



NAFTA 20 YEARS LATER

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CONTENTS

INTRODUCTION	3
1 THE ERRORS OF CONSERVATIVES OBSCURE THE CASE FOR TRADE ADAM S. POSEN	4
2 NAFTA AT 20: MISLEADING CHARGES AND POSITIVE ACHIEVEMENTS GARY CLYDE HUFBAUER, AND CATHLEEN CIMINO, AND TYLER MORAN	6
3 A TALE OF TWO MEXICOS: GROWTH AND PROSPERITY IN A TWO-SPEED ECONOMY JAANA REMES	30
4 HOW US INVESTMENTS IN MEXICO HAVE INCREASED INVESTMENT AND JOBS AT HOME THEODORE H. MORAN AND LINDSAY OLDENSKI	37
5 THE ACCOMPLISHMENTS OF THE PACIFIC ALLIANCE BARBARA KOTSCHWAR	43
6 UPDATING NAFTA: IMPLICATIONS OF THE TRANS-PACIFIC AND TRANSATLANTIC PARTNERSHIPS JEFFREY J. SCHOTT	48
7 A VISION FOR NORTH AMERICAN ECONOMIC INTEGRATION THOMAS F. “MACK” McLARTY	52
8 CHALLENGES FROM NAFTA: A MEXICAN PERSPECTIVE AMBASSADOR EDUARDO MEDINA MORA	57

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INTRODUCTION

Twenty years ago, enactment of the North American Free Trade Agreement (NAFTA) among the United States, Mexico, and Canada dramatically advanced economic integration—and started a public debate running to today about the costs and benefits of trade agreements in the era of globalization. As the first major trade accord between two wealthy countries and a relatively poor country, NAFTA created enormous opportunities in all three economies while generating anxieties about job losses and other kinds of displacement. Despite the fact that both Mexico and the United States have clearly reaped great gains at the aggregate level from their more open trading and investment relationship, NAFTA is frequently invoked as a job-killing precedent by opponents of further US trade agreements with poorer countries. For example, the Trans-Pacific Partnership (TPP) currently being negotiated has been derided by some critics as “NAFTA on steroids.”

The Peterson Institute for International Economics was in the forefront among policy research organizations in objectively exploring the potential costs and benefits of NAFTA when it was first proposed, and the Institute has analyzed the actual impact of the trade deal at intervals in the years since. Earlier this year, the Institute convened an all-day conference with new research by Institute and outside scholars to assess the impact of NAFTA on Mexico and the United States after 20 years. In addition, the Institute’s president, Adam S. Posen, has summarized his own view of the impact, drawing on this research and current policy discussions. In this report, part of a new series of publications called PIIE Briefings, we gather a selection of recent writings by PIIE scholars on NAFTA. Included are some previously published papers and the transcript of the NAFTA conference, “[Building on the Benefits of NAFTA](#),” held at the Peterson Institute on July 15, 2014. The Institute is proud that these papers and presentations assess the tradeoffs and problems, as well as the benefits of NAFTA with our customary intellectual rigor, objectivity, and research-based conclusions.

This PIIE Briefing makes clear the benefits of economic growth for the participants in a robust trading relationship made possible by NAFTA. It also tries to capture the related but overlooked benefit of helping Mexico make the historic transition from what many said was a failed state in the 1970s and 1980s to a healthy multiparty political state with a thriving market-oriented system today. The costs of displacement to some workers on both sides of the border are real but significantly exaggerated in much public discussion. The analyses presented here of the reality of NAFTA provide evidence for the ability of both richer and poorer countries to have mutual benefit from deeper economic integration—in practice, not just in theory—although the United States can still do much more in its own enlightened self-interest to ease the adjustment of its own and partner countries in future trade deals.

THE ERRORS OF CONSERVATIVES OBSCURE THE CASE FOR TRADE

ADAM S. POSEN

Twenty years after Bill Clinton, former US president, signed the North American Free Trade Agreement (NAFTA), its very name chills the spines of US voters and congressmen alike. Even advocates of new regional trade agreements insist that they are not countenancing “another NAFTA.” Yet NAFTA-phobia is irrational. None of the terrible things that were, according to its opponents, supposed to result from its implementation have in fact occurred. Members of the free trade area—Canada, Mexico, and the United States—enjoy a large joint market and a common supply chain. Consumers in all three countries have gained.

It is true that America’s less-skilled workers have received an increasingly raw deal since the 1970s. But NAFTA is not to blame. To claim otherwise is at best to mistake coincidence for causation. At worst, it is a cynical tactic employed to protect special interests at the expense of the common good.

Econometric studies have established that when US companies invest abroad, the net result is increased employment, stronger demand, and more investment at home. This makes sense, since it should on average be the more competitive businesses that have the resources and opportunities to expand abroad, and investing should increase their productivity. This conclusion applies specifically to US companies that have invested in Mexico. Recent research has found that, on average, for every 100 jobs US manufacturers created in Mexican manufacturing, they added nearly 250 jobs at their larger US home operations and increased their US research and development spending by 3 percent.¹

At least until the 2008 financial crisis, US unemployment rates were much lower in the decades following NAFTA than before the agreement came into effect, even at a time when the US labor force was growing steadily. Doomsayers claimed that after NAFTA, US exports of corn and other agricultural products would lead to a surge of displaced Mexican farmers drifting northward. Yet US Border Patrol apprehensions from Mexico have been declining steadily since 2000, in line with most estimates of illegal immigration from Mexico to the United States (Hufbauer, Cimino and Moran 2014; [see page 6]). The current tragedy of minors from Central America crossing the southwestern border illustrates how desperation, not globalization, is what truly triggers migration.

True, there have been job losses as a result of competition from Mexican (and Canadian) exports. Some critics of NAFTA estimate these at an average of 45,000 a year over the past two decades. But out of a US workforce of 135 million workers—between 4 million and 6 million of whom leave or lose their jobs every month—

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1. See Lindsay Oldenski, “American Manufacturing Growth since NAFTA,” presentation at Peterson Institute for International Economics, July 24, 2014, www.piie.com/publications/papers/oldenski20140715ppt.pdf.

that is less than 0.1 percent of turnover. What about the 4 million or more other American workers who change jobs every month, many of whom are forced to do so through no fault of their own? It is unclear why someone who loses their job because digital photography replaces film, or because the taste for business-casual decreases demand for suits, or because an industrial plant moves from California to Texas, is any less deserving of support than someone who loses their job because assembly of computers and flat-screen televisions moves to Mexico. It is clear, though, that since such a tiny fraction of total labor force churn in the United States is due to NAFTA, that deal cannot be a significant cause of wage or employment conditions at home.

Many on the left in the United States nevertheless use international trade, and especially NAFTA, as a scapegoat for the weakening of labor rights and growing inequality. Others have tried to use trade legislation as a bargaining chip with which to secure concessions on extending the American welfare state—something that conservatives oppose.

For all their efforts, opponents of trade legislation have won only meagre adjustment funds for workers whose job loss is supposedly attributable to international trade. Pro-trade Democrats and Republicans alike have seen these as the minimum concessions required to secure consent for liberalization. But the result is that job losses attributable to trade are unjustifiably given an outsize significance in the public mind. Moreover, this relatively minor cause of unemployment has been demonized in a way that other job losses are not, even when they are involuntary.

This bogeyman-based approach to trade has failed both the progressive agenda and the US economy as a whole. America has ended up delaying or missing out on opportunities for trade expansion and thus income growth, while the welfare state continues to shrink.

In most countries, increases in openness to trade are associated with a more generous welfare state. In contrast, the United States has steadily cut back benefits and worker protections at both the federal and state level. This has nothing to do with international trade. It is the result of legislative majorities that favor a smaller role for the state. Even many Democrats have attacked forms of welfare.

Progressives should stop blocking or scapegoating trade and instead tackle the problems that contribute to voters' grievances head-on. NAFTA resulted in increased employment, higher productivity, and greater purchasing power for American consumers. This did not come at the expense of less-skilled American workers. Attacking NAFTA has done little to help progressives win elected office. Nor has it produced policies that would offer workers greater security. It is time to move on.

Reference

Hufbauer, Gary Clyde, Cathleen Cimino, and Tyler Moran. 2014. *NAFTA at 20: Misleading Charges and Positive Achievements*. Policy Brief 14-13 (May). Washington: Peterson Institute for International Economics.

NAFTA AT 20: MISLEADING CHARGES AND POSITIVE ACHIEVEMENTS

GARY CLYDE HUFBAUER, CATHLEEN CIMINO, AND TYLER MORAN

Twenty years after its enactment, the North American Free Trade Agreement (NAFTA) continues to divide Americans and cast a shadow over the US trade agenda. Opponents of the most recent free trade agreements with Colombia and South Korea repeatedly cited NAFTA as a malignant precedent, charging that NAFTA cost millions of US jobs, suppressed wages, and deepened US economic inequality, and claimed that new trade agreements would do the same. Today NAFTA is being invoked again in debates over Trade Promotion Authority (TPA), which would give President Obama latitude to negotiate new trade deals, specifically the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP) (see [Scott 2013](#) and [2014](#)). One critic of the TPP recently labeled it “NAFTA on steroids.”¹

In truth the claims on both sides of the NAFTA issue 20 years ago were overblown. Since the Mexican economy is less than one-tenth the size of the US economy, it is not plausible that trade integration could dramatically shape the giant US economy, even though integration could exert a substantial impact on the relatively small Mexican economy. But exaggeration and sound bites are the weapons of political battle, and trade agreements have been on the front line for two decades. President Bill Clinton, for example, declared that NAFTA would “create” 200,000 American jobs in its first two years and a million jobs in its first five years. Not to be outdone, NAFTA opponents Ross Perot and Pat Choate projected job losses of 5.9 million, driven by what Perot derided as a “giant sucking sound” emanating from Mexico that would swallow American jobs.² Both of these claims turned out to be overblown, especially the one advanced by Perot and Choate.

In recent debates, NAFTA seems to have had few vocal defenders. Yet because of the central role it continues to play in the US consciousness, this is an opportune moment to separate fact from fiction in the long-running disagreement over NAFTA. The purpose of this Policy Brief is not to rehash old claims that may have been overstated but to clear the air so that the benefits and challenges of trade can be examined in an objective light.

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1. Lori Wallach, “NAFTA on Steroids,” *Nation*, June 27, 2012, <http://www.thenation.com/article/168627/nafta-steroids#> (accessed on March 13, 2014).

2. The contemporaneous debate is summarized in [Hufbauer and Schott \(2005\)](#).

NAFTA took effect on January 1, 1994, alongside the previously negotiated Canada-US Free Trade Agreement (CUSFTA). NAFTA committed the United States and Mexico to eliminate all US and Mexican tariffs over a ten-year period, except on a handful of agricultural exports that were to be phased out over 15 years. The accord also aimed to lower cross-border barriers to services and investments while setting standards for patents, trademarks, and other forms of intellectual property rights. One reason that NAFTA remains controversial is that, for the United States, which had previously embraced a series of global trade accords after the Second World War, NAFTA marked the first major trade deal with a poor country, namely Mexico.

The NAFTA partners encountered rough waters in the pact's inaugural year, and enduring perceptions of NAFTA were adversely shaped by three Mexican shocks. First, on January 1, 1994, the Zapatista rebellion erupted in the southern Mexican state of Chiapas. While the rebellion had little direct connection to NAFTA provisions, it was deliberately timed with the pact's entry. One of the rebels' many grievances was opposition to NAFTA for providing a "symbolic manifestation of the huge attention the Mexican government paid to the modern northern states and the neglect of the historically poor southern states" (Hufbauer and Schott 2005, 10). On March 23, 1994, the Chiapas uprising was followed by the assassination of presidential candidate Luis Donaldo Colosio, the heir apparent to then Mexican President Carlos Salinas. The culprits were never identified, and the assassination triggered alarms in the investor community. Finally and most damaging came the abrupt and progressively more severe devaluation of the Mexican peso, initially on December 20, 1994. The peso crisis followed the huge buildup of debt, denominated in US dollars, issued both by the Mexican government and Mexican firms, to finance a widening current account deficit. Beginning in the spring of 1994, investors began fleeing Mexico, depleting the Banco de Mexico's holdings of foreign exchange, as the central bank attempted to defend the peso's fixed rate to the dollar. When the peg was finally abandoned in December 1994, the steep devaluation of the peso led to a collapse of imports and a surge of Mexican exports. For many NAFTA critics, the "temporal connection between NAFTA ratification and Mexico's economic collapse was too powerful to be mere coincidence" (Hufbauer and Schott 2005, 9). While bad policy choices in preceding years had set the stage for the financial crisis, NAFTA was blamed for inadequate monitoring of Mexico's macroeconomic policies. While this criticism had some merit, NAFTA also played a decisive role in the recovery of the Mexican economy, both by fostering a large financial rescue package and by enabling a sharp turnaround in Mexico's external trade balance.³

Despite NAFTA's inauspicious launch and subsequent charges made against it, the agreement can be credited with making important strides toward intraregional integration and higher living standards in all three countries. The interdependence of the United States, Canada, and Mexico is striking. For example, goods imported from Canada are estimated to contain 25 percent of US inputs and from Mexico, 40 percent of US inputs (Koopman, Powers, Wang, and Wei 2010). In 2013, about 14 percent of US merchandise exports went to Mexico, exceeding the combined total of merchandise exports to Germany, France, the United Kingdom, and the Netherlands. Since 1993, US trade with Mexico quintupled in nominal terms, whereas trade with the rest of the world increased three times. NAFTA promoted the integration of the regional energy market—particularly between the United States and Canada—which somewhat mitigated US reliance on imports from sources across the Atlantic, while encouraging greater energy independence within the region.⁴

3. For a longer discussion, see Hufbauer and Schott (2005, 8–12).

4. The US shale revolution could well convert the United States into a net exporter in the coming decade, thereby altering the traditional dynamic of intraregional energy trade. Partial privatization of oil and gas production in Mexico might also release substantial new supplies. The combination of shale energy and Mexican liberalization could rapidly bolster the prospects of physical energy independence in North America.

Many US jobs depend on exports—an estimated 2.6 million on exports to Canada and 1.9 million on exports to Mexico.⁵ Following the approval of NAFTA, Mexico went into a financial crisis that discredited its policies in the eyes of many. But the mid and late 1990s were a period of boom times in the United States, and fears that NAFTA would cause a surge of unemployment subsided. Indeed almost 17 million jobs were added to the US economy in the seven years following enactment of NAFTA, and the unemployment rate dropped from 6.9 to 4.0 percent.

On the other hand, the last two decades have seen growing inequality in the United States and concerns that low-skilled jobs have been hollowed out both by advances in technology and the signing of trade agreements. Inevitably, in the 2000s, NAFTA again became a proxy for fear over job losses. But concerns about jobs during the initial NAFTA debate were badly distorted, and misstatements then are repeated today. It is widely understood that an expansion of two-way trade will shuffle jobs between sectors of the economy: Import-competing sectors will lose some jobs and export-oriented sectors will gain some. Yet most economists took the view that the *net number* of jobs gained or lost owing to NAFTA would be statistically insignificant in a US labor force that then numbered 110 million. In their analysis, [Hufbauer and Schott \(1993\)](#) calculated that the agreement could create 170,000 net US jobs “in the foreseeable future.” Advocates of NAFTA, including those at the Peterson Institute for International Economics, argued that the main payoff from NAFTA would be *better* jobs, not more jobs, as the US and Mexican economies were restructured according to the law of comparative advantage. But what economists had to say was lost in the political din of the 1990s and is often ignored in the contemporary debate over TPP and TTIP.

Economic analysis of the channels by which trade agreements potentially lead to higher national output has made significant advances since the 1990s,⁶ as has the understanding of the costs of job churn that inevitably accompanies economic restructuring in the wake of trade liberalization.⁷ (Churn refers to the phenomenon of large numbers of workers losing and gaining jobs over a fixed period.) Yet the US political rhetoric surrounding trade agreements essentially channels the NAFTA debate of two decades ago. Proponents claim job gains and higher living standards; opponents claim job losses, lower wages, and corporate enrichment.

No proponent argues that North America entered a golden age after NAFTA. But critics are wrong when they blame NAFTA for ills that should not be laid at the agreement’s doorstep and wrong when they dismiss the genuine achievements of the tripartite pact.⁸ In this Policy Brief, we first answer six charges voiced by NAFTA critics and then sketch the positive case. The six central charges and our short responses are:

- NAFTA fostered a growing US trade deficit.
 - Short response: Not perceptible.
- Trade with Mexico raised US unemployment.
 - Short response: Not perceptible.
- Job loss depressed US wages, especially in manufacturing.
 - Short response: In some cases, but not across the board.
- The boom in US agricultural exports turned rural Mexicans into illegal emigrants.
 - Short response: No connection.

5. The job estimates assume a coefficient of 7,500 direct and indirect jobs per billion dollars of exports. US exports to Canada in 2013 were \$366 billion, and US exports to Mexico were \$256 billion. The jobs coefficient is derived from the input-output analysis reported in table 2 of [Lawrence \(2014\)](#). Direct export jobs are approximately 5,100 per billion dollars of exports, and indirect jobs are another 2,400.

6. For a survey of the multiple payoff channels to the United States, see [Bradford, Grieco, and Hufbauer \(2005\)](#). For a summary of the payoff channels from foreign direct investment to a developing country host economy, see [Moran \(2011\)](#).

7. [Lawrence \(2014\)](#) summarizes the literature on job churn.

8. For examples of ills laid at NAFTA’s doorstep, see [Public Citizen’s Global Trade Watch \(2014\)](#).

- Apart from agriculture, NAFTA abetted illegal immigration.
 - Short response: The opposite.
- Mexican growth has not achieved the rate anticipated by NAFTA proponents.
 - Short response: A fair criticism.

While dubious at best, these charges have been repeated so often that they have congealed into conventional wisdom and are parroted even by mainstream journalists.⁹ Before addressing the charges, it's worth emphasizing that they are all directed at the US-Mexican experience. Yet NAFTA is a tripartite pact, and hardly anyone criticizes the US-Canada experience. In fact two-way trade and investment outcomes across the northern US border have been strong and almost uniformly positive.

US Trade Deficit with Mexico

Larger US trade deficits are often cited by critics of NAFTA and other trade agreements as a sure consequence of these pacts and an unhealthy outcome for the United States. Political leaders frequently decry trade deficits, arguing that exports support jobs at home whereas imports substitute for products that could be produced by American workers. These broadside attacks against trade deficits are misguided. Bilateral US trade deficits are not necessarily bad. In a world of multilateral trade, even if the United States achieved overall balance in its external accounts, US trade would not be in balance with each country. For example, the United States might be in deficit with Mexico but in surplus with Canada.

Those who measure the “success” of preferential trade negotiations in terms of the consequent *bilateral trade balances* among the participants overlook the fact that it is logically impossible for all members of a preferential trade agreement to end up with bilateral trade surpluses as a result. This observation pertains just as much to the upcoming TPP and TTIP negotiations as to NAFTA. It is possible that some members of a preferential trade agreement will improve their *global trade balances* after the completion of an agreement, but it will be because of two distinctive factors: first, increased efficiency in the use of resources and second, changes in the relationship between income and expenditure in the partner state.

As explained in the [appendix](#) to this Policy Brief, the United States is bound to run an overall trade deficit with the rest of the world when combined US savings of the household, business, and government sectors are negative, as they have been for some years. To finance the trade deficit, the United States is obliged to borrow from the rest of the world. In such circumstances, a global US trade deficit is inevitable. At best, trade agreements exert a second-order impact, possibly changing the pattern of bilateral surpluses and deficits but exerting a marginal impact on the size of the global trade deficit.

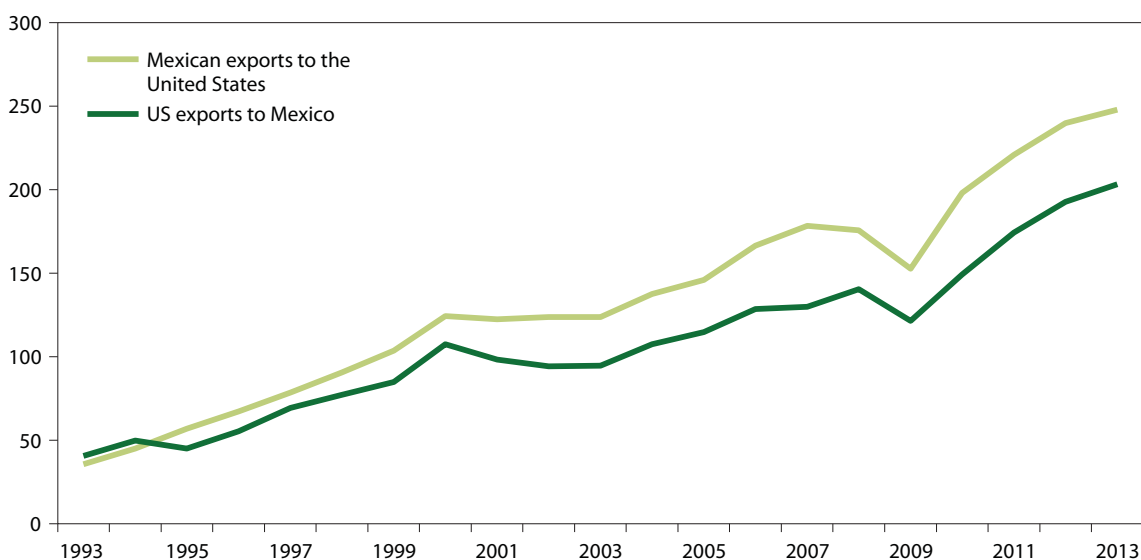
With these precepts in mind, a look at US two-way trade, and the trade deficit with Mexico since NAFTA was agreed in 1993, may be instructive. Our analysis excludes petroleum and natural gas trade from the picture for the simple but powerful reason that if the United States did not import petroleum and gas from Mexico and Canada, it would import fuels at higher cost from other countries. [Figure 1](#) charts US exports of goods and services to Mexico, and Mexican exports to the United States, excluding fuel in both directions. Two-way trade has expanded enormously, by a factor of five in current dollars. Just as the critics say, the US bilateral trade deficit with Mexico has also grown, going from a surplus of \$5 billion in 1994 to a deficit of \$45 billion in 2013.¹⁰ But this was not because of a “giveaway” deal by US trade negotiators. As [appendix table A.1](#) shows,

9. See, for example, Christopher Caldwell, “Popular sentiment is hardening against free trade,” *Financial Times*, February 28, 2014, http://www.ft.com/intl/cms/s/0/a538be0a-9ee9-11e3-8663-00144feab7de.html#_axzz2vjckoiimC (accessed on March 3, 2014).

10. Trade data from the World Bank's World Integrated Trade Solutions (WITS) database. Adjusted for inflation, two-way trade grew by a factor of three between 1994 and 2013. The 1994 US bilateral surplus with Mexico was largely illusory because, in that year, Mexico was running an unsustainable current account deficit with the world.

Figure 1 US-Mexico bilateral merchandise trade (nonfuel), 1993–2013

billions of current US dollars



Note: Mexican exports to the United States are based on US import data. Nonfuel merchandise trade based on Standard International Trade Classification (SITC) codes minus SITC 3 (mineral fuels/lubricants).

Source: World Bank's World Integrated Trade Solutions (WITS) database, <https://wits.worldbank.org/>.

at the time NAFTA was launched, the average US tariff on imports from Mexico was 4.3 percent, while the average Mexican tariff on imports from the United States was 12.4 percent. Since both tariff averages went to zero fairly quickly, the country “giving away,” measured by tariff concessions, was Mexico, not the United States.

The main reason for the growing US bilateral trade deficit with Mexico over two decades was the growing imbalance between income and spending within the United States. Reflecting this widening imbalance, between 1994 and 2013, the US nonpetroleum goods deficit with the world expanded from \$120 billion to \$510 billion.¹¹ The global enlargement of the trade deficit is not an outcome of NAFTA or other free trade agreements, as the [appendix](#) clearly shows. Rather, it reflects the fact that the United States gradually altered its status from small net borrower to huge net borrower driven largely by rising federal budget deficits and falling household savings. Moreover, the Mexican share of the 2013 global US goods deficit, about 9 percent (\$45 billion versus \$510 billion), was much smaller than the Mexican share of US nonpetroleum merchandise imports, about 13 percent (\$248 billion versus \$1,939 billion).

As mentioned, when NAFTA was launched, the average Mexican tariff was much higher than the average US tariff: 12.4 percent versus 4.3 percent.¹² In 1993, Mexican nonpetroleum exports to the United States were \$39 billion, and US nonpetroleum exports to Mexico were \$41 billion. Applying a simple trade-elasticity approach, and assuming an elasticity of 3.0 (a high value), eliminating these average tariffs would suggest an increase of \$5 billion in Mexican exports to the United States and an increase of \$14 billion in US exports to Mexico. Such calculations made it seem likely, in the view of some analysts, that US exports to Mexico would expand much more than Mexican exports to the United States. Nonetheless, the opposite happened, but for reasons that had little to do with the warnings of critics. The main reasons were Mexico's newfound openness to investment, much-improved access to US parts and components (owing to lower tariffs), and regulatory reforms.

11. The 2013 figure is based on the first three quarters of 2013 (US Bureau of Economic Analysis).

12. Tariff figures from the UN Conference on Trade and Development Trade Analysis and Information System (UNCTAD TRAINS) database.

Just as NAFTA was being implemented, in late 1994, Mexico was decimated by the unforeseen peso crisis (devaluing the peso from 3.97 to the dollar in December 1994 to 7.76 to the dollar in December 1995). The peso crisis erupted because the Mexican government and firms, in the preceding two years, had imprudently issued tens of billions of debt effectively denominated in US dollars.¹³ Seeing an unsustainable situation, Mexican and foreign investors alike headed for the exits during the spring and summer of 1994, depleting the central bank's holdings of foreign exchange as it tried to maintain a fixed rate between the peso and the dollar. When the central bank abandoned the exchange rate peg, the sudden peso devaluation led to a collapse of imports and a rise of exports. Mexicans could no longer afford American shopping trips to San Diego and, facing a depressed home market, Mexican firms did their best to sell into the US market. The nonpetroleum US bilateral trade surplus of \$5 billion in 1994 turned into a deficit of \$12 billion in 1995.

To its credit, the Mexican government responded to the crisis by cutting regulations that prevented foreign investors from coming into the country, accelerating a trend that had started earlier. Mexico laid out the welcome mat for foreign investors of all nationalities, rather than just its NAFTA partners. Foreign companies (led by US auto firms) expanded their plants in Mexico, integrating them with all of North America. The outcome was a sustained burst in Mexican exports, enlarging the nonpetroleum US bilateral trade deficit from \$12 billion in 1995 to \$45 billion in 2013.

What if NAFTA had never been agreed? Would the US trade deficit with the world be \$45 billion lower in 2013? Most unlikely. Viewing the no-NAFTA scenario from a macroeconomic perspective, a lower deficit with Mexico would have been like squeezing a balloon—most of the deficit would have popped out someplace else, because US expenditures would still have exceeded US earnings by ever larger amounts during the late 1990s and 2000s. Viewing the no-NAFTA scenario from a microeconomic perspective, US and foreign companies, in search of lower costs for their worldwide supply chains, would probably have opened additional plants elsewhere in Latin America and Asia.

To conclude, it may well be true—thanks initially to the peso crisis and over a longer period to Mexican reforms—that NAFTA fostered a larger bilateral trade deficit *with Mexico*. But it is not true that NAFTA fostered an equally larger US trade deficit *with the world*.

Trade with Mexico and US Unemployment

With or without trade, over 4 million Americans are separated involuntarily from their jobs each year by plant shutdowns and mass layoffs, even when the United States is adding overall jobs to the national payroll. But only a small fraction of the jobs lost are caused by imports in general or imports from Mexico. Growing US trade with Mexico (and with the world) clearly contributes to churn in the US job market, but trade is hardly the sole explanation. About 5 percent of this job churn (around 200,000 workers annually) can be explained by rising trade with Mexico (discussed below). Two-way trade expands some industries and shrinks others; this is the real-life face of comparative advantage. Within industries, growing trade downsizes less efficient firms and upsizes more efficient firms; this is the real-life face of the “sifting and sorting” phenomenon better understood since NAFTA was ratified (see [Bernard, Jensen, and Schott 2003](#)). Empirical evidence demonstrates that comparative advantage and sifting and sorting are exactly what happen when two-way trade grows. The inevitable outcome is that some Americans lose their jobs, identifiably because of increased imports, while other Americans gain new or better jobs, far less identifiably but because of increased exports.

Identifiable job losses are the stock-in-trade of NAFTA critics. At the Economic Policy Institute, [Scott \(2011\)](#) estimates that between 1994 and 2010 nearly 683,000 US jobs were lost due to US trade deficits with Mexico (about 40,200 jobs per year). His estimates of the net employment impact of NAFTA use direct and

13. Mexican government short-term debt, called *tesobonos*, contained an exchange rate guarantee clause that linked the debt to the US dollar. Mexican firms simply borrowed in dollars.

indirect labor requirements of producing output in a given industry and assume that industry trade deficits displace domestic production (and thus labor), dollar-for-dollar. Other accounts are more anecdotal. In 1997, Public Citizen interviewed more than 60 US companies and found that just three years after NAFTA, 90 percent of the promises made by pro-NAFTA companies to create domestic jobs or expand exports were not fulfilled, citing General Electric, Johnson & Johnson, Siemens, and Xerox, among others that laid off workers or shut down facilities and shifted production to Mexico.¹⁴ Public Citizen (2014) also points to tangible job losses based on the number of workers receiving Trade Adjustment Assistance (TAA), reporting that more than 845,000 workers were certified for TAA based on jobs lost to imports from Canada and Mexico or relocated factories between 1994 and 2013, on average about 44,500 per year.

Moreover, the general perception that job losses are associated with free trade agreements remains strong. A 2010 survey conducted by the Pew Research Center on the public view of FTAs, including NAFTA, found that 55 percent of respondents held the view that FTAs lead to US job losses, while only 8 percent view trade pacts as supporting job creation (24 percent said FTAs make no difference).¹⁵ Public perceptions mirror the observation that jobs supported by exports are often invisible and forgotten.

Job displacement is painful for the losers, but it pays off enormously for Americans as a whole. According to calculations by Robert Z. Lawrence, looking just at US trade with China over the last decade, for every net manufacturing job lost to trade with China (taking into account both jobs displaced by imports and jobs supported by exports), the US economy gained about \$900,000 in 2008. The gains reflect enhanced productivity, a broader range of goods and services, and lower prices at the checkout counter for households.¹⁶ The arithmetic of national gains relative to net jobs lost would be roughly similar for US trade with Mexico: several hundred thousand dollars of gains to the economy for every net manufacturing job lost.

However, for individual workers facing import competition, what counts most is “jobs displaced,” not “net jobs lost.” Between 1994 and 2013, US imports from Mexico (many of them parts and components used in American plants) expanded from \$48 billion to \$302 billion.¹⁷ In recent years (2009 through 2013), the expansion has averaged about \$27 billion annually. The direct and indirect US labor equivalent of every billion dollars of imports is currently about 7,500 workers.¹⁸ What these numbers imply is that in recent years additional imports from Mexico displaced about 203,000 jobs that are lost annually to the churn. These are painful numbers for displaced workers. However, in the overall picture of involuntary job churn, the contribution of Mexican imports is small. From the beginning of 2009 to the end of 2011, about 13 million workers were “dislocated” (meaning the victims of mass layoffs), indicating an annual dislocation of about 4 million workers—mainly because of technological and competitive forces *within* the giant US economy.¹⁹ At most, 5 percent of dislocated workers can be traced to imports from Mexico. Moreover, the churn number associated with imports from Mexico, about 203,000 jobs displaced annually, is much larger than the “lost jobs” number

14. “NAFTA’s Broken Promises: Failure to Create U.S. Jobs,” Public Citizen’s Global Trade Watch, January 1997, http://www.citizen.org/trade/article_redirect.cfm?ID=1767 (accessed on April 2, 2014).

15. “Public Support for Increased Trade, Except with South Korea and China: Fewer See Benefits from Free Trade Agreements,” Pew Research Center, November 9, 2010, <http://www.people-press.org/2010/11/09/public-support-for-increased-trade-except-with-south-korea-and-china/> (accessed on April 2, 2014). Similarly, 45 percent have the view that FTAs lower wages in the United States, while 8 percent view FTAs as increasing wages.

16. The \$900,000 figure is based on estimated gains to the US economy from Chinese manufacturing imports of 0.6 percent of US GDP in 2008, which works out to \$88 billion, or about \$250 per US citizen. See Lawrence (2014). A full explanation of the channels by which increased two-way trade delivers gains to the US economy can be found in Bradford, Grieco, and Hufbauer (2005).

17. Trade figures from the US Bureau of Economic Analysis.

18. The figures are derived from US manufacturing imports and their direct and indirect US employment equivalent (total jobs) in 2012; see table 2 in Lawrence (2014).

19. US Bureau of Labor Statistics, “Worker Displacement: 2009–2011,” news release, <http://www.bls.gov/news.release/pdf/disp.pdf> (accessed on March 7, 2014).

calculated either from trade deficits or TAA certifications (about 45,000 jobs lost annually). The reason is that many displaced workers land another job within a short period of time.

But focusing on jobs lost through imports is only half the story. It is important not to forget the export side of the job equation. As the Pew surveys on public perception of FTA effects on jobs seem to confirm, American workers who owe their jobs to rising exports are usually oblivious to their dependence on foreign sales (in sharp contrast to workers who lose their jobs to rising imports). Based on the increase in US exports to Mexico, averaging \$25 billion annually between 2009 and 2013, about 188,000 new US jobs were supported each year by additional sales to Mexico. The figure is almost as large as the jobs lost, but the jobs gained in other sectors pay better. On average, the export-related jobs pay 7 to 15 percent more than the lost import-competing jobs.²⁰ The wage differential, while positive, is only part of overall US gains from trade with Mexico. In recent years, net US jobs lost on account of two-way trade with Mexico have averaged about 15,000 annually (203,000 jobs displaced by imports minus 188,000 jobs supported by imports). Lawrence's calculations, cited earlier, suggest that gains to the US economy average several hundred thousand dollars per net job lost.

Amidst the arithmetic of jobs lost and gained, it should not be forgotten that a large portion of two-way trade among the NAFTA economies represents imported intermediates that raise the competitiveness of US firms, enabling them to improve their export profile in world markets. In other words, imports benefit not just US consumers but also US firms that can acquire just the right intermediate components at the right price.

The uneven impact of gains and losses from trade liberalization has been partially addressed by public policy at least since the 1960s when the TAA was introduced. TAA offers assistance (e.g., extra unemployment insurance, training benefits, etc.) for workers who are displaced by imports.²¹ The share of displaced workers certified as eligible for TAA is relatively small compared to the total number of displaced workers in the overall economy: In 2011, only 104,000 workers were certified for TAA, out of 4.3 million workers displaced for all reasons (Lawrence 2014). Even though the costs per TAA participant remain relatively low, namely \$3,600 in 2011 and \$6,500 in 2012, the program is frequently attacked in Congress, especially by Republican members, who argue that the United States should not support an "entitlement program" aimed at sustaining and training workers who lose their jobs to import competition.

A separate issue relates not to jobs lost or gained but to the overall unemployment rate. Critics claim that larger trade deficits add to the unemployment rate. In a hypothetical economy where everything else is held equal (*ceteris paribus*, in economists' jargon), this is true. But historically everything else is not held equal, and *rising* trade deficits are usually associated with *falling* unemployment. Figure 2 charts the *inverse* correspondence between the US unemployment rate, expressed as a percent of the labor force, and the US global trade deficit, expressed in billions of US dollars. As the figure shows, almost without exception, when the trade deficit *rises*, the unemployment rate *falls*. Over the past 30 years, periods of high import growth in the United States have usually been associated with tight labor markets and fast economic growth, rather than weak labor markets and a slack economy.²²

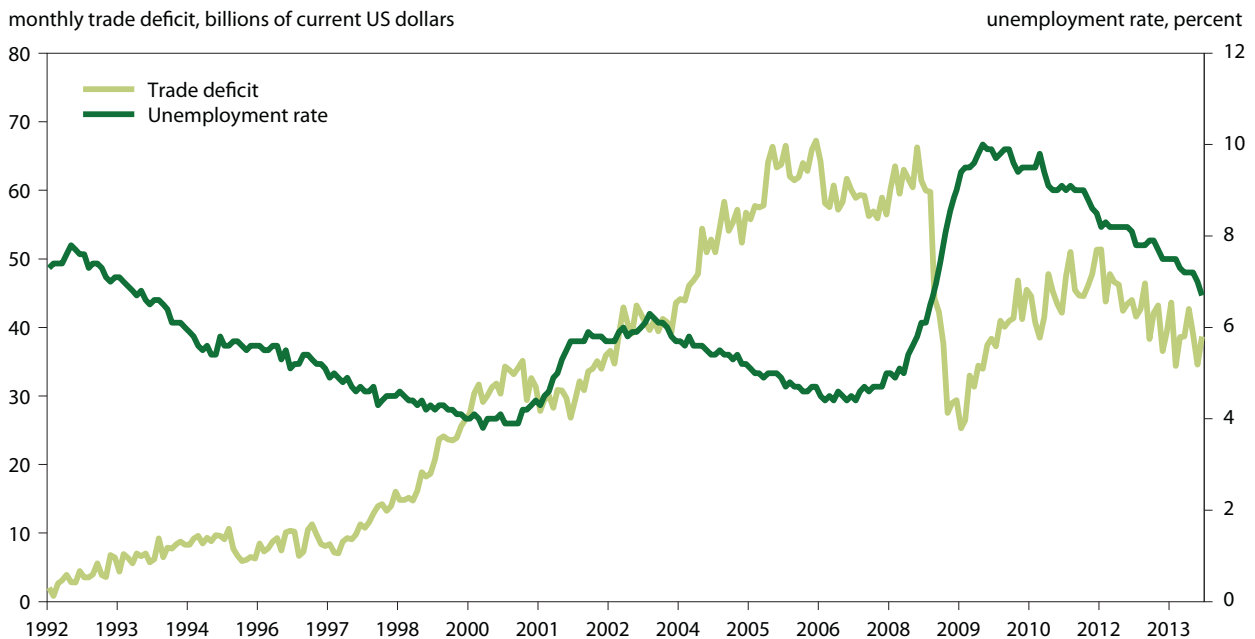
History is full of examples of a country at virtually full employment yet running a trade deficit. The United States enjoyed full employment in the late 1990s (unemployment below 4 percent), despite a surge in imports led by Mexico. The US economy reached close to full employment in 2007 despite rapidly rising imports from China and a large bilateral and multilateral trade deficit. History is also full of examples of a country with serious (if disguised) unemployment without a trade deficit (the last two decades in Mexico and China).

20. Richardson (2005) estimates that export jobs generally pay wages 10 to 11 percent higher and that US multinational firms pay 7 to 15 percent higher than firms that are not globally engaged.

21. To receive TAA benefits, a group of workers must petition the US Department of Labor and prove that international competition was the cause of their job loss.

22. Edwards and Lawrence (2013) emphasize the general disjunction between trade deficits and unemployment.

Figure 2 US trade deficit and unemployment rate, 1992–2013



Source: Federal Reserve Bank of St. Louis, <http://research.stlouisfed.org/>.

Thus the connection claimed by NAFTA critics between larger trade deficits and higher unemployment is seldom observed in real life.²³ But this is not to deny that an appropriate policy measure that boosts exports at times of high US unemployment, without cutting investment or government spending, could both reduce the trade deficit and lower the unemployment rate. The policy toolkit contains few such measures, but a sharp realignment of exchange rates is one candidate.²⁴ Repealing NAFTA or any other trade agreement is not a plausible answer to excessive trade deficits, for the simple reason that US exports would surely drop as much as US imports, if not more.²⁵

US Manufacturing Wages

A powerful charge leveled by NAFTA critics is that trade with Mexico has enabled US firms to hold back wage gains and even cut wages. Their argument is straightforward. The current average manufacturing wage is \$4.50 per hour in Mexico, against \$19.50 in the United States.²⁶ Taking advantage of the wage difference, firms shift work to Mexico and build new plants there. This puts pressure on US wages, directly through layoffs and

23. For examples of the misleading link between trade deficits and unemployment, see David E. Bonior, “Obama’s Free-Trade Conundrum,” *New York Times*, January 29, 2014, http://www.nytimes.com/2014/01/30/opinion/obamas-free-trade-conundrum.html?_r=0 (accessed on March 3, 2014); and Robert E. Scott, “NAFTA’s Legacy: Growing U.S. Trade Deficits Cost 682,900 Jobs,” December 17, 2013, <http://www.epi.org/publication/nafta-legacy-growing-us-trade-deficits-cost-682900-jobs/> (accessed on March 13, 2014).

24. See Bergsten and Gagnon (2012). Other plausible candidates are tax preferences that favor production for export markets and official support of export finance through the Export-Import Bank.

25. Moreover, in the view of Theodore Moran (communication to the authors), the argument that the United States should try to eliminate the trade deficit via tougher trade negotiations or firmer market access demands vis-à-vis its trade partners so as to increase US employment reflects faulty analysis.

26. The cited figures are from the US Bureau of Labor Statistics. The Bank of America reports a figure of \$2.50 per hour for the Mexican manufacturing wage, but possibly that figure excludes extensive fringe benefits.

indirectly when firms threaten to close down in the United States and open in Mexico, unless workers accept a lower pay packet.

Exhibit A for wage criticism is the US auto industry. Because this industry and its links with Mexico and Canada are iconic symbols, we trace important developments since NAFTA in box 1.

Box 1 Hard times in the US auto sector?

Table B.1 shows the total auto trade of the three NAFTA countries with the world in current US dollars. While US auto trade clearly expanded over 20 years, the direction of trade remained relatively constant, with US imports roughly double US exports in both 1993 and 2013. Of the three countries, Mexico saw the greatest growth by far in its global two-way auto trade, expanding more than 11 times since 1993, in current dollars. By comparison, in current dollars, two-way auto trade doubled in the case of Canada and nearly tripled for the United States. (Between 1993 and 2013, the US personal consumption expenditures [PCE] price index increased by 46 percent, so the nominal figures need to be deflated by that amount to calculate real growth in auto trade.)

Table B.1 North American auto trade with the world (billions of current US dollars)^a

	1993		2013	
	Imports	Exports	Imports	Exports
Canada	25	35	69	58
Mexico	2	7	32	70
United States	85	40	249	118

a. Includes all road vehicle trade and parts thereof. Between 1993 and 2013, the US personal consumption expenditures price index increased by 46 percent.

Source: World Bank, World Integrated Trade Solutions (WITS) database.

The labor picture in the auto industry (parts plus assembly) among the NAFTA partners changed dramatically, as shown in table B.2. US employment of autoworkers fell by nearly a third between 1994 and 2013, while Canada experienced a 10 percent decline. By contrast, Mexico enjoyed a massive expansion of auto employment. Should the total decline of US auto employment be laid at the doorstep of NAFTA? Probably not. According to the US Bureau of Economic Analysis,¹ total value added by the vehicle manufacturing industry (parts and assembly) was slightly higher in 2012 than in 1993, after accounting for inflation. Correspondingly, over this period, real value added per worker increased by 41 percent (since the auto labor force dropped by 28 percent).

1. US Bureau of Economic Analysis (BEA), GDP by Industry data, http://www.bea.gov/industry/gdpbyind_data.htm.

Table B.2 Persons employed in the auto manufacturing sector, parts and assembly (thousands)

	United States	Mexico	Canada ^a
1994	1,168	122	128
2013	820	552	115

a. 2012 data is the latest available for Canada.

Sources: US Bureau of Labor Statistics, Statistics Canada, and Instituto Nacional de Estadística y Geografía (INEGI).

The increase in labor efficiency, driven largely by advanced manufacturing technology, was not accompanied by a comparable increase in real US wages, as shown in table B.3.² Worker compensation (wages plus fringe benefits) increased by about 19 percent between 1994 and 2012, only 1 percent a year. At \$37 per hour in 2012, average compensation in the auto industry was slightly higher than average compensation in all manufacturing, about \$36 per hour in 2012.

Table B.3 Real hourly compensation cost per hour for motor vehicles, trailers, and semi-trailers (2012 US dollars per hour)¹

Country	1994	2012
Canada ²	24.45	36.59
Mexico	4.84	7.79
United States	31.54	37.38

1. Compensation costs include direct pay, social insurance expenditures, and labor-related taxes. The figures are adjusted for inflation by the chain-type personal consumption expenditures (PCE) price index of the US Bureau of Economic Analysis.

2. Canadian 2012 data for ISIC 29 not available. Figures estimated using the Canadian compensation cost for all manufacturers.

Note: For 2012, the industry is defined as ISIC 29 and for 1994 it is defined as SIC 371. Includes the manufacture of motor vehicles for passengers or freight, parts and accessories, and trailers.

Sources: US Bureau of Labor Statistics, International Labor Comparisons, 2013, <http://www.bls.gov/fls/ichccindustry.htm#29/>; and Hourly Compensation Costs for Production Workers in Manufacturing, 2006, <http://www.bls.gov/fls/flshcindsic.htm>.

2. Adjusted for inflation by the chain-type PCE price index of the US BEA. It is important to note that the apparent Canadian wage increases were largely driven by appreciation of the Canadian dollar.

(box continues)

Box 1 Hard times in the US auto sector? (continued)

Data from the US Bureau of Labor Statistics show that unit labor costs fell by some 40 percent in vehicle assembly and parts manufacturing over the past two decades.³ NAFTA critics claim that the trade pact accounts for a large part of the disparity between productivity gains and wage gains. But another reason for this disparity is that the density of union membership in auto manufacturing fell over time. Table B.4 shows the clear downward trend since the 1980s, but it does not appear that the trend accelerated following the signing of NAFTA. The shift of US industry to the southern states was a major factor in declining union density, since those states are generally less friendly towards unions. In 1984, the southeastern states were responsible for just 11 percent of US automobile and parts production, a share that reached 26 percent in 2011.⁴ Yet a third reason for the slow pace of wage growth in the auto industry was the bankruptcy, or near bankruptcy, of many auto firms in the Great Recession of 2008–09.

Table B.4 Union density in US auto manufacturing¹

	1983	1994	2004	2013
Percent of workers unionized	58.8	44.4	29.4	18.2

1. Includes parts and assembly.

Source: Union Membership and Coverage Database from the Current Population Survey, <http://www.unionstats.com>.

3. US Bureau of Labor Statistics, Labor Productivity and Related Data, Division of Industry Productivity Studies, March 2014, <http://www.bls.gov/lpc/#tables>.

4. See US Bureau of Economic Analysis (BEA), Regional Data. Figures based on SIC code 95000 for 1984 and NAICS code 95000 for 2011. As defined by the BEA, the southeast region of the United States includes: Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, South Carolina, Tennessee, Virginia, and West Virginia.

Most NAFTA critics acknowledge that the world is more complex than suggested by a simple comparison of Mexican and US wages. Many factors come into play when considering whether competition from Mexico creates measurable downward pressure on US wages. High worker productivity, ready access to needed inputs, reliable power, and an honest business environment all offset low Mexican hourly wages as reasons to produce in the United States.

Scholars have attempted to sort out the balance between competition from low-wage countries, such as Mexico, and other factors that determine wage levels in the United States. A powerful analytical construct, the Stolper-Samuelson theorem, demonstrates that if “other factors” can be ignored—most importantly, technology differences between countries—and if wage changes ripple across the labor market just like interest rate changes ripple across the bond market, then import competition from low-wage countries will depress average US wage levels (see [Stolper and Samuelson 1941](#)). In reality neither assumption truly holds. The empirical question is whether the assumptions underlying Stolper-Samuelson are close enough to reality to generate the predicted outcome.

What does empirical research show? A recent study by [Autor et al. \(2013\)](#) found that increased US imports from China between 1992 and 2007 did exert a modest negative effect on US wages in manufacturing, reducing average earnings in affected industries by roughly 3 percent from the base-year level.²⁷ By contrast,

27. In other words, if base-year manufacturing wages in an affected industry were \$45,000 in 1992, manufactured imports from China would reduce the base year wages by \$1,350.

increased imports from Mexico and Central American countries had no significant effect on US wages in the manufacturing sector. This is true even though the United States has engaged in substantial trade liberalization with its Mexican and Central American trading partners and despite the fact that in 2007 imports from Mexico and Central America (\$233 billion) totaled over two-thirds that of imports from China (\$340 billion). Possibly the main reason the wage impact between Chinese and Mexican imports differs is that US trade with Mexico is roughly balanced and has a large intraindustry component (e.g., autos and parts shipped in both directions), whereas US trade with China is highly unbalanced and entails very large US imports of consumer goods in exchange for much smaller US exports of capital goods. Because of these features, US imports from Mexico compel considerably less job churn *between* industrial sectors than US imports from China, and this could account for the difference in estimated wage impact.

Like [Autor et al. \(2013\)](#), [McLaren and Hakobyan \(2010\)](#) reported that, as a result of NAFTA, local US manufacturing wages were not reduced, nor was there an industrywide depression of wages. A separate study by [Autor, Dorn, and Hanson \(2013\)](#) found that while the number of manufacturing jobs fell due to increased imports, average manufacturing wages within “commuting zones”—defined as metropolitan areas and their surrounding localities—were not significantly affected by rising imports. This finding will surprise observers who assume that labor markets are fungible, akin to bond markets. Reviewing the overall pattern of wages, [Edwards and Lawrence \(2013\)](#) found that while workers at the lower end of the pay scale did not experience much improvement over the past decade, they did not fare much worse than the middle class, suggesting that globalization has not significantly affected the distribution of wage outcomes within the middle 80 percent of the American economy. Whether globalization makes a major or minor contribution to the good fortunes of the “top 1 percent” is another question, one that we do not explore.²⁸

NAFTA critics place far more emphasis on case examples (“anecdotes”) than on the statistical analysis just reported. So do the public and many politicians. Instances can certainly be cited where import competition from Mexico led to wage cuts in US plants or where the threat of moving a factory to Mexico was used for leverage in wage negotiations. A study conducted by Cornell University for the North American Commission for Labor Cooperation found evidence that, between January 1993 and December 1995, over 50 percent of companies in the United States threatened to close all or part of their production plants in response to union activity or organizing campaigns of workers ([Bronfenbrenner 1996](#)). Specifically, companies made direct threats to relocate to Mexico in more than 10 percent of the cases, while other cases involved implicit threats, such as “given NAFTA we may need to reconsider our options” (p. 2). In one case, ITT Automotive in Michigan underlined the threat by setting up a dozen tractor-trailers full of production equipment from a closed site, plastered with signs reading “Mexico Transfer Job.” In another case, a company handed out statistics to its workers on the differential between average wages of Mexican and US autoworkers. [Bronfenbrenner \(1996 p. 3\)](#) concluded that “NAFTA created a climate that has emboldened employers to more aggressively threaten to close, or actually close their plants to avoid unionization.”

But the anecdotes and the [Bronfenbrenner \(1996\)](#) survey simply do not support the conventional wisdom that competition from Mexico has been a major force in suppressing the growth of average US wages over the past two decades. Empirical evidence in the cited studies indicates that increased imports do decrease the

28. [Lawrence \(2008\)](#) argues that the growing income share of the “super rich” is largely driven by forces other than international trade. Those forces include technology that amplifies the market scope of top entertainers (like Stephen Colbert) and computer geniuses (like Eric Schmidt), financial deregulation, plus changes in US corporate governance and rising share prices. [Haskel et al. \(2012\)](#) find “suggestive evidence” that globalization has contributed to rising earnings of superstars (defined as the small group of highly skilled, highly compensated workers), but likely through globalization channels other than merchandise trade, such as improved tradability of services and larger markets abroad (p. 136). [Kaplan and Rauh \(2007\)](#) argue that trade is a poor explanation of increasing inequality, since the shift towards top earners extends well beyond the sectors that produce tradable goods and services.

overall number of manufacturing jobs. However, increased imports of manufactures exert, at most, modest and highly localized downward pressure on wages. Import competition has not so far created measurable downward pressure on average wages, nor even on the wages of those who keep their jobs in the manufacturing sector.

US Agricultural Exports and Mexican Immigration

Within a decade after the launch, NAFTA critics claimed that US agricultural exports to Mexico had driven peasant farmers from the land who then continued straight north to cross the US border as illegal immigrants.²⁹ The alleged damage was said to be especially severe for cultivators of corn (maize), a staple crop in hilly and arid agricultural districts, supposedly undercut by huge corn exports from US agribusiness.³⁰ To be sure, NAFTA required some liberalization of Mexican corn imports. But Mexico, of its own accord and in an effort to lower food prices and control inflation, unilaterally accelerated liberalization by allowing tariff-free imports of corn almost every year since 1994. But the cause-and-effect story that labels US corn exports as the cause of illegal Mexican immigrants does not stand up.

First, US corn exported to Mexico (the yellow variety) is predominantly consumed by animals, whereas most corn grown in Mexico (the white variety) is largely consumed by people (tortillas and the like). Huge US exports of yellow corn have enabled Mexicans to sharply increase the share of chicken and beef in their daily diet. It has not replaced white corn.

Second, as in other emerging countries, the Mexican population is moving from the countryside to cities. Rural life in most of Mexico is harsh, and incomes are barely 50 percent of the urban average according to 2012 statistics from Mexico's National Institute of Statistics and Geography.³¹ However, in the NAFTA era, the rate of rural-to-urban migration has actually decelerated. In the 20 years between 1970 and 1990, the rural share of the Mexican population dropped 15 percentage points, from 42 to 27 percent. In the 20 years between 1990 and 2010 (the NAFTA era), the decline was only 5 percentage points, from 27 to 22 percent.

Third, to maintain rural incomes, the Mexican government has consistently supported the price of white corn with subsidies for farmers. In recent years, the average wholesale price of white corn in major producing states ranged from \$5.30 per bushel in 2000 to \$9.68 per bushel in 2013.³² One consequence is that the area under corn cultivation in Mexico has declined only modestly in the NAFTA era, despite predictions that these areas would be wiped out. In 1994, Canada, the United States, and Mexico cultivated 1.0, 29.3, and 8.0 million hectares of corn, respectively. By 2013, these figures reached 1.5 million hectares for Canada, 35.5 million for the United States, and 6.8 million for Mexico.³³ Mexican cultivation decreased modestly, but the big expansion of US corn cultivation reflects the ethanol mandate—which in turn raised the global price of corn—not exports to Mexico.

29. For an example, see Ellen R. Shaffer, "Immigration Is a NAFTA Problem. This Is Not Big News," *Huffington Post*, July 10, 2010, http://www.huffingtonpost.com/ellen-r-shaffer/immigration-is-a-nafta-pr_b_642484.html (accessed on March 12, 2014).

30. For a detailed exploration of this corn saga, see *Hufbauer and Schott (2005)*, pp. 328–44.

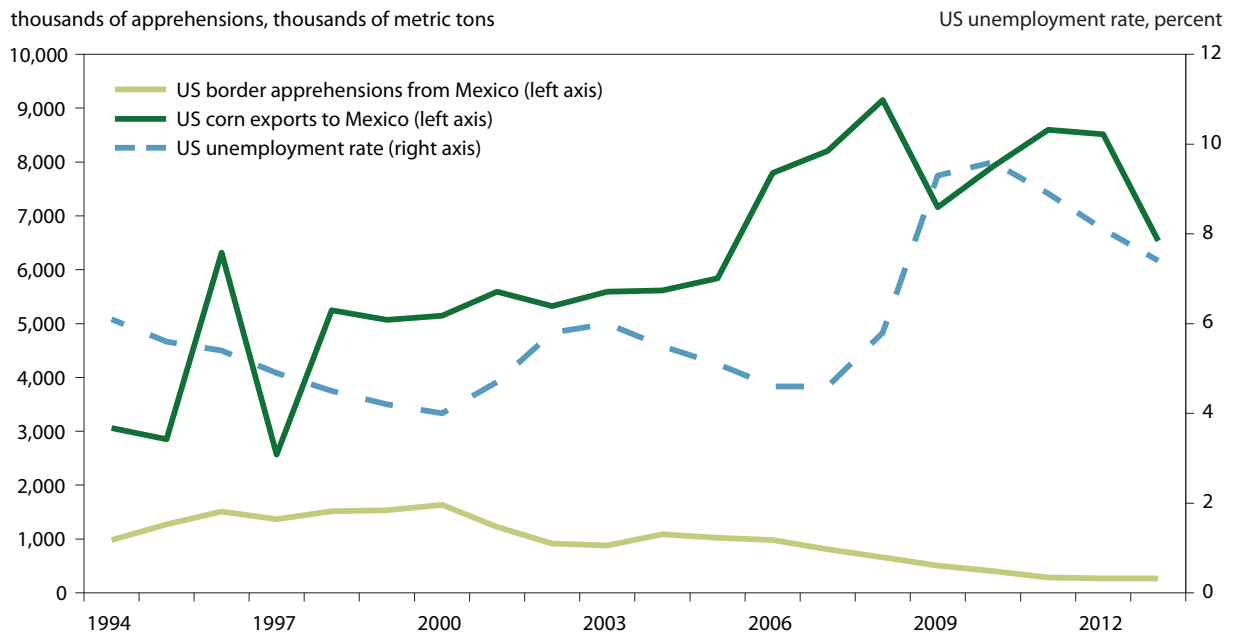
31. Based on the 2012 National Survey of Mexican Household Income and Expenditures, available at <http://www.inegi.org.mx/est/contenidos/Proyectos/Encuestas/Hogares/regulares/Enigh/Enigh2012/tradicional/default.aspx>.

32. According to the Food and Agriculture Organization (FAO) Global Information and Early Warning System (GIEWS) food price and data analysis tool, <http://www.fao.org/giews/pricetool/>. The original prices were expressed in US dollars per metric ton; these prices were converted to bushels using a conversion factor of 39.37 bushels = 1 metric ton.

33. Figures from the US Department of Agriculture, Production, Supply and Distribution database, <http://apps.fas.usda.gov/psdonline/psdHome.aspx>.

Fourth, there is little or no connection between the pace of illegal immigration from Mexico and the level of US corn exports to Mexico. Mexicans migrate to the United States to earn a better living. But depending on the state of the US economy, it can be easier or harder for an illegal immigrant to land a job. Figure 3 shows the general correspondence between the annual US unemployment rate and the number of border apprehensions (the best proxy for the annual number of illegal immigrants). No surprise: Higher unemployment discourages illegal immigration because Mexicans are less likely to cross the border if job opportunities are scarce. Tough border control has an effect as well. Figure 3 also shows the annual tonnage of US corn exports to Mexico (both yellow and white varieties). Visual inspection fails to reveal a positive correspondence between corn exports and apprehensions (if anything, the correspondence is negative). Even fancy econometrics cannot support the claim that US corn exports drive Mexican migrants across the Rio Grande. The corn-immigration story was a myth created by US critics in their stretch to create an alliance between anti-immigrant forces and anti-NAFTA forces.

Figure 3 Illegal immigration, US unemployment, and US-Mexico corn trade, 1994–2013



Notes: Due to data availability, total apprehensions for the US southwest border are used as a proxy for Mexican apprehensions for 1994–98. 1999–2013 is data for all apprehensions of Mexicans.

Sources: US Bureau of Labor Statistics; US Border Patrol Fiscal Year 2013 Statistics; USDA Foreign Agricultural Service, Global Agricultural Trade System (GATS), 2014.

Broad Association between NAFTA and Illegal Immigration

In the original NAFTA debate, President Carlos Salinas famously framed NAFTA as a “choice between getting Mexican tomatoes or tomato pickers,” while President Clinton predicted that NAFTA would curb illegal immigration “because more Mexicans would be able to support their families by staying at home.”³⁴

In their assessment, [Hufbauer and Schott \(1993\)](#) were skeptical of both claims. In the short run, they argued, illegal immigration would likely increase, both because of the huge wage differential between the United States and Mexico and because of the general movement of the Mexican population to cities on the northern border (Tijuana, Juárez, Nuevo Laredo, and others).³⁵ In any event, immigration was essentially ignored in the NAFTA text; the only exception was a limited number of visas for business and professional migrants.

Taking a longer view, which [Philip Martin \(2005\)](#) does, as the Mexican fertility rate falls and the population ages, the number of young Mexicans who want to relocate in the United States will diminish. This is the famous “demographic hump,” first analyzed by Martin as a cause of immigration pressure. In fact, as [figure 3](#) shows, illegal immigration has noticeably diminished since 2000, a combined outcome of three forces: the demographic hump; higher US unemployment, especially since 2007; and much stronger border controls.

Moreover, if the Mexican economy performs better in the next two decades than in the past two (the subject of the next section), the flow of illegal immigrants will diminish further. To the extent that the Mexican economy flourishes as a result of integration between the United States and Mexico, fostered by NAFTA, the pact will serve as a positive force for higher incomes and better living standards in Mexico and therefore diminished immigration to the United States. President Clinton’s optimistic forecast will eventually prove right, but it may take two generations for Mexican per capita incomes to converge to half of the US level.

Mexican Growth in the NAFTA Era

Mexican growth in the NAFTA era has been disappointing. In the wake of substantial economic reforms, Mexico should have delivered a performance as good as Chile’s. It did not. [Figure 4](#) compares real per capita GDP levels (adjusted for inflation), between 1993 and 2013, for four relevant countries and country groups: Mexico, Chile, the “ASEAN-4” (Indonesia, Malaysia, the Philippines, and Thailand), and the “Andean-3” (Bolivia, Ecuador, and Venezuela). Over the two-decade period, Mexican real GDP per capita expanded 31 percent, which works out to 1.3 percent annually (compounded), whereas Chile expanded 90 percent, 3.1 percent annually. The ASEAN-4 expanded 75 percent, 2.7 percent annually, while the Andean-3 expanded 24 percent, only 1.0 percent annually.

Why did Mexico perform more poorly than Chile or the ASEAN-4? Not because of NAFTA or lagging exports. Between 1993 and 2013, Mexican exports expanded 640 percent, Chilean exports expanded 730 percent, and ASEAN-4 exports expanded 420 percent.³⁶ Instead, Mexico suffered from three handicaps that were not nearly so burdensome in Chile and the ASEAN-4. Foremost was organized mayhem stemming from drug wars driven by the craving “made in the USA.” Drug cartels have not only killed 70,000 people just since 2006,³⁷ spreading fear across Mexico; they have also knocked GDP growth down by around 1 percent annually. Other causes of the lagging Mexican performance include weak primary and secondary education; poor infrastructure (water, sewer, gas, electricity, roads) in major urban areas, discouraging the migration from farm to city;

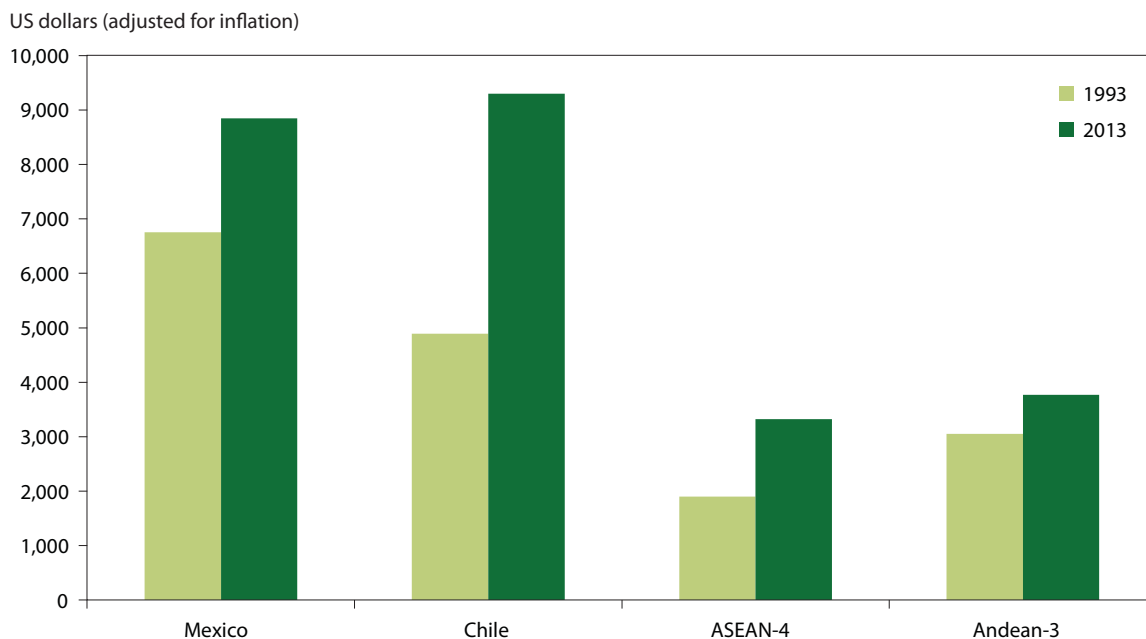
34. Quoted in [Heyer \(2012\)](#).

35. The portion of the Mexican population living in Mexican states that border the United States has grown from about 16 percent in 1990 to 18 percent in 2013, according to data from the Instituto Nacional de Estadística y Geografía (National Institute of Statistics and Geography).

36. Data from the International Monetary Fund (IMF), Direction of Trade Statistics. Total exports for 2013 estimated based on the first three quarters. The figures are in current dollars, not adjusted for inflation.

37. Nik Steinberg, “End Mexico’s Disastrous ‘War on Drugs’ Once and For All,” Human Rights Watch, December 2, 2013, <https://www.hrw.org/news/2013/12/02/end-mexicos-disastrous-war-drugs-once-and-all> (accessed on March 5, 2014).

Figure 4 Real GDP per capita levels for select countries



Note: ASEAN-4 consists of Indonesia, Malaysia, the Philippines, and Thailand. Andean-3 consists of Bolivia, Ecuador, and Venezuela.

Source: ERS baseline dataset, US Department of Agriculture.

extensive corruption (compared to Chile); persistent monopolization of key sectors (telecoms, television, petroleum, electricity, cement); and sundry tax and regulatory obstacles that stifle small business firms.

In fact, a [McKinsey Global Institute report \(2014\)](#) finds that sectors of the Mexican economy oriented towards NAFTA—primarily large firms employing 500 persons or more—enjoyed productivity growth of 5.8 percent annually between 1999 and 2009. The Mexican productivity problem is concentrated in traditional small firms—employing 10 or fewer persons—which have little connection to NAFTA. These firms account for 42 percent of the Mexican labor force, but their productivity actually declined between 1999 and 2009, dragging down the overall growth of the Mexican economy.

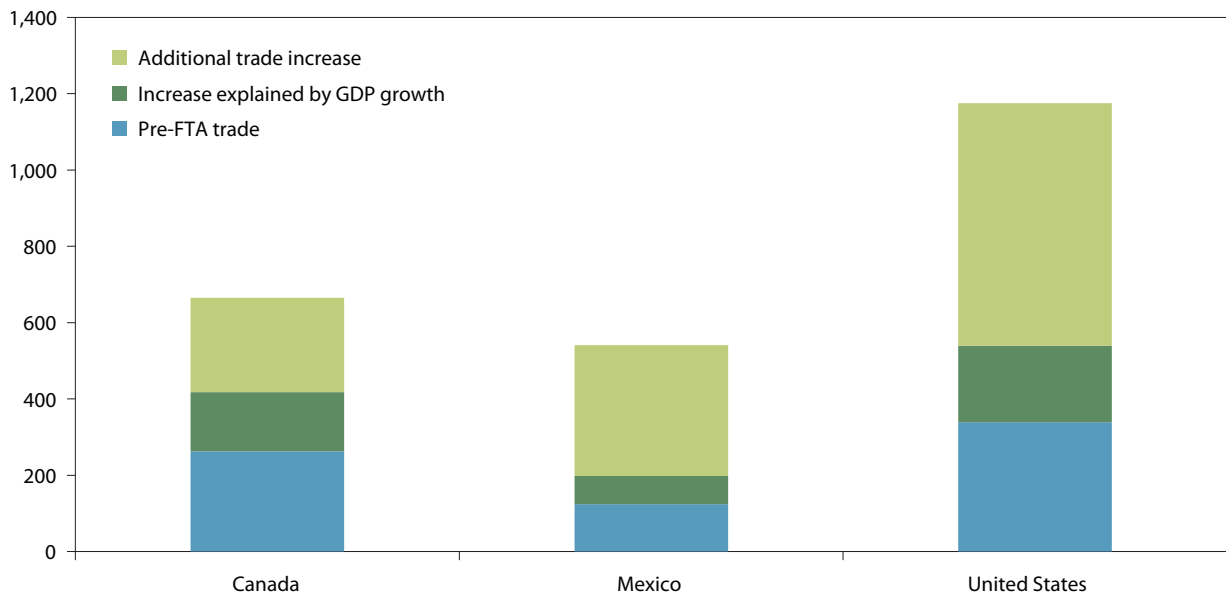
As mediocre as Mexican GDP performance was for two decades, it could have been worse. Look no further than the Andean-3 to see the adverse impact—in per capita income levels as well as growth—of populism, macroeconomic follies, and deep state intervention. Conceivably, if the US Congress had rejected NAFTA and refused to throw Mexico a financial lifeline following the peso crisis of 1994, Mexican political and economic policies might have taken a sharp left turn. Instead of growing real per capita GDP at 1.3 percent annually, the Mexican economy might have followed the trajectory of the Andean-3, possibly shrinking per capita GDP, and the Mexican political system might be rejecting new reforms rather than tackling the problems of the state-owned petroleum company Pemex and entrenched private monopolies.

What CUSFTA and NAFTA Achieved

The Canada-US Free Trade Agreement (CUSFTA), signed in 1988, was the precursor to NAFTA, signed in December 1992, and should be grouped with the trilateral pact when considering achievements delivered by North American economic integration. CUSFTA and NAFTA were foremost trade and investment agreements, but of course they conveyed a larger message of North America cooperation. Thus we start with “hard” economic statistics and then move to “soft” political aspects.

Figure 5 NAFTA two-way merchandise trade

exports plus imports, billions of 2013 US dollars



FTA = free trade agreement

Note: Pre-FTA two-way trade is prior to the Canada-US FTA (1988) for Canada and prior to NAFTA (1993) for the United States and Mexico. The middle part of each bar is the increase in two-way trade explained by growth in real GDP up to the year 2013 for all countries, annualized based on the first three quarters of 2013.

Source: International Monetary Fund, Direction of Trade Statistics, 2014.

Economic Payoffs

Figure 5 shows bar graphs for the North American two-way merchandise trade of the United States, Canada, and Mexico, respectively, expressed in 2013 dollars, adjusted for inflation. The bottom portion of each bar (blue) shows the country’s two-way trade prior to CUSFTA (1988) for Canada and prior to NAFTA (1993) for the United States and Mexico.³⁸ The next segment of each bar (green) shows the amount of two-way trade in 2013 that corresponds to North American GDP growth—in other words, “business as usual” trade. The top segment of each bar (light green) shows the country’s “extra” two-way trade. For reference, table 1 presents much the same data underlying figure 5 but expressed in current dollars.

	1993		2013	
	Imports	Exports	Imports	Exports
Canada	113	101	338	302
Mexico	40	41	287	227
World	779	589	2,294	1,590

Source: US Bureau of Economic Analysis.

Judging from these simple bars, “extra” US merchandise trade is some \$635 billion, about 55 percent of total North American trade for the United States; \$247 billion and 37 percent for Canada; and \$345 billion and 63 percent for Mexico. Of course CUSFTA and NAFTA cannot claim credit for all the “extra” trade, but the agreements can claim credit for a good portion.

38. To be precise, the start date for Canada-US trade is 1988, and the start date for US-Mexico and Canada-Mexico trade is 1993.

CUSFTA and NAFTA have not exerted the same buoyant impact on North American services trade as they have on merchandise trade. Table 2 summarizes US services trade with Canada, Mexico, and the world in 1993 and 2013, expressed in current dollars. Imports and exports within North America grew no faster, and sometimes slower, than with the world. While CUSFTA and NAFTA both contained services chapters, and while investment in some service sectors was liberalized (e.g., banking and retail trade in Mexico), regulatory barriers to cross-border trade in services were not much reduced. To this day, they remain high: One recent study by Centre d'Etudes Prospectives et d'Informations Internationales, or CEPII (Fontagné, Guillin, and Mitaritonna 2011), estimates the average tariff-equivalent barriers to cross-border service imports as follows: 24.2 percent for Canada, 46.8 percent for Mexico, and 30.5 percent for the United States.³⁹

Ample econometric evidence documents the substantial payoff from expanded two-way trade in goods and services. Through multiple channels, benefits flow from *both* larger exports *and* larger imports.⁴⁰ As a rough rule of thumb, for advanced nations, like Canada and the United States, an agreement that promotes an additional \$1 billion of two-way trade increases GDP by \$200 million. For an emerging country, like Mexico, the payoff ratio is higher: An additional \$1 billion of two-way trade probably increases GDP by \$500 million.⁴¹ Based on these rules of thumb, the United States is \$127 billion richer each year thanks to “extra” trade growth, Canada is \$50 billion richer, and Mexico is \$170 billion richer. For the United States, with a population of 320 million, the pure economic payoff is almost \$400 per person.

Appraising trade through a mercantilist lens, figure 6 shows the percentage of growth in real US exports to Canada, Mexico, and the rest of the world in the CUSFTA-NAFTA era. The starting point is indexed at 100 for each destination. While US exports to Canada have grown almost as fast as US exports to the rest of the world (which includes fast-growing Asia), US exports to Mexico have grown much faster. From the American perspective, NAFTA must be credited with this mercantilist payoff.

CUSFTA and NAFTA probably had little impact on inward foreign direct investment (FDI) to Canada and the United States, because both countries were already open, with settled commercial law and property rights. But for Mexico, NAFTA turned the page from policies that said to foreign investors “stay far away!” to policies that said “come on in!” And because of its new access to US and Canadian markets, Mexico became an attractive location for companies around the world. In 1993, Mexico’s inward stock of FDI was just \$52 billion, about 7 percent of GDP. By 2012, the stock reached \$315 billion, some 27 percent of GDP.

Political Payoffs

Possibly the largest payoff—for the United States more important than the economic benefits—was the creation of a new foundation for US-Mexican relations through NAFTA. Unlike Canada, Mexico has not been a US military ally in a long list of wars, running from the First World War to the Afghanistan conflict. In international conflicts, Mexico plays a neutral role. Mexico was the only Latin American country to maintain ties with

Table 2 US trade in services (billions of current US dollars)

	1993		2013	
	Imports	Exports	Imports	Exports
Canada	9	17	30	64
Mexico	8	11	17	29
World	124	186	428	660

Source: US Bureau of Economic Analysis.

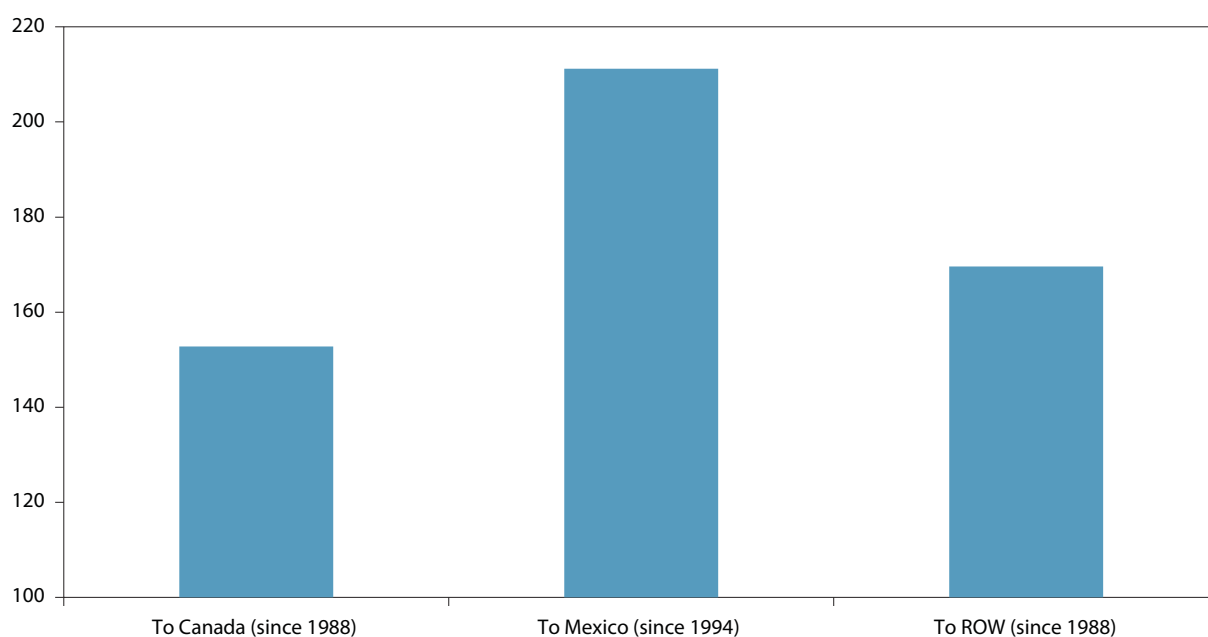
39. Based on the simple average of the ad valorem equivalents for communications, finance, insurance, other business services, and other services.

40. For a survey of the channels, see Bradford, Grieco, and Hufbauer (2005). The channels include more efficient use of resources through the workings of comparative advantage, higher average productivity of surviving firms through “sifting and sorting,” and greater variety of industrial inputs and household goods.

41. See Hufbauer, Schott, and Wong (2010, appendix A, table A.2).

Figure 6 US real export growth since the pre-FTA level

percent increase, constant US dollars



FTA = free trade agreement; ROW = rest of world

Note: Pre-FTA for Canada is pre-CUSFTA; pre-FTA for Mexico is pre-NAFTA.

Source: International Monetary Fund, Direction of Trade Statistics, 2013.

Cuba for the entire duration of the Cold War. More to the point, beginning with Mexico's expropriation of Jersey Standard and other foreign oil companies in 1938, the official Mexican attitude towards foreign investment originating in the United States was antagonistic. Generations of young Mexican schoolchildren learned that the United States had stolen vast swaths of Mexican territory by annexing the Texas Republic in 1845 and by seizing present day New Mexico, Colorado, Utah, Arizona, Nevada, and California in the Mexican-American War (which was concluded by the Treaty of Guadalupe Hidalgo in 1848). Bearing this history in mind, it is fair to characterize US-Mexican relations prior to NAFTA as cool.

NAFTA dramatically improved the dynamic of official and private relations. The Clinton administration spearheaded bilateral and multilateral assistance to Mexico in the wake of the 1994 peso crisis. As drug wars escalated in the 2000s, the United States provided, and Mexico welcomed, intelligence assistance and military supplies. Cooperation was good on issues ranging from agricultural inspection to climate change to border inspections. Certainly the United States could have done more to foster integration with Mexico.⁴² NAFTA did not address the thorny problem of a path to citizenship for 11 million undocumented Mexicans living in the United States, an issue that continues to flare up in congressional debates. But it seems highly unlikely that bilateral relations over the past 20 years would have been equally cordial without NAFTA.

In addition, NAFTA gets some credit for Mexico's transition from a one-party political system with extensive state capitalism to a multiparty market-oriented system—but of course most of the credit for these reforms goes to internal Mexican forces. NAFTA can also claim some credit for the rise in Mexico's ratings in the Heritage Foundation's Index of Economic Freedom, from 63 in 1995 to 67 in 2013.⁴³

While political payoffs cannot be quantified in economic terms, over the course of the next 20 years they are likely to prove more consequential than the economic payoffs already realized from the NAFTA pact.

42. The late Robert Pastor was a forceful exponent of more energetic and generous US policies towards Mexico. See Pastor (2011).

43. For details on the Index of Economic Freedom, see <http://www.heritage.org/index/>.

APPENDIX A: TRADE AGREEMENTS AND TRADE DEFICITS

A favorite attack line of trade skeptics is that US free trade agreements (FTAs) inevitably worsen US trade deficits.⁴⁴ “Uncle Sucker” is their metaphor: US negotiators open wide the gates for foreign imports but gain precious little access for American exports. The predictable outcome, they reason, is larger US trade deficits. According to their arithmetic, trade deficits translate into lost US jobs. The main text spells out the normal *inverse* relationship between trade deficits and unemployment. In this appendix we examine the starting point in the critics’ chain of logic: the supposed strong connection between trade agreements and trade deficits.

Foreign Trade Barriers Fall More

At the launch of an FTA, US trade barriers are almost always lower than the barriers of a prospective partner country. Why? Because, unlike many countries, the United States has progressively trimmed its trade barriers for 70 years, since the end of the Second World War. Lower US trade barriers at the launch of the agreement were true of the Canada-US FTA (CUSFTA) in 1989; NAFTA, which added Mexico in 1994; the US-Chile FTA in 2004; the US-Australia FTA in 2005; the US-Peru FTA in 2009; the US-Korea FTA in 2012; and others. Since the goal of any FTA is to reduce the trade barriers of *both* partners to zero, the US partner almost always has further to go.

In other words, the partner opens its markets to US exports *more* than the United States opens its markets to partner exports. Using tariff data, table A.1 illustrates this basic and important fact, both for existing FTAs and the prospective Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP). FTAs also lower nontariff barriers (NTBs, for example, quotas and regulatory obstacles) in both partners. Extensive research shows that, like tariffs, NTBs are generally higher in the partner country when an FTA is launched. Again, the partner has further to go. So, just looking at negotiated FTA texts, it is “Uncle Smart,” not “Uncle Sucker.”

US Trade Deficits with FTA Partners and Others

According to the skeptics, the United States should be accumulating a mountain of trade deficits with its 20 FTA partners, starting with Israel in 1985, then Canada and Mexico in the 1990s, and moving along to Korea, Colombia, and Panama in the 2010s. But this hasn’t happened. [Figure A.1](#) tells the story. Excluding fuel imports and exports from the picture (if US oil imports did not come from Canada and Mexico, they would come at higher cost from Venezuela, Nigeria, and elsewhere), it is evident that US trade deficits with its FTA partners are coasting along at \$50 billion to \$100 billion annually, while US deficits are mounting with the rest of the world. It would be wrong to promise that the TPP or the TTIP would “cure” US trade deficits with those countries. But it’s false to claim that NAFTA and other FTA pacts are the locomotive driving higher US trade deficits over the last two decades.

Table A.1 US and FTA partner average tariffs at year of entry (unweighted)

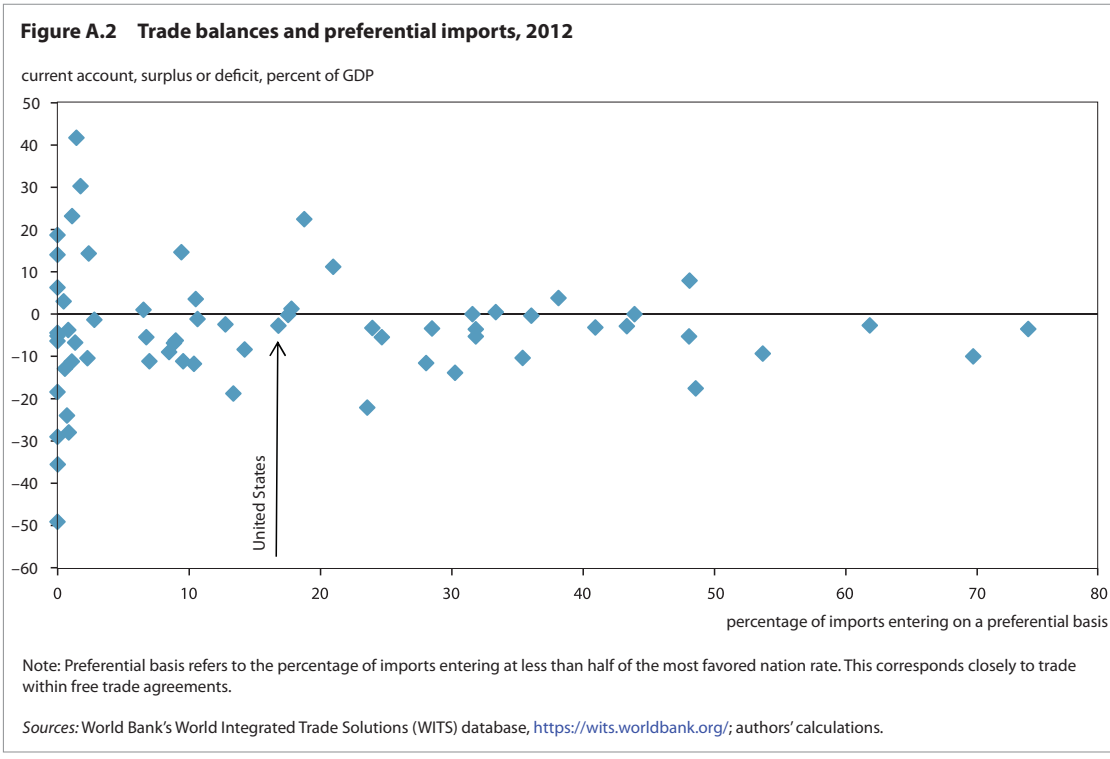
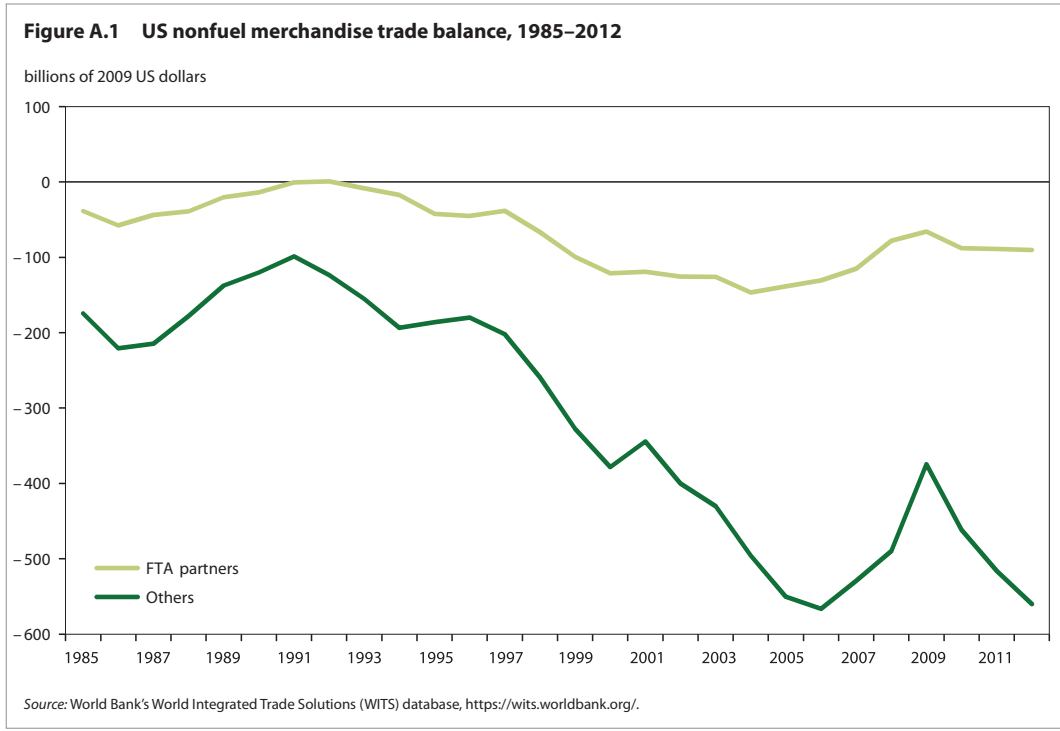
	US applied tariff	Partner applied tariff
Existing FTAs		
Canada (1989)	5.06	9.65
Mexico (1994)	4.32	12.36
Australia (2005)	3.11	5.10
Peru (2009)	2.98	8.57
Colombia (2011)	2.79	11.17
South Korea (2012)	2.79	10.08
TPP (2015?)		
Malaysia (2012)	3.4	6.5
Vietnam (2012)	3.4	9.5
Japan (2012)	3.4	4.6
TTIP (2016?)		
European Union (2012)	3.4	5.5

FTA = free trade agreement; TPP = Trans-Pacific Partnership; TTIP = Transatlantic Trade and Investment Partnership

Note: Year of entry into force or closest earlier available year for US FTA partners, latest available year for prospective FTA partners. Tariff data is from 1993 for Mexico, 2004 for Australia, 2006 for Peru, and 2011 for South Korea.

Sources: World Bank, World Integrated Trade Solutions (WITS) database; WTO tariff profiles; UN Conference on Trade and Development Trade Analysis and Information System (UNCTAD TRAINS) database.

44. Ross Perot started this line of attack, claiming that NAFTA would create a “great sucking sound.” Prominent among current skeptics are David Bonior (former Congressman), Thea Lee (AFL-CIO), Clyde Prestowitz (Economic Strategy Institute), Robert E. Scott (Economic Policy Institute), and Lori Wallach (Public Citizen’s Global Trade Watch).



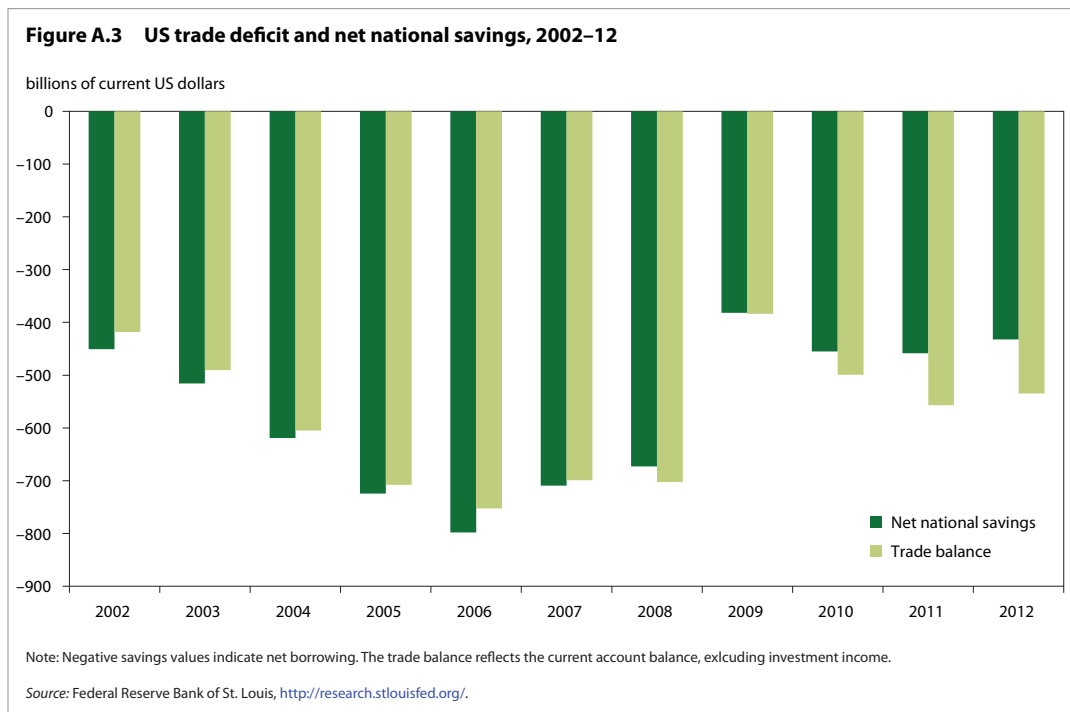
Global Experience: Trade Agreements and Trade Deficits

If the FTA skeptics were right, greater coverage of a country’s imports by trade agreements should foreshadow larger trade deficits. Figure A.2 examines this hypothesis. The vertical axis portrays each country’s 2012 trade surplus (positive) or trade deficit (negative) as a percentage of its GDP.⁴⁵ The horizontal axis shows the percentage of the country’s imports that are covered by trade agreements (leading to tariff preferences). If more trade agreements meant larger trade deficits, the country dots would drift downwards, left to right in the figure. They don’t. As far as the eye can tell, trade deficits are symmetrical around the horizontal axis in figure A.2: In other words, more import coverage by trade agreements doesn’t foreshadow either larger trade surpluses or larger trade deficits. As the arrow in the graph indicates, the United States is a middling country when it comes to both trade agreements and trade deficits. In 2012, US preferential tariffs covered less than 20 percent of US imports, and the US trade deficit was about 3.4 percent of US GDP.

Well, What Explains Trade Deficits?

Though a household budget analogy might seem simplistic, it’s not far off the mark. When a household earns \$100,000 and spends \$105,000 on goods and services, that household has a deficit of \$5,000. The deficit must be financed by a mortgage loan, credit card debt, or a generous relative. (We’ll assume that neither Willy Sutton nor Bernie Madoff heads the household.) Likewise, when a nation earns \$15.7 trillion and spends \$16.2 trillion on goods and services (approximately the US case in 2012), the national trade deficit will be \$500 billion. That deficit must be financed by loans or investment from abroad.

Figure A.3 portrays this basic and fundamental story in a bar graph. The annual US trade deficit closely matches, year by year, the combined deficiency in US net national savings (in other words, net national borrow-



45. The technical term for trade surpluses and deficits is “current account balance,” a concept that covers trade in goods and services and other current transactions such as remittances.

ing). The combined deficiency is the sum of household financial savings (or deficits), government deficits, and business savings (the difference between company profits and company investments). Adding these three components gives net national borrowing—in other words, negative national savings. When net national borrowing goes up, so does the trade deficit—because the borrowed money is spent on foreign goods and services (or, to put the relationship another way, because the United States spends more than it earns, it must borrow from abroad).

If the United States wants to reduce its trade deficit, it must reduce its net national borrowing. Many policies can help. Government deficits can be cut, household financial savings can be encouraged, foreign central banks can be asked to appreciate their currencies and buy fewer US Treasury bonds, and the US Export-Import Bank can enlarge its lending to foreign buyers of US exports. In addition, as Bergsten and Gagnon (2012) have urged, in periods of high US unemployment, the United States might reduce its trade deficit by policies that realigned the exchange rate—in plain English, a cheaper dollar relative to the euro, the yuan, or the yen. But one policy that makes no sense, and will do little or nothing to reduce the trade deficit, is to block new FTAs—such as TPP and TTIP. Instead, these agreements should be pursued vigorously for what they can bring: higher productivity and better living standards for all Americans. That’s what NAFTA promised and that’s what NAFTA delivered.

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A TALE OF TWO MEXICOS: GROWTH AND PROSPERITY IN A TWO-SPEED ECONOMY

JAANA REMES

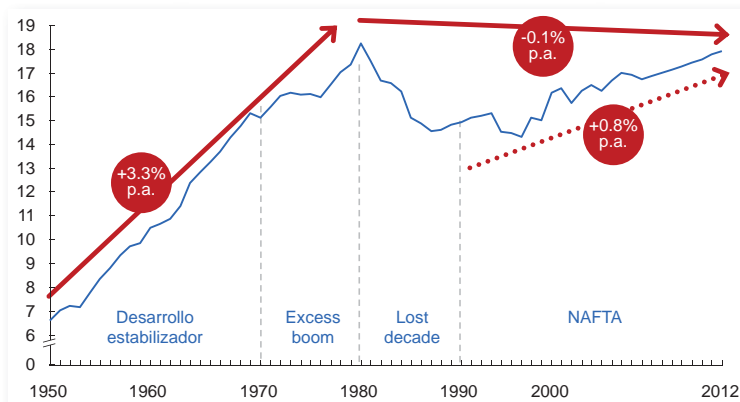
At a time when there are increasing concerns about emerging markets and their growth, Mexico looks like the exception. In spring 2014, Mexico’s sovereign debt was upgraded; multinational companies announced billions worth of investments in different sectors; and the press talked about Mexico’s renaissance. Despite the latest downticks in near-term growth prospects, there is a sense that Mexico is where the opportunity is: “The opportunities are huge,” as BlackRock’s CEO has put it. Yet, for many who have been watching Mexico’s economic performance for a few decades now, there is a sense that we have seen this picture before, that multiple times over the past few decades Mexico’s growth has been just around the corner. Perhaps most notably, that was the case two decades ago at the signing of the North American Free Trade Agreement (NAFTA).

So is this time now different? Is this now Mexico’s moment, or are we going to be disappointed again? To shed light on this question, our research started by asking: What happened over the last two decades that kept Mexico’s performance so low? As many of you know, the answer is really the incapacity to raise productivity (figure 1).

When you look at Mexico’s productivity performance over the past few decades, you can see the picture of the nation’s economic history. This begins in the second half of the 20th century with the rapid growth period of import substitution, the *Desarrollo Estabilizador*. We see that rapid boom even in the 1970s (the excess boom, if you want), then the lost decade of the 1980s, and after that the slow turn to growth again.

Figure 1 Despite NAFTA and reforms, Mexico has not raised its average productivity in 30 years

GDP per hour worked (2012 purchasing power parity dollars)



p.a. = per annum

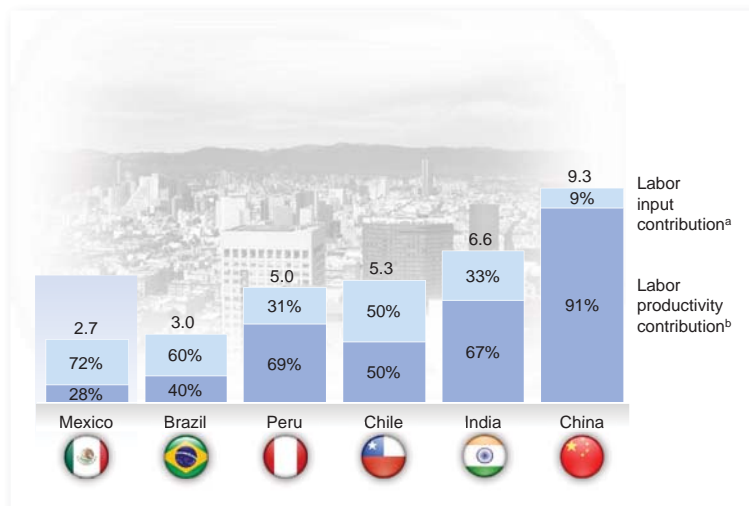
Source: Conference Board Total Economy Database, 2013; McKinsey Global Institute analysis.

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JAANA REMES is a partner at the McKinsey Global Institute (MGI). This presentation is based on findings from Eduardo Bolio, Jaana Remes, Tomás Lajous, James Manyika, Eugenia Ramirez, and Morten Rossé, *A tale of two Mexicos: Growth and prosperity in a two-speed economy* (New York: McKinsey Global Institute, 2014). Available at www.mckinsey.com/insights/americas/a_tale_of_two_mexicos.

Figure 2 Population growth, not productivity has fueled Mexican GDP growth

contribution of labor inputs and productivity increases to GDP growth, 1990–2012 (compound annual growth rate, percent)



a. Higher labor input reflects increased population and changes in participation and employment rates; calculated as a residual

b. Labor productivity growth is measured as real GDP per employee

Sources: Conference Board Total Economy Database 2013; McKinsey Global Institute analysis.

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But the big takeaway from this is that, in essence, the average productivity of Mexican workers today is no higher than it was 30 years ago in real terms. That really is Mexico's growth challenge. Given that the productivity of workers hasn't grown, most of Mexico's growth has come from expanding the labor pool (figure 2).

Over the last two decades since 1990—after the lost decade of the '80s—Mexico's productivity has grown on average 2.7 percent a year. This is a disappointingly slow growth rate for a nation that still has a rapidly growing population. A full 2 percent of Mexico's GDP growth over the last two decades came from the fact that there were more workers in the pool. Productivity contributed only a little more than a quarter to that growth; over 70 percent came from an expanding population.

When you compare this picture to Mexico's peers in the emerging markets,

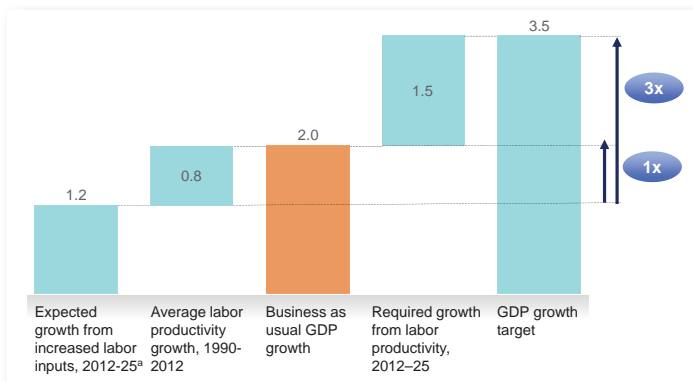
it is dramatically different from all the other nations (figure 2). It really is the lack of productivity that differentiates Mexico even from Brazil or some of its other Latin American peers.

The challenge with the population-driven growth and labor force expansion growth is that Mexico has now gone through the demographic transition. In the early 1970s, the average woman had seven children. That's not the case any longer. So population growth is declining and labor force growth is declining. When we look forward, the picture is going to be very different (figure 3).

Over the last two decades, almost 2 percentage points of productivity growth came from the expanding labor force; in the coming decades, that growth is going to decline to 1.2 percent. If we don't see an acceleration in productivity and Mexico maintains the 0.8 percent of the last two decades, that means that the kind of the growth rate we should expect for Mexico going to 2025 would be something on the range of 2 per-

Figure 3 Without a boost in productivity, Mexico's growth will slow further to 2 percent per year

annual real GDP growth rate (percent)



a. Driven by additional workers joining the workforce due to demographics and increased participation in workforce, employment rate assumed constant at 2012 level.

Sources: ENEO, INEGI; McKinsey Global Institute analysis.

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cent. That clearly is not even close to the 3.5 percent that is roughly the expectation for the medium-term growth through 2025.

To make that growth target, Mexico would need to increase its productivity. It would, in essence, need to roughly triple the productivity growth rate from 0.8 percent to 2.5 percent to meet that growth.

So the big question for most of our research was to assess how realistic this is: Can we expect Mexico to really boost productivity growth? We start by looking at the academic data and we worked with our colleagues who work with industries across Mexico in different businesses. And we started to look at what was happening over the last two decades in the productivity of these different industries. What do we see going forward? What kind of underlying macroeconomic dynamics for productivity do we see?

The first finding will not surprise any of you. We found that Mexico has a very dualistic economy. On one end on the right-hand side of figure 4, you can see that the large modern operations—whether they are Mexican national or multinational companies or multinational companies operating in Mexico—are relatively highly productive, they are the export companies, and in many ways, the frontier for Mexico’s productivity.

On the other extreme, on the left-hand side of figure 4, you see the very small enterprises, less than ten employees. These are traditional, labor-intensive, and often with subscale technology, and many operate outside the formal economy. Among these firms, productivity in the 1999 census was roughly 28 percent of the large corporations’ productivity. So among the smallest ones, there is roughly a quarter of the productivity than that of the large corporations.

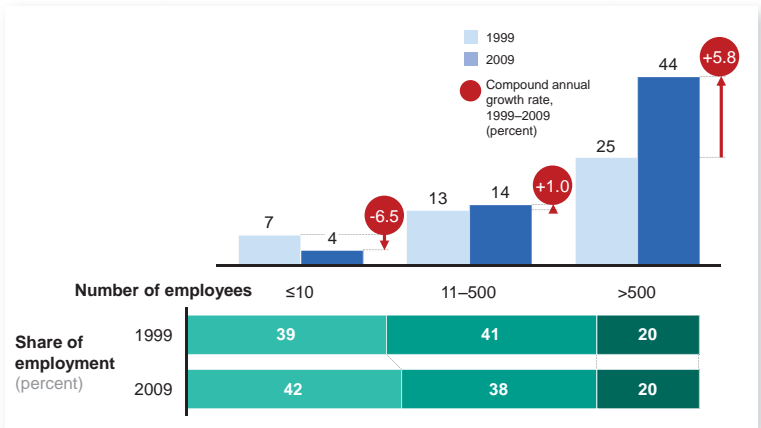
This is not dramatically different than what we see elsewhere. What really surprised us was that this gap between these two productivity gains has been widening over the last decade. So let’s look again at the large corporations. Their productivity grew between 1999 and 2009 by almost 6 percent a year. Not a bad performance, even by the standards of the Asian tigers.

On the other end of the spectrum, when you look at the small-scale enterprises on the left-hand side of figure 4, their productivity had declined by over 6 percent a year. This means that the productivity gap between the smaller and larger enterprises has widened. The small businesses used to be 28 percent as productive as the large companies; now they are less than 10 percent.

In between these two extremes, we have the middle, which has been actually shrinking. These are mid-tier companies that have between 10 and 500 employees. Their productivity has been relatively flat, and their overall share has declined. So, in essence, behind that very flat overall productivity performance are dramatically widening trends across the large and small enterprises.

Figure 4 Behind flat performance is a widening productivity gap between large modern and traditional businesses

value added per occupied person (thousands of constant 2003 dollars)



Sources: *Censos Económicos 1999, Censos Económicos 2009*, Instituto Nacional de Estadística y Geografía; McKinsey Global Institute analysis.

McKinsey & Company

And this, of course, means that when we look forward and see how realistic it is for us to expect the acceleration in productivity, we will need to see changes across all of these different kinds of corporations and companies, particularly the small ones.

Key Levers to Boost Productivity Growth Across Economy

Let's look at the three kinds of things that we would expect to see change dramatically for Mexico's productivity to accelerate. The first one is clearly that the small traditional enterprises need to increase their productivity. We need to reverse the productivity decline. What would it take to do that? Clearly there are many reasons why small enterprises are small—one of the reasons is that some have no other employment options (box 1).

Box 1 High cost of formality and poor enforcement discourage growth



Sources: OECD; *Doing Business*, World Bank; McKinsey Global Institute analysis.

McKinsey & Company

However, when looking at it at the sector level, there were two factors that really matter. First, the economic incentive of staying small and informal continues to be high. Second, capital constraints are very binding for these companies to grow to become mid-tier and potentially even larger companies.

In the case of the economic cost of becoming formal and “growing up,” it is clear that in Mexico overall, formalizing your business is expensive. Because of Santiago Levy's work, we know that Mexicans' social security costs are significant—yet overall, they are seen to have limited value to employees. Labor laws continue to be restrictive and expensive particularly on the firing end, which limits a desire of companies of all sizes—including the large ones—of hiring.

The cost of registering your business in Mexico is roughly 10 percent of the annual income. This is seven times the 1.4 percent that it costs in the United States. So it is actually very expensive. And some other costs, like energy, are very high; commercial energy costs are roughly 75 percent higher than they are in the United States. All of this means that in order to run a business formally, you will have quite significant costs—a cost that will eat up into the margins of your small business. And that is one incentive that, together with the fact that the perceived cost of the enforcement is weak, most companies don't think there is a big risk that they will be caught, and even if they do, the cost of any punishment is relatively low.

This means that many of the companies choose to stay small, stay informal, and that way they can stay under the radar and keep their margins higher relative to their formal peers that look otherwise similar. Just to give you an example of how that influences particularly the growth of those small companies that would like to grow, we talked to a small bakery that was very successful. The company was providing new kinds of products that you typically wouldn't see in a Mexican *panadería*, and it was expanding. The owner had three

businesses, but at that time, the owner said, “Well, we really can’t expand any beyond [this] because then it will be harder for us to grow. Instead my brother-in-law and my daughter are going to open the other three businesses under a different business—they’re operating them separately.” So in a way, the company was growing in a fragmented manner to avoid having to formalize and incur all of these costs. So this was one of the big constraints we saw across the board, and it influences the incentives of becoming part of the formal economy and providing formal employment.

The second factor clearly is that capital is constrained particularly for mid-tier and small and medium enterprises. I don’t think we have ever seen an economy where small and medium businesses don’t consider that capital is a constraint. It is the nature of the beast, but Mexico truly is an extreme case—and it is also a country where we can see the dual economy over the last two decades.

When you look at the cost of capital to different kinds of companies, clearly the large corporations have seen a significant benefit from the close integration to the North American financial markets. Today, multinational corporations in Mexico have access to capital at costs comparable to their peers in the United States. There is really no significant difference in the costs that they need to pay. That is not true for the mid-tier companies or the small ones.

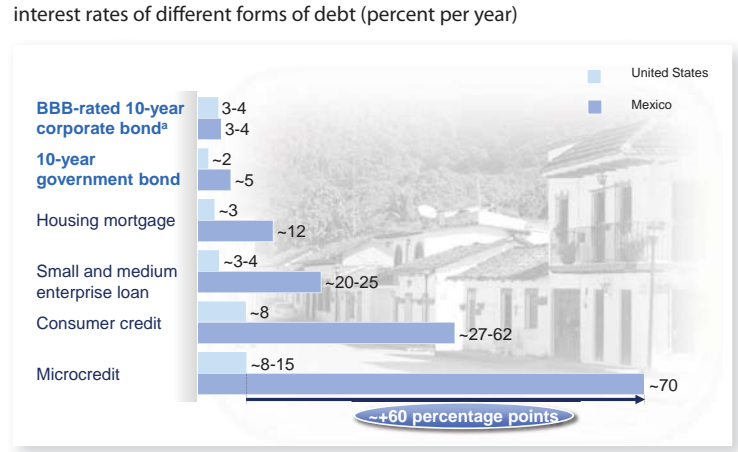
When you look at the small and medium enterprise loans (see figure 5), the interest rates are raised from 20 to 25 percent already, which is seven times the rate that you would see in the United States. The relative cost to smaller businesses is significantly higher and, of course, much more if you are talking about the informal sector.

This is another example where clearly the changes of the last two decades have influenced, in a significant way, the large corporations differently than the small ones. And the outcome of these differences in costs is quite striking (see figure 6). When we looked at the financial assets (outstanding debt and equity) of Mexico compared to its peers, at 130 percent it is already second to last, only before Russia.

However, I would like to draw your attention to the red part of that bar in figure 6, representing bank loans. This is the typical funding source for small and medium enterprises, and Mexico, at 32 percent of GDP, is dramatically below all of its peers. When we look at the global rankings across all the countries in the world, Mexico is right behind Ethiopia in the level of bank debt. So this really is significantly lower than in any other peers, which suggests that clearly the credit constraints are more binding in Mexico than you would expect in any other places.

This is one of the constraints that particularly influences the mid-tier companies—the kind of growth companies we would like to see more of—the gazelles we talk about in the United States that tend to create a lot of jobs. That might be one of the factors. And we hear the same thing from companies that say that it is a

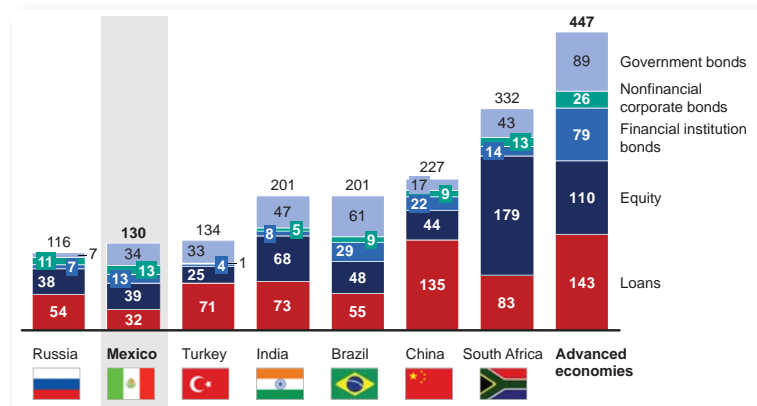
Figure 5 Households and small businesses pay a large interest premium



a. PPL Energy Supply LLC in the United States and Banco Santander de México in Mexico.
 Sources: Bloomberg; Banco de Mexico; national sources; McKinsey Global Banking Pools; McKinsey Global Institute Financial Assets database; McKinsey Global Institute analysis.
 McKinsey & Company

Figure 6 Access to capital is limited relative to other emerging economies, with particularly wide gap in loans

financial depth, 2013 (stock of debt and equity as percent of GDP)



Sources: McKinsey Global Institute Financial Assets database; McKinsey Global Institute analysis.

McKinsey & Company

real constraint on their growth. This influences all kinds of companies. US private equity companies feel that they can't get credit cards for their employees since new arrivals are without a credit history. So in a way, it is a big challenge.

In order for Mexico to raise its productivity, there needs to be a change in the productivity of the large pool of small businesses. We need to see more of the mid-tier growth companies and have capital play a bigger role in creating a dynamic mid-tier company. And the third component is that we need the large modern local and global multinationals and local companies to continue to do what they're doing: increase their productivity and push their frontier.

These companies have maintained their employment share at roughly 20 percent of employment, which means they have been growing at that 2 percentage point a year of employment growth. So they have been growing but just not fast enough to gain share. It is important for them to continue to gain share, and what it would take is to continue to improve the business environment for these companies—things like the labor laws that continue to reduce formal sector employment.

One out of nine employees in companies of 50 or more employees remains outside the books, according to some of the data, and the cost of electricity is a 75 percent higher cost. All of these factors are reducing Mexican competitiveness, and I think there are more things to make it more likely for the modern sector to expand and grow faster.

Let me finish with three final thoughts.

Conclusion

First, it is very clear that despite the very flat aggregate performance, NAFTA and the reforms of the last 20 years have dramatically changed many parts of the Mexican economy. There are many success stories—especially the automotive and aerospace industries. We just haven't seen enough of them yet.

So looking at the aggregate performance, you cannot draw the conclusion that there haven't been some significant changes in the economy. And the good news is that we are likely to see much more of that. Clearly, the manufacturing global environment is such that Mexico has become increasingly more competitive as global corporations are looking to shorten and simplify their supply chains. The prospects of that transformation to continue, in our view, are quite strong.

Yet you can say that the transformation has not gone far enough. The biggest challenge for Mexico now is to see some change among the over 40 percent of employment that continues to be in traditional, small businesses, and see its productivity grow. This is an area where it's much easier for us to diagnose the problem

than create the solution. A lot of it has to do with the implementation—not just changes at the highest policy level—but the secondary legislation, the implementation across the different regions, etc., and it will take time. However, given the facts you saw, it is hard to imagine that Mexico’s growth will dramatically change unless we see a significant change in this segment.

The good news is that when looking across the different industries and sectors, we saw plenty of opportunities for change, plenty of opportunities for productivity improvements across all kinds of companies, small and large alike. So clearly the potential for raising Mexico’s productivity trajectory is there. There is no reason to believe that wouldn’t be the case, and in many ways, the current Peña Nieto administration is well aware of many of the challenges, and some of the reform agenda includes many of the topics that we have highlighted as challenges.

Of course, it will take a lot to translate those into real changes on the ground, depending on how the law is implemented. But there is no reason to believe that Mexico couldn’t do that. We are optimistic and hope that this will be the last time that we’ll be asking, “Is this Mexico’s moment?” Because the next time we talk about it, it will have been realized.

HOW US INVESTMENTS IN MEXICO HAVE INCREASED INVESTMENT AND JOBS AT HOME

THEODORE H. MORAN AND LINDSAY OLDENSKI

Enactment of the North American Free Trade Agreement (NAFTA) 20 years ago was accompanied by dire predictions that an increase in US investment in Mexico would lead to job losses and investment reduction at home. The rhetorical highpoint for this concern was captured by H. Ross Perot's assertion in the 1992 presidential campaign that NAFTA would create a "giant sucking sound" as US jobs and investors rushed south of the border.

But that warning overlooked the possibility that foreign direct investment (FDI) and job creation abroad are complements to investment and job creation at home, that offshoring strengthens the competitiveness of the US outward investor (leading to both substitution for and enhancement of home country economic activity), and that the complementary effects may be even greater than the substitution effects.

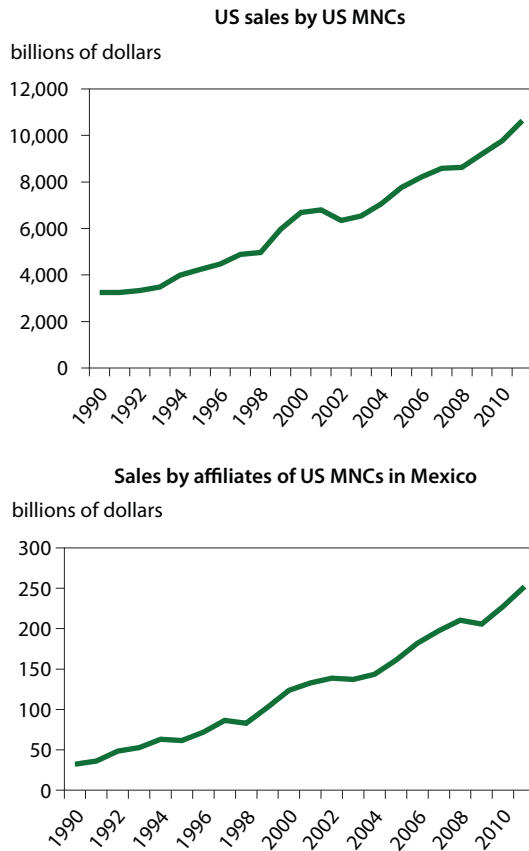
This essay builds on our recent [PIIE Policy Brief *The US Manufacturing Base: Four Signs of Strength*](#) (Moran and Oldenski 2014), which presents empirical evidence that increased offshoring by US manufacturing multinational corporations (MNCs)—a phenomenon criticized as contributing to domestic job losses—is actually associated with overall greater investment and increases in jobs at home. This update focuses on the subset of US firms that offshore to Mexico. We find that they, too, use their foreign activities to complement, and not just substitute for, their employment, sales, investment, and exports in the United States, with the net result not a loss but an increase in jobs and investment at home that can be directly linked to investment abroad.

In 2012, Mexico was only the 23rd largest recipient of FDI worldwide, but it was the 11th largest destination for investment by US firms. In 2011 (the most recent year for which detailed data are available), affiliates of US firms in Mexico sold \$252 billion of goods and services and employed 1.3 million Mexican workers.

Figure 1 shows that the volume of sales by US MNCs, both sales that originated in the United States and those by affiliates of US firms in Mexico, has grown over two decades. Sales by affiliates of US firms in Mexico grew from about \$32 billion in 1990 to \$252 billion in 2011. In 1990 these sales were 2.2 percent of sales by US MNCs that originated in the United States, and in 2011 they were 3.6 percent of US-based sales. Foreign and domestic sales by US MNCs follow similar trends, with the rate of growth varying with times of overall economic growth and contraction.

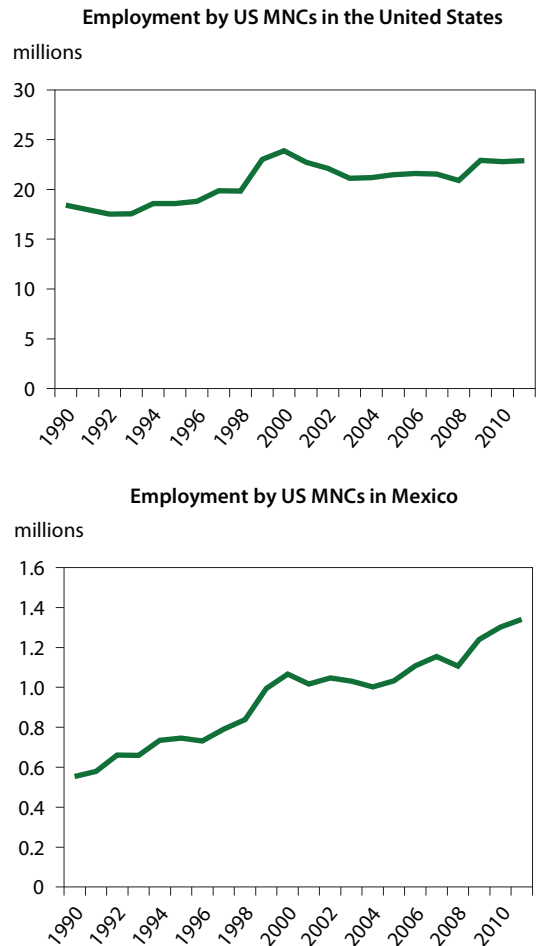
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Figure 1 Sales by US multinational corporations (MNCs) originating in the United States and affiliates in Mexico, 1990–2011



Source: US Bureau of Economic Analysis.

Figure 2 Employment by US multinational corporations (MNCs) in the United States and at affiliates in Mexico, 1990–2011



Source: US Bureau of Economic Analysis.

Figure 2 shows the employment trend by US MNCs in the United States and at their affiliates in Mexico over the same time period. Employment by affiliates of US firms in Mexico grew from about 553,000 workers in 1990 to 1.34 million in 2011. Employment in Mexico went from 3 percent of employment by US MNCs in the United States to 5.9 percent of employment by US MNCs in the United States in 2011. As was the case with sales, it is clear from figure 2 that employment by US MNCs in the United States and Mexico both follow similar trends, with the rate of growth varying with times of overall economic growth and contraction.

Trade between US MNCs and their affiliates in Mexico has also grown since the signing of NAFTA. Trade in both directions increased rapidly in the second half of the 1990s and was close to being balanced during that period. In the early 2000s, US MNCs imported more from their affiliates in Mexico than they exported to them, though the trade gap began to narrow in 2008.

US firms with affiliates in Mexico operate in a variety of industries. Not surprisingly, given the extent of offshoring by US auto companies, the largest of these is transportation equipment, which includes automo-

Table 1 Employment at affiliates of US multinational corporations in Mexico in 2011, top 15 industries

	Industry	Employment (thousands)
1	Transportation equipment	206.6
2	Beverages and tobacco products	164.9
3	Chemicals	43.2
4	Machinery	31.5
5	Professional, scientific, and technical services	24.6
6	Semiconductors and other electronic components	22.3
7	Plastics and rubber products	22.0
8	Accommodation and food services	17.0
9	Mining	14.1
10	Communications equipment	11.4
11	Finance, except depository institutions	11.3
12	Agriculture, construction, and mining machinery	10.7
13	Architectural, engineering, and related services	10.7
14	Soap, cleaning compounds, and toilet preparations	9.5
15	Computers and peripheral equipment	9.1

Source: US Bureau of Economic Analysis.

what happens to domestic employment, sales, capital investment, and exports in the United States when an individual firm expands its FDI activities. Obviously many other factors such as recessions, industry trends, and idiosyncratic firm decisions will also affect the domestic operations of US firms. For this reason, we employ panel regression methods that allow us to control for those factors and isolate the direct relationship between foreign expansion and domestic outcomes at US firms.

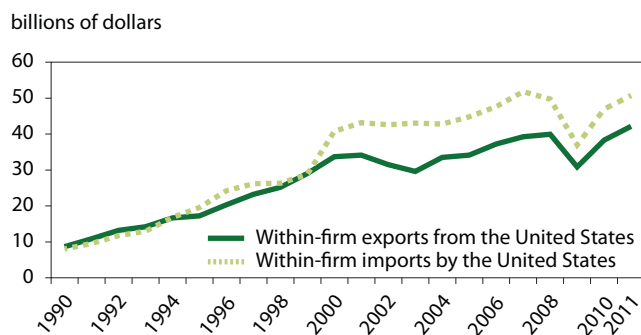
These methods use data on all US MNCs with foreign affiliates in Mexico. We include firm fixed effects, which allow us to examine changes within each firm over time, rather than comparing one firm to another. Firm fixed effects hold constant everything that is unique about a given firm, isolating how its employment in the United States and the other variables we examine change when the firm increases its outward FDI. Thus all the characteristics that define a given firm—such as the industry it operates in, its size, its relative market power, etc.—are controlled for, allowing us to focus only on the relationship between offshoring and the domestic activities of US firms.

bile manufacturing. Table 1 provides details on the 15 largest industries, ranked by the number of workers employed by US MNCs in Mexico in 2011.

What Happens to US Firms' Domestic Operations When They Invest Abroad? The Case of NAFTA

Figures 1–3 show that investment by US MNCs in Mexico has increased since the signing of NAFTA. But has this expansion come at the expense of investment and employment in the United States? To disentangle the extent to which MNC activity at home and abroad are substitutes or complements, we examine detailed microdata on how individual firms behave over time. The US Bureau of Economic Analysis (BEA) collects confidential firm-level data on the activities of US-owned multinationals, both at home and at their foreign affiliates. All US-owned firms with at least one foreign affiliate that meet a minimum threshold by size are required by law to provide this data to the BEA. These data allow us to examine

Figure 3 Within-firm trade exports from US multinational corporations (MNCs) to their affiliates in Mexico and imports by US MNCs from their affiliates in Mexico, 1990–2011



Source: US Bureau of Economic Analysis.

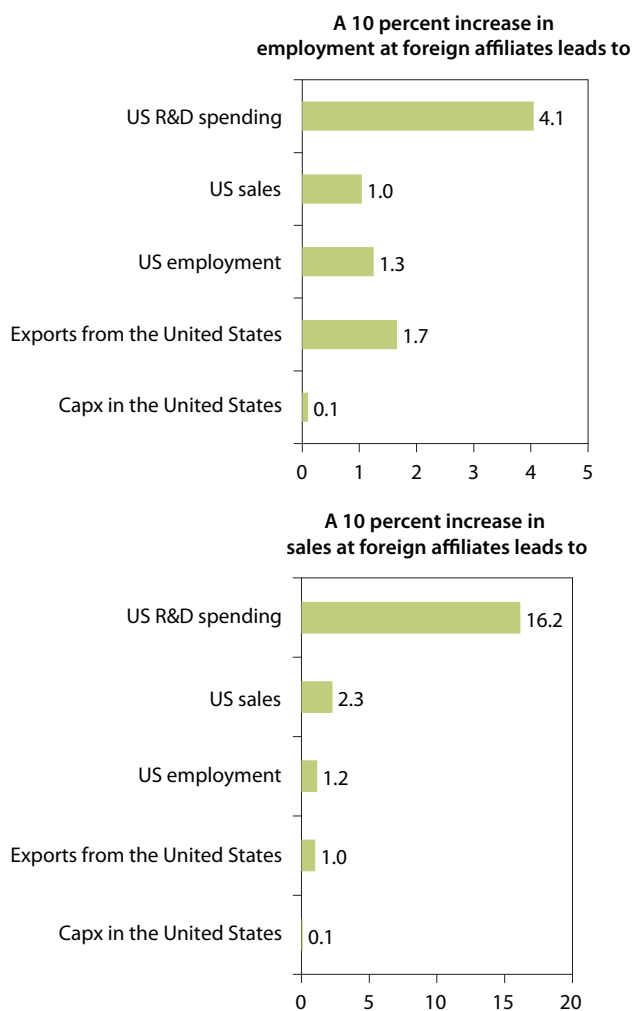
We also include year fixed effects, a technique that controls for the potential impact of recessions and booms (controlling for such impacts is particularly important in light of the severe Mexican currency crisis shortly after NAFTA was signed). Just as firm fixed effects hold constant firm characteristics, year fixed effects hold constant everything external to the firm that was going on in a given year. The only way to truly identify a causal effect between foreign and domestic activity would be to randomly assign some US firms to become multinationals, while forcing others to remain purely domestic. This type of pure experiment is neither possible nor desirable. Using the fixed effects methodology is the next best option, however. This approach controls for everything that is unique about a given firm and looks at changes within each firm over time, rather than drawing conclusions based on observed behaviors across very different firms.

Figure 4 summarizes the relationship between US MNC activities at home and in Mexico. These results draw on firm-level data from 1990 through 2009, covering hundreds of US MNCs and their more than 1,000 affiliates in Mexico.

The first thing to note about these results is that they all show a positive impact on investment and jobs in the United States. Thus expansion in Mexico by a US-based MNC is associated with domestic US expansion by the same firm. The foreign operations of these firms are net complements to domestic US operations. These results are consistent with the complementarities that we found using all countries in which US firms invest (Moran and Oldenski 2014). US firms that have greater sales, hire more workers, spend more on R&D, export more goods, and invest more capital in Mexico also have greater sales, hire more workers, spend more on R&D, export more goods, and invest more capital in the United States. So the overall message is that greater investment in Mexico by US firms benefits both countries.

To explain the results from figure 4 more specifically, consider that the average US firm in the sample employs 25,642 workers in the United States and 1,311 workers in Mexico. Thus a 10 percent increase in employment at affiliates of US firms in Mexico would correspond to about 131 jobs in Mexico. Using the em-

Figure 4 Relationship between foreign expansion in Mexico and domestic activities of US multinational corporations, 1990–2009



Capx = capital investment by US multinational corporations;
R&D = research and development

Notes: The numbers in this figure are regression coefficients that isolate the relationship between each variable listed and either domestic employment or sales, controlling for firm characteristics, industry characteristics, and business cycle macroeconomic conditions as described in the text. All results are statistically significant at the 1 percent level. The statistical analysis of firm-level data on US multinational companies was conducted at the Bureau of Economic Analysis, US Department of Commerce, under arrangements that maintain legal confidentiality requirements. Views expressed here are those of the authors and do not reflect official positions of the Department of Commerce.

Source: Authors' calculations.

ployment numbers from the top panel of [figure 4](#), this increase would be associated with a 1.3 percent increase in employment per MNC in the United States, or 333 US jobs per firm. Accordingly, for the average US firm, adding 131 jobs in Mexico would create 333 new jobs in the United States at that same firm. These relationships may be hidden by other simultaneous trends, including economic downturns, US economic growth, or developments within a given industry. That is, without the benefit of econometric analysis such as ours, these relationships may be hidden within the aggregate data. But it is clear from these results that any fall in US employment by US MNCs is not due to offshoring to Mexico, since this offshoring exerts a net positive force on the domestic operations of US firms.

These findings do not mean that certain aspects of overseas expansion never diminish similar aspects of home country MNC activity. Quite the contrary, the spread of investment and R&D, like trade in general, is likely to result in reshuffling economic activity within and among the United States, Mexico, and Canada and within and among sectors in each country. The point is that a dispassionate public policy analyst would have to conclude that the aggregate result from outward FDI on the part of US firms after NAFTA is strongly positive. Conversely, the overall consequences would be less activity at home—not more activity at home—if overseas operations of US MNCs had not been able to take advantage of NAFTA.

A case study illustrates this point. One of the best-selling and most successful trucks in the world has been Ford's F-150 series. Following the completion of NAFTA, Ford redesigned the F-150 line, making the Ford Essex engine plant in Windsor, Canada, the exclusive source of the 5.4 liter, 32-valve high-performance Triton V-8 engine, and choosing Ford's contract manufacturer, IMMSA of Monterrey, Mexico, as the sole supplier of the M450 chassis, using inexpensive but reliable Mexican steel alloy.

Ford's prospects for holding its share of the truck market in subsequent years vis-à-vis the Toyota Tacoma and the Isuzu D-Max, not to mention the Chrysler Dodge Ram, depend upon this NAFTA-integrated supply chain. Recently, the United Auto Workers' called for NAFTA to be "renegotiated to fix the many problems with this agreement and to stop the outsourcing of good-paying manufacturing jobs to Mexico."¹ However, the competitive fate of UAW workers at Ford's US assembly facilities actually depends on NAFTA.

Other previous studies have found results that tell a similar story. [Mihir A. Desai, C. Fritz Foley, and James R. Hines \(2009\)](#) use firm-level data from 1982 to 2004 to show that growth in employment; compensation; fixed assets; and property, plant, and equipment at foreign affiliates of US firms is associated with US domestic growth in these same measures. (Similarly, [Lee Branstetter and Foley \[2010\]](#) find that US firms that invest in China simultaneously invest more in the US home market.)

Overall the evidence paints a picture in which outward investment is an integral part of MNC strategy to maximize the competitive position of the whole corporation, a goal for which headquarters raises the needed amount of capital from sources all around the globe. In determining where to deploy capital and where to locate production, relative costs—including relative wages and benefits (and well as relative skills and relative productivity)—play a role. But in the end, operations at home and operations abroad complement each other as the MNC parent tries to make the deployment of tangible and intangible assets most productive and most profitable.

Fears that expansion abroad may lead to contraction at home have been raised in discussions of trade agreements now on the US agenda, particularly the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP). But the strong complementary relationship revealed here—and in other similarly rigorous studies—means that firms, workers, and communities will likely be net beneficiaries of such market-opening and investment-widening agreements.

1. The quotation comes from the UAW website. Ford's decision to shift from steel to aluminum for the F-150 will involve a new configuration in source of inputs. Available at www.uaw.org (accessed on July 2, 2014).

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THE ACCOMPLISHMENTS OF THE PACIFIC ALLIANCE

BARBARA KOTSCHWAR

The Pacific Alliance, comprising Chile, Colombia, Mexico, Peru, and Costa Rica (which joined recently), is not as large as the other megaregionals, the Trans-Pacific Partnership (TPP) and Transatlantic Trade and Investment Partnership (TTIP), but it is an interesting initiative in which Mexico is participating and can be seen as the next phase in the evolution of the North American Free Trade Agreement (NAFTA).

The Pacific Alliance is knitting together preexisting trade arrangements in a deepening integration arrangement. It is a relatively significant chunk of Latin America, representing over 40 percent of Latin America's GDP and about 37 percent of the population ([table 1](#)). In terms of global trade, members represent 68 percent of Latin America's share of world trade and about 40 percent of foreign direct investment (FDI) inflows into Latin America. So the Pacific Alliance is a relatively big deal. It's also a big deal because of the signals that it sends in terms of Latin American trade.

Mexico already has free trade agreements (FTAs) with the Pacific Alliance countries. They all have FTAs with one another. They all also have FTAs with the United States and Canada. So even though NAFTA is not a member of the Pacific Alliance, Mexico's NAFTA partners are observers, NAFTA is present in terms of the joint FTAs, and US FTAs are all based on NAFTA and evolving NAFTA disciplines.

Another interesting element of the Pacific Alliance is the attention that it has gained. The Pacific Alliance is the next big thing. The press has paid a lot of attention to it because it represents a Latin America that is actually moving forward, increasing its liberalization, and showing signs of wanting to engage. All these countries were pro-progress in the Free Trade Area of the Americas (FTAA) negotiations.

Chile, Mexico, and Peru are also TPP negotiating parties, while Colombia and Costa Rica, since they are not yet APEC members, are not. But there is a common base in terms of relationships with Asia and the Pacific. All of these countries have been increasing their participation in trade agreements and bilateral investment treaties with countries in the Asia-Pacific region.

Another notable signal is the large number of observer countries to the agreement: another sign of the increasing interest in the Pacific Alliance. Observers include countries from Latin America that would like to join, like Panama and Guatemala; NAFTA members Canada and the United States; and countries in Europe, the Middle East, and Asia (including China and India)—in other words, significant countries are observer countries in the Pacific Alliance (see note to [table 1](#) for complete list).

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Table 1 Pacific Alliance membership

Country/grouping	GDP (PPP) in billions of international dollars, 2013	Per capita GDP (PPP) in international dollars, 2013	Population, 2013 (millions)	Share in world trade, 2012 (percent)	FDI inflows, 2012 (billions of US dollars)
Chile	335	19,067	18	0.43	30.3
Colombia	528	11,189	47	0.33	15.8
Mexico	1,843	15,563	118	2.03	13.4
Peru	344	11,124	31	0.24	12.2
Costa Rica	62	12,942	5	0.08	2.3
Pacific Alliance	3,111		219	3.1	74.0
LAC	7,513		593	4.53	174.5
Pacific Alliance as percent of LAC	41		37	68	42.0

FDI = foreign direct investment; LAC = Latin America and the Caribbean; PPP = purchasing power parity

Note: Observers = European countries (Belgium, Finland, France, Germany, Italy, the Netherlands, Portugal, Spain, Switzerland, and the United Kingdom); NAFTA countries (Canada and the United States); Central American and Caribbean countries (Dominican Republic, El Salvador, Guatemala, Honduras, Panama, and Trinidad and Tobago); South American countries (Ecuador; Paraguay and Uruguay from the Mercosur customs union), Middle Eastern countries (Israel, Morocco, and Turkey) Asian countries (Australia, New Zealand, China, India, Japan, Korea, and Singapore).

Sources: International Monetary Fund, *World Economic Outlook* (WEO) database, April 2014; World Trade Organization, *International Trade Statistics*, 2013; and Economic Commission for Latin America and the Caribbean, *Foreign Direct Investment in LAC*, 2012.

Why do we care about the Pacific Alliance? What makes it so interesting? The stated objectives include

- to construct an area of deep integration;
- to liberalize the circulation of goods, services, capital, and persons;
- to increase the growth, development, and competitiveness of the member countries;
- and
- to become a political platform for greater economic and trade integration with an emphasis on the Asia-Pacific region.

The Pacific Alliance is trying to do a couple of things. One, which is what the FTAA should have done but was unable to do, is iron out some of the wrinkles in America's "spaghetti bowl" by harmonizing some of the rules and administrative procedures in existing bilateral FTAs.

Second is to send a signal welcoming foreign investment and to create a larger area for investment. This has drawn a lot of attention from investors outside of the region, who see this as a potentially very interesting platform for economic activity in the greater Latin American region.

And third is to bolster regional value chains with the aim of exporting more to Asia and becoming a greater part of the Asia-Pacific value chain. So these are very ambitious objectives.

What has been done to date? The Pacific Alliance was signed in February 2014 and is starting to come into effect. The countries have harmonized their bilateral FTAs and published their tariff schedules (table 2). We've been taking a look at the tariff schedules, and it does seem that progress is being made, even though the trade impact of the Pacific Alliance, of the joining together of these countries, is not huge. The triangles are relatively small because these countries already had free trade pacts with one another. However, the bulk of the universe of trade among the membership is now free.

Table 2 Pacific Alliance: Accomplishments

Area	Achievement
Trade and integration	Harmonization of bilateral free trade agreements (FTAs) Elimination of tariffs and other trade and investment barriers Other common FTAs: US, Canada, EU, European Free Trade Association, some Asia
Services and capital	Mercado Integrado Latinoamericano (MILA) (currently 26 percent of Latin American market capitalization; with Mexico, represents 49 percent, nearly equal to Brazil's stock exchange, Bovespa) All participating in Trade in Services Agreement (TiSA) negotiations
Movement of persons	Elimination of visa requirements for Pacific Alliance nationals "Work holiday" visas for youth
Institutions and cooperation	Shared embassies and trade missions. This helps induce investors to view the region as a significant investment space.

The impact of merging those bilateral pacts will be slightly bigger than just the sum of the FTAs. One area of greater impact is the potential of knitting together some of their other common FTAs. One could anticipate the Pacific Alliance countries getting together and proposing some harmonization within their FTAs with the United States and Canada. The megaregionals, TPP and TTIP, loom large and so this could be a good strategy for these countries of integrating into these megaregionals swaths of 21st century trade rules.

While the scope of the Pacific Alliance on paper looks smaller than did the FTAA proposed text, this initiative has actually been much more ambitious. In terms of services and capital three of the four stock exchanges have already joined together, and Mexico has pledged to join

in December 2014. This is a big deal. This will now rival the Bovespa (Brazil's stock exchange) in terms of magnitude, and the potential is great. All these countries are participating in the Trade in Services Agreement (TiSA) negotiations—the plurilateral negotiations on trade and services—and will continue their services negotiations in the Pacific Alliance.

Significantly, Pacific Alliance countries have started liberalizing the movement of persons. The original Pacific Alliance agreement includes the elimination of visa requirements for Pacific Alliance nationals. In other words, Mexicans can travel to other Pacific Alliance countries without having to pay or take the time to obtain a visa.

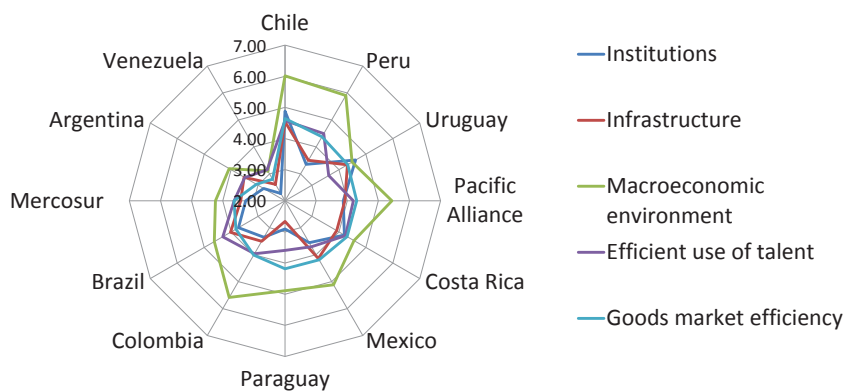
Recently this has been supplemented with a work holiday visa for youth. So Mexicans between 18 and 30 years of age can go to Colombia and find work and stay for up to a year. This is interesting in a region where youth unemployment is an issue and where each of these countries has labor market issues with skill mismatches. So a greater pool of people is moving around to take advantage of opportunities.

A final compelling element is the formation of institutions. And I don't mean things like a BRICS¹ bank or a parliament but a very pragmatic approach to sharing institutions, such as shared embassies and trade missions. There are already a number of shared embassies in, for example, Vietnam and Ghana, where the trade promotion agencies are working together marketing joint products. And so if you go to Vietnam you can buy Pacific *pisco* and you won't necessarily know whether it comes from Chile or Peru. It is not clear whether that is actually true, but you will have information on the shared-joint promotion of all of these countries.

The Pacific Alliance is also a political signal that this region is different from the rest of Latin America. Latin America over the last couple of years has become increasingly bifurcated. And by any measure of competitiveness, if you plot any of the indicators, for example, the World Economic Forum Global Competitiveness

1. BRICS stands for Brazil, Russia, India, China, and South Africa.

Figure 1 Pacific Alliance versus Mercosur



Note: The hemisphere is bifurcated in terms of economic policy. The Pacific Alliance emphasizes this division and sends a signal to investors.

Source: World Economic Forum, Global Competitiveness Index (GCI) 2013-2014.

indicators, you get a picture that looks much like figure 1, with a division between the liberalizers and the nonliberalizers or the 21st century socialist versus the 21st century capitalist, and it's always the Pacific Alliance in the fuller area where, in figure 1, bigger is better.

So in terms of institutions, infrastructure, macroeconomic environment, efficient use of talent, and goods market efficiency, the Pacific Alliance countries consistently rank above Mercosur (Argentina, Bolivia, Brazil,

Paraguay, Uruguay, and Venezuela) and other neighbors in Latin America. The Pacific Alliance recognizes and builds upon that.

This is not to say that the Pacific Alliance is trying to further bifurcate the hemisphere. This is simply plotting data, but it is a signal to investors and has been taken as such. Investors, particularly from Asia, are really interested in this new bloc. They have seen some of the bigger southern Atlantic countries as a reasonable place to locate their production facilities and are now looking at countries like Colombia or Chile, which are smaller but now have greater scope.

What does the Pacific Alliance mean to Mexico (table 3)? In terms of Mexico's export profile, it's relatively small. NAFTA is still obviously bigger. But the Pacific Alliance markets have been growing at an annual rate of about 18 percent over the past decade. And what's important with the Pacific Alliance is also the growth of exports and some joint exports to the Asia-Pacific region.

In terms of future prospects, one of the keys to the Pacific Alliance's success has been flexible pragmatism. Unlike the FTAA, where the single undertaking constrained the ability of countries to move forward, the Pacific Alliance has taken a very different approach. Members have gone forward in the areas in which they are able to progress and haven't let themselves be hung up in areas that might be desirable but are not at the moment feasible. And so this is very important and I think will be important to the continued success of the Pacific Alliance.

Limited size has meant that bigger goals are possible for member countries, which have similar policy objectives. So the small number of countries engaged in the Pacific Alliance has meant that they are able to engage in this flexibly pragmatic manner. This has helped members undertake things like allowing citizens of each other's countries to come in and now to work for a certain period of time.

Table 3 What does the Pacific Alliance mean to Mexico?

Country/grouping	Percent of Mexico's exports	Annual growth of Mexican exports, 2004-13 (percent)
NAFTA	82	6
European Union	5	11
Pacific Alliance	3	18
Mercosur	3	16
ASEAN	less than 1	12
China	2	21
Japan	1	7
Korea	less than 1	21

ASEAN = Association of Southeast Asian Nations; NAFTA = North American Free Trade Agreement

Source: International Monetary Fund, Direction of Trade Statistics (DOTS) database.

Agreement on the goals increases the chance of success. Therefore, like-minded countries are able to do more and undertake more like-minded initiatives. Even though this is a political signal and there's an element of politics and policy, increased trade and investment has been the endgame. And the Pacific Alliance has pursued that in its policy initiatives.

Recently, Pacific Alliance countries have engaged in talks with Mercosur countries, which as we see in [figure 1](#) have very different policies, at least currently. Where that will go depends on the desires of both sets of countries. I suspect that the Pacific Alliance will be flexibly pragmatic about this and members will not get bogged down in Latin American politics and institution building.

Finally, the Pacific Alliance can be a potential pathway for Latin American participation in the megaregionals, particularly for countries like Colombia and Costa Rica, which are not part of the TPP negotiations. This can serve as a hub for knitting together FTAs, for linking up to TPP for those who are not already negotiating in TPP, and for linking up to TTIP. There's a larger base of trade, a larger base of policy concordance, and this could be an interesting way for these small and medium countries to have an impact in the megaregionals.

UPDATING NAFTA: IMPLICATIONS OF THE TRANS-PACIFIC AND TRANSATLANTIC PARTNERSHIPS

JEFFREY J. SCHOTT

Barbara Kotschwar mentioned that the Pacific Alliance is the next big thing and explained very well why that's the case. In the early 1990s, people said the same thing about the North American Free Trade Agreement (NAFTA), and that agreement was state of the art. It was the most comprehensive trade agreement ever negotiated. And it was designed also to give a kick in the pants to the stalled Uruguay Round of multilateral trade negotiations in the General Agreement on Tariffs and Trade (GATT), and it did so. So NAFTA served a number of important purposes for the United States, Canada, and Mexico.

A similar situation has arisen now with the confluence of regional, bilateral, and multilateral talks. The slow pace of the Doha Round of multilateral trade negotiations in the World Trade Organization (WTO) has led key trading nations to look to complements, alternatives, hopefully new initiatives, that could revive the multilateral system. We have megaregionals that have been launched over the past five years or so, namely the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP).

Unfortunately, they haven't given a kick in the pants to the WTO talks. Despite the agreement on the Bali package of trade reforms in December 2013, that breakthrough now seems like a fleeting and distant memory. The WTO talks are stuck in the mud. They're not going anywhere. And it seems like the great enthusiasm of the agreement on trade facilitation in Bali has already been long forgotten. Negotiators and diplomats in Geneva are back to their talking points from 2008 and 2009.

That returns the focus to the megaregionals. The United States, Canada, and Mexico are all negotiating in the TPP. Each has a separate agreement with Europe. But the aims of these megaregionals are to deepen trade and investment ties with partner countries, to create new trade rules in areas not yet covered by WTO obligations, and to set broader precedents for multilateral negotiations if a new strategy can be devised to revive those talks.

This article addresses the implications of these megaregionals for NAFTA and North American economic integration.

The first thing to emphasize is that the TPP is important for NAFTA countries, which are a critical part of the TPP. The TPP represents almost 40 percent of global output and 25 percent of global exports. And of that, NAFTA is really the economic core of the TPP countries. Even with Japan in the deal, 68 percent of the combined output and almost 60 percent of the population of the 12 participants in the TPP are NAFTA countries. It's important that they are working together to help develop the 21st century rulebook for the world trading

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system. It's important for each of the countries because it adds new FTA partners. But it also updates existing pacts with other TPP countries. One often finds too casual a discussion of trade agreements as if they are all the same. But old trade agreements are actually much less comprehensive with many more exceptions and lack coverage of some of the new trading rules that are critically important for the conduct of international commerce in the 21st century. And so that is something that the TPP is trying to build in and thus would be incorporated into NAFTA.

Like NAFTA in the North American region, the TPP has great strategic importance for its members in the broader Asia-Pacific region. For NAFTA partners, this is manifested in two respects. First, for each country by deepening the economic and political ties with the partner countries, it makes it easier to manage frictions that inevitably arise in international relations. Second, it provides an important channel to project North American interests and NAFTA precedents in the TPP region.

The TPP would also generate significant income and trade gains for each of the countries. Very important work has been done here by my colleague Peter Petri on the estimated income and export gains from a TPP-

12. Petri's estimates show that for the United States, Canada, and Mexico both income and export gains would be significantly greater than would otherwise have occurred in the absence of the agreement. When the deal is fully implemented, Petri projects income gains of 0.4 to 0.5 percent over the baseline. These small percentages actually are large gains: 0.4 percent of GDP for the United States is a big number. And the NAFTA total represents about a third of the total income gains and more than a third of the export gains of the TPP-12 countries. If additional countries join the TPP as is expected in the coming years—Korea, Indonesia, Thailand, and the Philippines, all of which are seriously studying prospective membership—then the gains become even greater and the NAFTA share becomes even greater, as shown in table 1. Now how will the TPP affect NAFTA provisions? In brief, a

critical gain for the United States, Mexico, and Canada is that the TPP will update and augment NAFTA without having to renegotiate NAFTA. And, in fact, the TPP is a substantial augmentation of the original NAFTA.

Table 1 NAFTA and TPP, 2025

Country	Income gains			
	TPP-12		TPP-16	
	US dollars ^a	Percent ^b	US dollars ^a	Percent ^b
United States	76.6	0.4	108.2	0.5
Canada	8.7	0.4	12.4	0.6
Mexico	9.9	0.5	31.2	1.6
NAFTA total	95.3	0.4	151.9	0.6
TPP-12 total	285	0.9	395.6	1.2
NAFTA gains as a percent of TPP total	33.4	n.a.	38.4	n.a.
Country	Export gains			
	TPP-12		TPP-16	
	US dollars ^a	Percent ^b	US dollars ^a	Percent ^b
United States	123.5	4.4	190.5	6.8
Canada	13.8	2.3	17.7	3
Mexico	19.1	3.8	40.1	7.9
NAFTA total	156.4	4	248.3	6.3
TPP-12 total	440.5	6.6	633.1	9.5
NAFTA gains as a percent of TPP total	35.5	n.a.	39.2	n.a.

a. Billions of 2007 US dollars.

b. Percent change from 2025 baseline.

n.a. = not applicable; NAFTA = North American Free Trade Agreement; TPP = Trans-Pacific Partnership

Note: The TPP-16 scenario is based on membership of Indonesia, Korea, the Philippines, and Thailand.

Sources: Petri, Plummer, and Zhai (2013); asiapacifictrade.org.

Now in the area of labor and environment, I think it's important to spell out what was said in the [last panel](#). [Gary Hufbauer](#) had it right. One of the important changes for NAFTA countries is integrating the labor and environmental chapters into the core agreement, which means tying them to the dispute settlement provisions of the overall agreement. This is one of the biggest sources of contention in the TPP negotiations right now because members of the US Congress insist on having labor and environment as part of the core agreement subject to dispute settlement.

Other countries are willing to augment their trade obligations on labor and environment, but not in areas that [José De Gregorio](#) was worried about, like capital controls, where they have different policies, but in areas where they have already reached common agreements and accepted common obligations in other international conventions. They are unwilling to do so, however, if tied to dispute settlement. And so there is now a calibration going on in the TPP negotiations between the strength of the dispute settlement procedures and the level of detail of the obligations on labor and environment. Whatever the final balance, the TPP outcome will surely improve upon existing NAFTA obligations and enforcement in these areas.

Regional rules of origin will also be important. And added coverage of government procurement, new disciplines on state-owned enterprises and e-commerce will also be a value added of the TPP for NAFTA countries, but no new disciplines on contingent protection policies. These weren't included in NAFTA, and the United States Trade Representative (USTR) and Congress refuse to consider any changes in US antidumping or countervailing duty law in any US FTA negotiation.

And finally a comment on TTIP because it is important (box 1). TTIP is on a much slower time path than TPP. Talks are underway again in Brussels, but they have a much longer time horizon. They could have implications and create frictions or distortions within North American economic integration if not done properly.

Right now, the three NAFTA countries have separate arrangements or are negotiating separate arrangements with the European Union (EU). Canada and the EU announced a deal in 2013, but it was incomplete and they agreed to continue to finish the negotiations following the announcement. Mexico and the EU have an agreement that goes back 14 years and it's much less comprehensive than subsequent deals that Mexico has negotiated. And this is an area where Mexico and the EU are now considering updating as well, but again, on a slower time path.

The one area that could cause substantial distortions on North American economic integration is if the United States and the EU make substantial progress on regulatory convergence and adopt higher standards than exist in the NAFTA region right now. That would apply to the United States and Europe, but not necessarily to Canada and Mexico, if the standards and the regulations were applied differently to non-TTIP countries. That is one area that needs to be followed very closely and one reason why some observers, including Carla Hills, a member of the Peterson Institute board, has suggested that there be a trilateral or NAFTA negotiation with the EU instead of the bilateral TTIP. That hasn't been accepted by either the United States or the EU, though both are anxious to see an expansion of the TTIP once it is concluded. But if it's on a slower timetable that means that the timing of these integration efforts or their sequencing may not work out as well as desired.

Box 1 NAFTA: Implications of the TTIP

- NAFTA trading partners have separate bilateral efforts with the European Union (EU): the TTIP, the Canada-EU Comprehensive Economic and Trade Agreement (CETA) (signed in 2013), and the EU-Mexico FTA (entry into force in 2000).
- TTIP's novel contribution will be regulatory convergence; higher TTIP standards/regulations could affect access to US/EU markets for Canada and Mexico.
- The CETA includes some enhanced provisions on agriculture (e.g., market access through tariff-rate quota [TRQ] and geographical indication [GI] protection) and procurement (e.g., subfederal level), but has a less advanced agenda on regulatory issues compared with the TTIP agenda.
- The EU-Mexico pact is relatively less comprehensive; concerns that advantages gained through EU FTA could easily be eroded by US and Canadian deeper liberalization.
- The TTIP membership procedures will limit third-country accession until after the deal is concluded, despite interest of Mexico and Turkey.

Essentially, there is scope for distortions in agricultural trade because of the compromises made in the Canada-EU deal and likely to be made in the US-EU negotiations that could have an impact on North American trade and on the ability of the three North American countries to work more closely with the EU.

So those are just warnings not necessarily problems that will eventuate, but it's better to mention them to try to avoid the problems before they take full form.

So final conclusions or main takeaways: The TTIP will update and augment NAFTA without renegotiating NAFTA and that would contribute to a deepening of North American economic integration. TPP should strengthen North American competitiveness and significantly boost output and exports of each country. Moreover, TTIP could also produce additional advantages for NAFTA countries, but US officials need to take care in how it's developed and not create new frictions in the NAFTA region as a result of the TTIP regulatory reforms.

Last, if TTIP and TPP could follow the original NAFTA impetus and spur more plurilateral and multilateral agreements that strengthen the world trading system—like NAFTA did originally with Uruguay Round—then it would be a win-win-win for all three countries.

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A VISION FOR NORTH AMERICAN ECONOMIC INTEGRATION

THOMAS F. “MACK” McLARTY

The first point I would make [about] the North American Free Trade Agreement (NAFTA) is it may be a little surprising that we’re all here on its 20th anniversary. NAFTA was not an ordained conclusion. In fact, about a month before we went forward with it, *Business Week*, said, “NAFTA is not out, but it is down,” because the forces against it had already rallied in a very serious way.

The Clinton administration built on the agreement that was negotiated by [PIIE] board member Ambassador Carla Hills with President George H. W. Bush, and there were clauses in the agreement that had to be renegotiated. I remember President Salinas and others saying, “No, you’re not asking us to go an extra mile. You’re asking us to go the extra-extra mile,” as we finally got down to the specifics.

So the first point in terms of history and importance is [that] presidential leadership was critically important [for] NAFTA and will be [for] the other trade agreements discussed today. I recall so well driving in from Andrews Air Force Base with President Clinton and Ambassador Medina Mora. I asked, “Mr. President, are you ready for us to move forward on NAFTA following our economic plan?” He was usually very easy to deal with; he turned and said a bit tersely, “Mack, I have told you now three times I am ready to move forward.” I said, “Mr. President, I’m aware of that. But not everybody in our White House and our administration is ready to move forward. I just want to make absolutely sure that you are before we do.”

Any trade agreement is difficult, and the sequencing of those agreements within any administration with other legislative matters, other priorities, is always a challenge.

The second point is that it is so much better, and really essential, to pass any major piece of legislation, and certainly any major trade agreement, in a bipartisan manner. You really can’t get enough votes without doing that. But even if you’re able to force [legislation] through with a small [number] of votes from one side of the aisle to the other—and it’s usually on my side, the Democratic side, that the challenge occurs—it’s not going to be as well received or broadly accepted.

I have good memories of marshalling support on both sides of the aisle. It’s the only time I can remember Newt Gingrich and George Stephanopoulos in the Roosevelt Room counting heads together. It only happened that one time. I think we were pretty effective in bringing together former presidents, and I really commend

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President George H. W. Bush, who had just come off the election, as well as President Carter and former secretaries of state, [for] support[ing] the initiative on a bipartisan basis.

The third point [about] NAFTA—[and] which applies to the Transatlantic Trade and Investment Partnership (TTIP) and the Trans-Pacific Partnership (TPP)—is that NAFTA was much more than a trade agreement. In many ways it put a framework in place, particularly for Mexico, but now we're seeing also in the North American continent [and] in the world the reality that economics, security, and so many other factors [are] increasingly interconnected.

That was particularly important in Mexico. As we have seen, Mexico's development still [has] many challenges—as Ambassador Medina Mora would note, and we've got a few challenges here in the United States—but you see the development of such a strong independent central bank, you see a rising middle class. You certainly now see reforms that we knew would take some years to get in place but [that are] going forward under the current administration with President Peña Nieto. With the middle class rising, you see the retail segment really developing in Mexico with the United States and other international firms going into Mexico in that manner. You see more emphasis on environmental stewardship than you did 10 or 15 years ago.

I think [this progress] certainly wasn't solely because of NAFTA, but NAFTA put out a pillar, or marker if you will, for Mexico to continue forward, including the political process where you now consistently see historic political processes with different parties coming into power.

The fourth point is that we have to put forward trade agreements in a way that recognizes the legitimate concerns, and the dislocations, even though they may not all be attributed to a specific trade agreement. But in Spartanburg, South Carolina, or Elkhart, Indiana, that's a personal human face [on] a specific issue. Although I would note, in Spartanburg and Elkhart, just to pick two cities somewhat at random, you have major BMW or Boeing plants in that area.

But still, what's hopeful is that you see a bipartisan effort, a rare occurrence these days, [for example] job training programs being streamlined and [made] much more efficient [by] Congress by [a] 90-to-3 vote. We will have to do more with Trade Adjustment Assistance (TAA). Gary Hufbauer really took some of the specific issues and with empirical data addressed them in a very head-on way in his panel.

Finally, I think it is unlikely that trade promotion authority (TPA) is going forward between now and the mid-term [elections]. I would hope that we would get ready to move forward, assuming President [Obama] is serious about trade agreements in his legacy, and I believe he is. I think Ambassador Froman and Secretary Pritzker and others are advocating [TPA] in a very skilled and hard manner. I think Chairman Wyden has gotten the smart track approach, which is how he is trying to build a democratic, bipartisan consensus. So I hope we would be ready to move forward after the mid-terms.

To me, the theme of this conference is really [what] President Clinton captured very well when he looked at trade issues as a Democratic candidate in 1991 and 1992. When Governor Clinton gave his major speech on trade, he was 45 minutes late getting off the airplane because he rewrote [his speech] in a specific manner, [with] great preciseness, to couch his stance on trade.

I think what he concluded was exactly what this Institute has advocated in such a serious, deep, and thoughtful manner. It is reality in terms of trade and goods and capital and services moving. [Trade] does cause some dislocation and unease and anxiety in all countries, but the challenge is to harness that inevitability and make it work for people [by] lifting their lives and standard of living. That's really the essence of trade agreements and the essence of NAFTA. Particularly from the standpoint of Mexico and from the North American platform, [that's] the real future in terms of building on NAFTA, which hopefully will be strengthened by the passage of TPP.

Question and Answer Session

Question by Adam Posen: Mack, we invited representatives of 12 different US multinational companies with significant interest in Mexico—autos, nonauto manufacturing, services—to speak. Each one had a different reason, but not a single one showed up today to speak.

Where Ambassador Eduardo Medina Mora speaks, I think tellingly, about taking each other for granted in a relationship, I worry that large business in the United States takes trade for granted. We're very aware of the loud opposition, but we don't always hear the loud chorus. You mentioned going for a bipartisan deal, of showing presidential leadership, [as] the things we could be calling upon or should be calling upon American business to do—or am I missing the point that they automatically will free ride, and it's only the losers who will be public?

Response by Thomas F. “Mack” McLarty: I think you're making the point, not missing it. I think there won't be any ride, if not only the business community but what I would call the vital center doesn't engage because it will be drowned out by the left and the right, particularly now with the way we communicate with each other. We all know about those [technological] forces and factors, of cable television, and all of that. It's a very different environment than we had even in the 1990s.

So I think you make a very critical point. It's disappointing that you didn't have more participation, interest, and support from the business community. It's an old standing joke—in any White House, Democratic or Republican—that the business community is the most difficult group to organize and energize. That's just a given. We were able to do that pretty well on NAFTA with Bill Daley and Bill Frenzel. We had a bit of a tailwind building and the tailwind building on [the negotiations of] the George H. W. Bush [administration]. It had a timeline. And here you had a centrist Democratic president and the economy—was the economy stupid? That was the focus, so we were able to move forward.

But trade votes are difficult. Part of the feeling in our country today goes into a point you made—without trying to sermonize, I think it's important and it hurt the perception of NAFTA—that [in] the American business community, particularly major corporations—and I've had the privilege to be associated with a number of them—there's this insensitivity or lack of sensitivity. If you want to call it arrogance, you can. But there has to be more sensitivity shown by businesses in how they conduct their affairs, including trade agreements, employment, and so forth. That was part of the point of NAFTA: “We'll never close this plant,” and then six months later, it might have been closed. That's not the storyline you want.

So I think, Adam, if the business community doesn't get a little smarter, more engaged, more energized, you're going to have more and more trouble building a bipartisan consensus and really moving forward with responsible policies, and that would be a sad day.

Question by Barry Solarz, Nucor: The TPP has already been attacked as “NAFTA on steroids.” All kinds of reasons have been given today as to why NAFTA over the last 20 years has been beneficial to all three countries. Let me posit something, and I'd like to get a reaction from our two esteemed guests.

When you cut through all of these reasons and the data, in terms of the insecurities that Dr. McLarty just referred to—at least in the US citizenry—might it not be more effective to build on the last point that Ambassador Medina Mora made, which is that what NAFTA has done—and arguably, depending on how these arguments are negotiated, TTIP and TPP [will do]—the end result could, hopefully will, improv[e] the international competitiveness of the United States and North America in competing against state capitalism, the unique brand of state capitalism that exists in China in particular.

To me, that is a more salient argument with a lot of the population than some of the other points that have been made today. Because while there has not been a clear “giant sucking sound” vis-à-vis Mexico, I think

one can make an argument that there has been somewhat of a sucking sound vis-à-vis the rise of China. So I'd be interested in your views on it.

Response by Thomas F. “Mack” McLarty: Three basic points: One, I think your framing is very thoughtful and well done. I mean, you're really saying we're all 20 years older too, in addition to some of the changes that the Ambassador noted. So it's a different world; just like in anything, you evolve. And now, while most [people] in the United States believe [NAFTA has] been a strong positive, in many ways Mexico even more so, but it's time to move on with life. And I think the North American platform of competitiveness, particularly with energy—not to bugle that too much, I was in the natural gas business for a decade, so I'm a big believer in that—I think that's number one. That's the way to frame it. It just fits with contemporary reality.

Number two, the stronger we are at home, the stronger we are going to be abroad. The more engaged we are abroad, the stronger we are going to be at home.

My point is we had the benefit that the economy was getting better as we were moving forward with NAFTA. And then it really got a strong momentum behind that, and we actually began to cut down the deficit, finally moving even to a surplus, and employment and per capita income and so forth obviously were moving in the right direction. My point is the more secure people feel, the more likely they are to embrace change and look outward. We've got just the opposite of that now, so that's really the second point.

Thirdly, I do think again, not to overstate it, particularly in these hallowed halls here, but I do think there's a lot of factors, including energy certainly, including the integration of the platforms, that are helping [to] provide good opportunities in the workforce, [which was] not the case five years ago. There's still a lot to be done. That's why I tried to emphasize the training programs; as kind of mundane as that sounds, that's obviously very key.

China is a good point because Walmart has been a huge importer of goods from China. I do think the [empirical] points are critically important. You have to make them—imports helping with per capita income, buying power—but that won't win the [argument] at the end of the day; you have to have a broader argument. But Walmart now has a Buy American program, which was just profiled on ABC News. It's because manufacturing is more competitive here in the United States and they're going to buy billions of goods. It's going to create about a million jobs over the next five years. I think it likely will, in terms of suppliers. So you're seeing that.

Another fact, you're seeing automotive plants, basic manufacturing, good paying jobs, good benefits, in the Midwest and in the South, both either begin[ning] or reopen[ing]. That's a pretty strong side. There's been more employment in the South in [the] automotive [sector] than jobs lost in the Midwest. And those are middle income, upper middle income jobs with good benefits.

Those would be the three points I would make. But I do think the framing and putting this in a different context, in a very authentic credible manner, is absolutely crucial.

Question by C. Fred Bergsten: Mack's comments reminded me of the very direct link between NAFTA and today's Trans-Pacific Partnership. Mack will remember that the day after Congress took the final vote on NAFTA and you guys got it through, the president arrived in Seattle for the first APEC summit. And I'll always remember asking him, “Suppose you had lost that vote yesterday?” He said, “I couldn't have come.”

The flip-side was the tremendous momentum that he had coming into that, and that's where APEC agreed to achieve free trade and investment in the region by 2020, which the TPP is now emerging from. The point being, we talked about the payoffs of agreements like NAFTA going beyond just the numbers [as] a tremendous momentum effect, promoting what now becomes one of the biggest trade agreements of all time, and that's got to be chalked up, I think, as a big success for NAFTA on top of all the other things we've talked about.

Response by Thomas F. “Mack” McLarty: Well, Fred, you’ve given me some new material. You’ve refreshed my memory and given me some new material for a future commentary, and I really mean that. Fred has, as usual, hit on a key point; he’s absolutely right. It did give us momentum going into our first Asia-Pacific meeting, a very critical meeting with Japan, China, and all the other players.

But the basic point that we did not mention in this discussion of NAFTA—and perhaps it is because we are comfortable in a positive way with the relationship with Canada and Mexico, maybe we’ve taken it all too much for granted—when we are unable to move forward on trade agreements in a bipartisan manner, it affects US leadership around the world. It goes way beyond just trade agreements. Now, this goes back to the framing of the question: You can put that in terms of US leadership, and that will resonate in Peoria, to use President Reagan’s formulation here.

So I think that’s a great point and probably exactly the positive note we need to conclude a full and important day.

CHALLENGES FROM NAFTA: A MEXICAN PERSPECTIVE

AMBASSADOR EDUARDO MEDINA MORA

There is an old African saying that there are two good moments to plant a tree: 20 years ago and right now. The North American Free Trade Agreement (NAFTA) rules allowed us to achieve a lot and the numbers are overwhelming in many senses. Those achievements are not irrelevant, though challenges are also here with us. I would say that NAFTA has to be seen not merely as a trade agreement; it is much more than that. It is a shared production platform. And in that sense we have to not only look at the numbers, but look at the quality of the numbers, as well as the way we have successfully integrated value-added chains throughout North America.

There are those sectors that have been very successful through this arrangement, automobiles of course, aerospace now increasingly so, the electrical and electronics industry, and services, which are also quite important. The quality of trade numbers has to be taken into account when addressing offshoring, for not all offshoring is equal. When you import Chinese products into the United States, it is very clear that the US value-added into those products is quite low—4 percent. From Europe it is not any better; it's 3 percent. It is 25 percent from Canada because of history in terms of integration, and it's 40 percent from Mexico.

And this has a two-sided story: the relatively low value-added coming from Mexican companies into this equation, which I referred to previously, but there is also the opportunity to grow these numbers in the future, not in terms of changing the value-added equation, but in terms of growing the shared production platform, which is really the opportunity.

We have had a set of rules that has allowed us to achieve a lot, but for the most part, it has been the merit of the private sector and business people taking risks, making decisions, and changing reality from their actions. It has not been primarily due to public policy, although public policy has not been absent but it is not really the result of the vision of governments. They did have that vision 20 years ago, but the process has been led by the private sector.

The challenge and the opportunity towards the future is to build a common vision for the shared economic space of North America. I do not talk about NAFTA anymore. I talk about North America as our area. And from the Mexican perspective, let me end by saying this. I love this alleged quote from Porfirio Díaz, "Poor Mexico, so far from God and so close to the US." I have actually looked for the source of this quote and I have never found it.... But I also heard Shimon Peres, when he was the prime minister of Israel, say, "No, no, no that's not the case: poor Israel, so close to God and so far from the United States."

AMBASSADOR EDUARDO MEDINA MORA is the ambassador of Mexico to the United States. This is an edited transcript of his remarks at the closing panel of the conference on [Building on the Benefits of NAFTA](#), Peterson Institute for International Economics, Washington, July 15, 2014.

So this neighborhood is a blessing and Mexico is very clear on where it stands. The Pacific Alliance is a good example of this. Mexico is Latin American in identity, in values, in its approach to life, but it is located in North America and the reality looking towards the future is geography. We can be forgiven by history, but not by geography.

Question and Answer Session

Question by Adam Posen: Representing not just Mexican business but the Mexican government, the Mexican people, do you ever feel sort of frustrated with how the American popular media or popular opinion treats cross-border issues? I mean, I'm sort of giving you a soft ball, so let me put it a little differently. What are the things that you would like to, if you could get the right hearing, you would want to see corrected or changed in the US public discussion of economics of Mexico?

Response by Ambassador Eduardo Medina Mora: I am frustrated. But I have to say that the main issue is that we take each other for granted; it is a serious problem here, and it is a serious problem in my country as well. We do not understand each other enough. And we do not actually make fact-based assessments. The fact is that Mexico is the second largest US customer, only behind Canada, but we will surpass Canada because of demographics. This is going to happen sooner rather than later.

And in that sense, it is important to go from stereotypes and into facts. For instance, you mentioned migration this morning. Yes, of course, migration has been a very important component of the bilateral relationship. But looking forward, Mexico is not today, and it's not going to be, a major source of migration into the United States. But this is not only because Mexico is performing better, it is essentially because of demographics.

As it was stated this morning, our fertility rates dropped from 7 to 2.2 and are coming down further. And in that sense, we have to see this looking forward. For instance, the border, and what is going to be the reality 20 years from today into the future and not 20 years from today into the past. I was a chief negotiator for the Border Safety Agreement back in 2002. And back then we had 5,000 border patrol officers, 4,500 deployed in the southwest border and they apprehended 1.7 million people in 2000. In 2012, we have 20,500 border patrol officers and they apprehended 386,000 people. And this is not only coming from the improved effectiveness, it is coming actually from the flows. And we have to distinguish the stocks from the flows. And those have two different problems. Both in many ways are US domestic issues, but the latter has a more bilateral aspect, but also regional, because we have to take into account other countries in the region.

If we look closely at the facts and how well integrated we are, how effectively we deal with each other, it is easier for us to deal with each other than it is for you to deal with Asia, for instance. And it's not that Asians have anything different in the sense of opportunity, but it is something that comes more naturally between us. And yet we take each other for granted. In that sense, we do not receive enough attention in terms of addressing the challenges ahead of us.

We have a fantastic opportunity to really build up this shared strategic view of the region, on the shared economic space to make North America the most competitive and attractive economic area in the world.

Question by Barry Solarz, Nucor: The TPP [Trans-Pacific Partnership], of course, has already been attacked as NAFTA on steroids. And all kinds of reasons have been given today as to why the NAFTA over the last 20 years has been beneficial to all three countries. Let me posit something and I'd like to get a reaction from our two esteemed guests.

When you cut through all of these reasons and the data and what not, in terms of the insecurities that Dr. McLarty just referred to, at least in the US citizenry, might it not be more effective to build on the last point

that the Ambassador made, which is that what NAFTA has done and arguably, depending on how these arguments are negotiated, TTIP [Transatlantic Trade and Investment Partnership] and TPP, the end result could be, hopefully will be, improving the international competitiveness of the United States and North America in competing against state capitalism, the unique brand of state capitalism that exist in China in particular.

To me, that is a more salient argument with a lot of the population than some of the other points that have been made today. Because while there has not been clearly a “giant sucking” sound vis-à-vis Mexico, I think one can make an argument that there has been somewhat of a sucking sound vis-à-vis the rise of China. So I’d be interested in your views on it.

Response by Ambassador Eduardo Medina Mora: First of all, 20 years later, the three musketeers are not the same today as 20 years ago. I mean, 20 years back, “tweet” was the sound made by a bird and “cloud” was an aggregation of moisture up there in the sky. And we have a different reality that we have to tackle and profit from and there is room for that. And of course, the Asian markets will grow more than any other region in the world in the next 20 years. Maybe after that demographic dynamics will change in favor of North America.

But in that sense, I would say that it would be unwise not to profit together from this opportunity and also from the ability to craft the agreement in a way that actually favors opportunities and capital information and trade in the most kosher sense of the word. And actually capturing these opportunities for the region, holding the pen is important.

Question by Brian Dabbs, *International Trade Today*: So in terms of North American economic integration, I wanted to ask about trade facilitation and how that plays a role, specifically in automation. So the US is trying to complete its automated and commercial environment, which is a single window portal equivalent to what Mexico currently has in place and Canada is working on a similar program.

So my question is, and I know officials from all three countries have been present for this, what do you think the viability of that unified single window is in the foreseeable future and are there any kind of insurmountable hurdles that you see there and then what’s the impact potentially of that?

Response by Ambassador Eduardo Medina Mora: I think it is not only viable, but it’s already happening. The reality, in terms of border infrastructure and the framework in which trade is carried out from Mexico to the United States and vice versa, is that we are also learning from past experiences at the northern US border with Canada.

We have, as a good friend of mine the former US assistant secretary of commerce put it one day, we have 21st century trade, on top of a 20th century regulatory framework, on top of a 19th century infrastructure. And we have tremendous opportunities moving forward. These systems, in terms of having the single window and integrated customs facilitation and requirements, are doable.

It is more so due to the fact that most of the trade is carried out among companies that are very much integrated and know each other. And they are integrated within the United States and Canada. They are integrated within Mexico. It’s relatively easy to arrange these in this more integrated approach.

But I think our opportunities looking forward are very clearly stated now. We have a road map for the first time in 20 years. And the opportunities, in terms of customs facilitation, in terms of improvements in infrastructure, in terms of certification and recognition of standards, are tremendous opportunities looking forward if we really work on it. It is already mapped and agreed upon by the three leaders and I think that this is achievable.

