen this gap widening. Second, the rate of productivity growth has been falling dramatically since 2000, far more than in the United States. And third, at least for Canada, this gap is mainly due to the MFP (multi-factor productivity). Many reasons have been given to explain this fact, but they all converge in the same directions: (1) low exchange rates combined with large trade surpluses have not encouraged firms to invest as much as they should have, and have led to poor economic decisions; (2) companies have lagged behind in implementing new technologies and investing capital, largely because of weak demand for innovation and insufficient pressure from competition; and (3) political authorities have not been sufficiently reactive in terms of research and development, innovation and education (Ibarra 2010; Ito 2010; Dion 2007; Fujii, Candaudap and Gaona 2005; Sharpe and Arsenault 2008).

One of the great objectives of Canada and Mexico was to use the US market as a springboard, and they both expected free trade to boost competitiveness. Both economies have opened outwards significantly as the share of trade in GDP increasing from 26 percent to 37 percent between the 1980s and 2000s in the case of Canada, and from 15 percent to 27 percent for Mexico. But, this opening has largely been due to integration trade with the United States and it has not spurred much growth as was expected. One should be cautious in this respect. It would be disingenuous to say that NAFTA did not produce dynamic effects. Quite the contrary, as evidenced by the very high ranking of Canada's Competitiveness Index of the World Economic Forum (10th) or, in the case of Mexico, the technological composition of exports, higher than that of Canada. Even though, the fact remains that both countries suffer from serious weaknesses in innovation and investment, with Mexico even receding on the scale of global competitiveness (66th in 2010). All in all, if a cause must be found for the difficulties faced by both countries in diversifying their trade, it lies in the shortcomings of both governments and businesses and not in NAFTA primarily.

This is indeed one of the great lessons to be learned from the experience of NAFTA. Trade liberalization offers windows of opportunity and in this sense, NAFTA, by creating an environment favorable to trade, has allowed Canada and Mexico to seize this opportunity, and turn North American to their advantage. Of course, we cannot compare Canada and Mexico, still an emerging country which, despite the reforms, still suffers from economic rigidities, structural weaknesses and severe inequalities. But it is also clear that in order to lead to results a policy of export-led growth must be supported by investments and endogenous growth policies which priori-

Table 5

Labour productivity, levels, growth rates and contribution to GDP growth

	Levels of GDP productivity 2008		GDP productivity growth rate		GDP growth	Contribution to GDP growth		
	per capita	per hour worked	per hour worked			Labour	Capital	Multi-factor productivity
	US dollars, current prices and PPPs, US = 100		1995–2000	2001–2008	1985–2008			
United States	100	100	2.38	1.96	2.89	0.94	0.86	1.09
Canada	83	78	2.26	0.72	2.65	1.19	1.10	0.37
Mexico	31	34	1.95	0.45	2.80	–	–	–
Chile	31	28	–	1.44	5.60	–	–	–
OECD	71	76	2.33	1.70	–	–	–	–

Source: OECD Factbook 2010: Economic, Environmental and Social Statistics.

tize innovation, research and education, without neglecting the domestic market (Zeda, Wise and Gallagher 2009).

Conclusion: time for a change?

NAFTA will turn twenty in 2013. It should be given credit for having significantly strengthened economic ties among Canada, the United States and Mexico and thus to have contributed to the revitalization of national economies. It is, however, far from having achieved all the objectives that the governments were aiming at when they signed the agreement. One can identify gaps and deficiencies in this integration model, especially in terms of economic and political convergence as well as in terms of inequalities, which remains a problem. One can also point to the limits of a trilateral cooperation that is far too circumscribed for adequate management of the agreement and to the fact that it triggered a proliferation of trade agreements that led to a messy international trading system. But the focus of this article is not so much to address these shortcomings of NAFTA as to emphasize the fact that while well adapted to the context of the 1990s, NAFTA is much less adapted to the reality of the 2000s. Is the NAFTA model running out of breath? One can readily answer ‘YES’.

To put it simply, there is a *before 2000* and an *after 2000*. The institutional model of NAFTA is now much less convincing than it was in the 1990s. As a model of integration, it is also weakened by changes in international economic trends. Both in Canada and Mexico, the stimulating effects of regional integration seem exhausted or, at least, insufficient to stimulate investment and productivity. Economic conditions have changed: neither Canada nor Mexico can now count on the US locomotive, let alone surf on a favorable exchange rate as before. In both Canada and Mexico, the dramatic drop in bilateral trade with the United States in 2009 was cause for concern. Although trade has indeed resumed vigorously in 2010, these worries remain. Fear, as they say, is the beginning of wisdom. Or at least, in these spreading concerns, the crisis should be credited for reminding us not only that competitiveness is built first at home, but also that regional integration cannot be reduced to a simple exercise in trade diplomacy. NAFTA is certainly out of breath and even outdated, but too many interests are at stake and the current challenges are too important to let things go astray (Schott 2008; Alexandroff, Hufbauer and Lucenti 2008). In this sense, the crisis offers an opportunity to redefine the framework of regional cooperation, and to rethink terms of integration that do not rely primarily on market forces, as it has been the case until now.

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