Chapter 20:
The Future of NAFTA: A Policy Perspective

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In the final session of the conference, a panel of economists, including Justino De La Cruz, Alan V. Deardorff, Richard G. Harris, Timothy J. Kehoe, and José Romero, discussed their views on NAFTA's future. In his remarks, Justino De La Cruz noted that his comments, built around two basic points, would be from Mexico's perspective. The first point regards Mexico's trade policy: De La Cruz suggested that for Mexico, NAFTA's primary objectives were to promote and encourage trade and foreign direct investment (FDI) with Canada and the United States. The second point is that NAFTA is only one growth-promoting policy instrument among many at Mexico's disposal—and it is one with limited influence. Other, more powerful policy instruments that Mexico uses to promote economic growth are monetary and fiscal policies. De La Cruz noted that according to an important rule of economic policy theory, to achieve various policy targets there must be at least an equal number of policy instruments.[35] Thus, if Mexico's goals are to achieve high rates of economic growth, employment, real wages, and productivity, as well as balance of payments equilibrium and low rates of inflation, policymakers must use several policy instruments, not just NAFTA. NAFTA alone should not be expected to achieve more than one policy goal.

Has Mexico achieved its goal for NAFTA? Returning to his first point, De La Cruz observed that since NAFTA's implementation, trade flows and FDI between Mexico, the United States, and Canada have grown substantially. In that sense, NAFTA has successfully achieved Mexico's objectives for it. As to the future: First, efforts by NAFTA's Free Trade Commission to facilitate trade and investment—in areas such as harmonization of standards and norms, mutual recognition agreements, and rules of origin—will likely continue to encourage trade and investment expansion. Furthermore, these upward trends will be supported by the eventual successful completion and implementation of the Trans-Pacific Partnership (TPP) agreement and the Trans-Atlantic Trade and Investment Partnership (TTIP). However, Mexico's gains from these agreements will be limited, given that the country has already free trade agreements with Japan and the European Union. Finally, the effect of NAFTA preferences will continue to erode, due to the free trade agreements that Mexico, the United States, and Canada have individually signed and will continue to sign with non-NAFTA countries. Thus, although it is likely that the upward trend in trade and

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[34] The views in this article are solely the opinions of the authors and should not be interpreted as reflecting the views of Federal Reserve Bank of Minneapolis; and U.S. International Trade Commission or any of its Commissioners.
[35] See, for instance, Robert A. Mundell, *International Economics*, New York, Macmillan, 1968.

investment will continue, it will do so at a slower pace. And this upward trend will be due less to NAFTA than to the geographic location of the three member countries and their economic integration, in which supply chains play a significant role.

Given the second point—that trade is only one among many instruments available in the toolbox of policy making—one may consider that for Mexico to promote its own development, it could undertake other policies as well. And these other policies go beyond the fiscal and monetary policies referred to above. For example, there are the reforms that Mexico is currently adopting— education reform, energy reform, and others. These will certainly help trade and investment, but more importantly, they will support development of the entire Mexican economy.

However, one key reform that plays a key role in development—not only for Mexico, but for any country—is the "rule of law." And that is not even being considered at the present time. "It is crucial for Mexico to implement the rule of law," said De La Cruz. "And by that I mean adopting and executing it, not just having laws on the books." He added, "My own feeling is that Mexico's strongest limitations stem from the weakness of its enforcement of the rule of law: ensuring the security of its people, guaranteeing property rights, and eliminating or moderating the abuse of power, both political and economic."

De La Cruz stated in conclusion that the future of NAFTA will be affected indirectly by what happens with the other policies Mexico has been applying. But, even if there were a 'super NAFTA', Mexico will not fully develop without the rule of law.

Alan V. Deardorff focused his comments on the future of NAFTA. He noted that the Democratic Party's base, to which its leaders must cater, for years has been very negative about international trade in general and NAFTA in particular, adding, "I think the public perception of NAFTA is still problematic." However, the Trans-Pacific Partnership (TTP) agreement, a free trade agreement that includes the NAFTA countries, among others, may make a huge difference. Deardorff said he feels that if the TPP is agreed upon and enacted in what appears to be its current form, it would simply replace NAFTA. If, however, the TPP were to include some provisions that are weaker than those of NAFTA, then the NAFTA countries would still be obliged to follow the NAFTA rules, and the TPP would not replace it. But this would seem to be the less likely outcome: Apparently, the negotiations for the TPP are aimed at making the TPP stronger than NAFTA in many ways, as discussed further below. If that were the case, then the future of NAFTA, in some sense, could turn out to be whatever the TPP does.

Deardorff noted that there are some features of the TTP that he is concerned about. The first has to do with its rules of origin. He hopes that the TPP, if it goes into effect, will not only have broad and generous rules of origin but also include cumulation across the different member countries. Second is the closed nature of the TPP. As envisioned by the handful of countries that started the TPP negotiations, the TPP was to be open to accession by other countries that accepted its set of rules, without causing much difficulty or having to negotiate a whole new agreement. In Deardorff's view, the TPP would be far better if it could expand by adding countries over time. But "I doubt very much that that will actually happen," he said. And yet, Deardorff believes that in some ways the TPP would still be better than NAFTA, because it would include a bigger group of countries with zero barriers. As it is, NAFTA was not designed for any other country to join easily.

The third problematic feature is NAFTA's Chapter 11 and its equivalent under the TPP. This provision established the investor-state dispute mechanism, by which companies can file complaints against host country governments that they feel have breached their investment obligations and then have a case decided not in the national courts but using the trade agreement's mechanism. "My perception is that Chapter 11 has not been a good thing," said Deardorff, "and what is unfortunate is that the TPP will expand it and strengthen it." The last feature of concern is the role of side agreements, similar to the labor and environment side agreements included in NAFTA. The TPP negotiators are considering including not only stronger versions of NAFTA's labor and environment agreements but also an agreement on intellectual property. And yet, it is exactly in those dimensions, according to Deardorff, that NAFTA has, to some extent, been problematic. These agreements, he concluded, are likely to become a problem for the TPP as well.

Richard G. Harris noted that although most of the discussion of NAFTA had focused on trade, his comments would focus on other issues from the Canadian perspective. To begin, he noted that border issues are and will continue to be at the front and center of the agenda for discussion of all three countries. This has been exacerbated since 9/11 and will continue to be a major concern. Second, an issue of enormous importance is the lack of regulatory harmonization. For instance, in two of the biggest sectors, services and telecom, there has been absolutely no progress toward free trade and integration. Another important sector, energy, is of joint interest because of the close integration of the industry between the United States and Canada. However, the industry's regulatory mechanisms across the two countries are dramatically different. In contrast, the e-commerce sector has seen a lot of progress and is growing very rapidly within the existing framework of rules.

A third issue involves labor mobility, specifically via the temporary visas offered under NAFTA. Harris noted that the program has been very successful and has made a significant difference to Canadian companies. Some of these companies are in favor of further liberalization of the NAFTA labor provisions, but there has been little progress in this area. Finally, Chapter 11, or the dispute settlement mechanism under NAFTA, is problematic for both Canada and the United States. Harris commented in conclusion that all these examples are about economic integration and asked the question: is North America going to become more deeply integrated economically? The answer is yes, he said—that is going to happen. But it is unlikely that NAFTA will be the mechanism by which this will be carried out; Harris believes that, as outlined by Deardorff, the future of NAFTA will be subject to the future of the TPP.

Timothy J. Kehoe focused his comments on the future of Mexico. He stated that the United States has grown at about 2 percent per year per capita—at least, it has done so for the last 113 years, with the exception of the Great Depression and its aftermath. Kehoe said he believed that every country could grow 2 percent per year by just following the United States. "When you are behind, though, you can play catch-up," said Kehoe, "and that's what Mexico was doing in the fifties, sixties, and seventies, with high-growth policies that eventually caused the later problems. But then you get to the point that your institutions matter," he said. Kehoe emphasized that institutions matter, so his remarks would pay particular attention to institutions in Mexico.

Mexico's growth has hit a plateau. According to Kehoe, the country therefore has to do something to increase productivity—which, by the way, has been disappointingly low. Why? Kehoe stated that he believes the work of Acemoglu and Robinson (2012) offers a general explanation, but that his response would focus on an earlier work by Douglass North (1968).[36] In a study of European ocean shipping between 1600 and 1850, North found that productivity in the industry went up by a factor of four. He also found that technology did not play a significant role in that increase, so what was the cause? According to North, it was getting rid of the pirates that had plagued shipping lanes for centuries. Getting rid of them meant that ships could be better designed—to carry cargo rather than defend themselves against pirates—and that ships didn't have to go in convoys all the time.

So, what are the barriers to growth to Mexico? "In Mexico, too, we have to identify the pirates," Kehoe stressed. The pirates are the drug traffickers and the big monopolies. Bureaucrats, he said, are pirates as

[36] Daron Acemoglu and James A. Robinson, *Why Nations Fail: The Origins of Power, Prosperity, and Poverty*, Crown Publishing Group, Random House, Inc, New York, 2012; Douglass C. North, "Sources of Productivity Change in Ocean Shipping, 1600–1850," *Journal of Political Economy* 76, no. 5 (September/October 1968): 953–70. As discussed below, North's main conclusion was that most of the productivity change observed was caused by a decline in piracy and an improvement in economic organization, rather than being due to technological change.

well: When we look at doing business in Mexico, it becomes clear how much those bureaucratic pirates are holding the economy back. The financial institutions in Mexico could function more efficiently as well, as shown by the total loan amount that the banking system makes to entrepreneurs—which, Kehoe pointed out, are at the African level. Contract enforcement, rule of law, labor markets are all in need of reform. But Mexico is not the worst country out there, according to Kehoe. "Just think about Mexico versus China, for instance," he said. "China is probably worse on every single one of those dimensions."

Why, then, is Mexico not growing, while China is? It is because they are at different levels of development, Kehoe said. Mexico grew between 1950 and 1980 for the same reason China is growing now: It's getting people off the farm, giving them basic education, and doing some kind of industrial development. Now, China is doing better than Mexico did because China is further behind than Mexico was, and playing catch-up, according to Kehoe, is easier the farther you are behind. He added that China is an open economy, but that of Mexico wasn't, so economic development in Mexico was hindered by things that are not now hindering China. But when are the barriers that are stopping Mexico going to start binding China as well? It will be when China develops, in Kehoe's view. Citing Kehoe and Ruhl (2010), Kehoe predicted that China will slow down to about 2 percent growth—but it is difficult to say how soon, because the available data are difficult to trust. However, Mexico has to start growing again. And while reforms of the financial institutions, labor markets, and rule of law are all difficult, "I am hopeful that Mexico can get rid of the pirates," Kehoe concluded.

In the final presentation of the panel and of the conference, José Romero addressed the current state of Mexico's economy, as related to its policies of liberalizing trade and fully opening its capital markets. Romero started by looking at Mexico's income per capita. He first stated that the predicted convergence of U.S.-Mexican GDP per capita has not happened: Mexico's per capita GDP is about 33 percent of that of the United States. Second, Mexico's export growth strategy has not produced economic growth in the country. Comparing Mexico with South Korea—which also has a trade liberalization strategy—Romero noted that Mexico's per capita GDP is about half of that of Korea.

Next, Romero discussed Mexico's trade and investment policies and their harmful consequences to the Mexican economy. His argument focused on the following points: (1) When trade liberalization started in 1983, it was aimed at fighting inflation, not at achieving free trade. But the inclusion of agriculture in trade liberalization helped to impoverish the Mexican population and increase emigration. (2) When Mexico signed trade agreements granting national treatment to FDI, this made it impossible to implement any industrialization policy. (3) Trade liberalization, trade agreements, and oil exports have caused an overvaluation of the Mexican currency that has made investment in the tradable sector unprofitable.

Without investment or the accumulation of capital, labor productivity cannot increase. (4) Mexico is a very open economy with a propensity to import of around 0.4. As a result, Mexico's fiscal policy is highly ineffective as a source of growth.

Romero added that full opening of the Mexican capital markets also made monetary policy to promote growth ineffective, since interest rates in Mexico and the United States are practically the same. According to Romero, Mexico does not have an independent monetary policy. Similarly, the exchange rate cannot be used to make the economy more competitive. Thus, said Romero, Mexico lacks effectiveness in its trade policy, industrial policy, fiscal policy, monetary policy, and exchange rate policy. "We are in a canoe without any control, going into rapids," Romero stated.

How does growth in Mexico relate to that of the United States? Romero noted that from 1962 to 1982, GDP in the United States grew at about 3.3 percent, while GDP in Mexico grew at 6.2 percent. During the NAFTA period (1994–2013), both the U.S. and the Mexican GDP grew at the same rate, but with the Mexican GDP varying more widely than that of the United States (table 1).

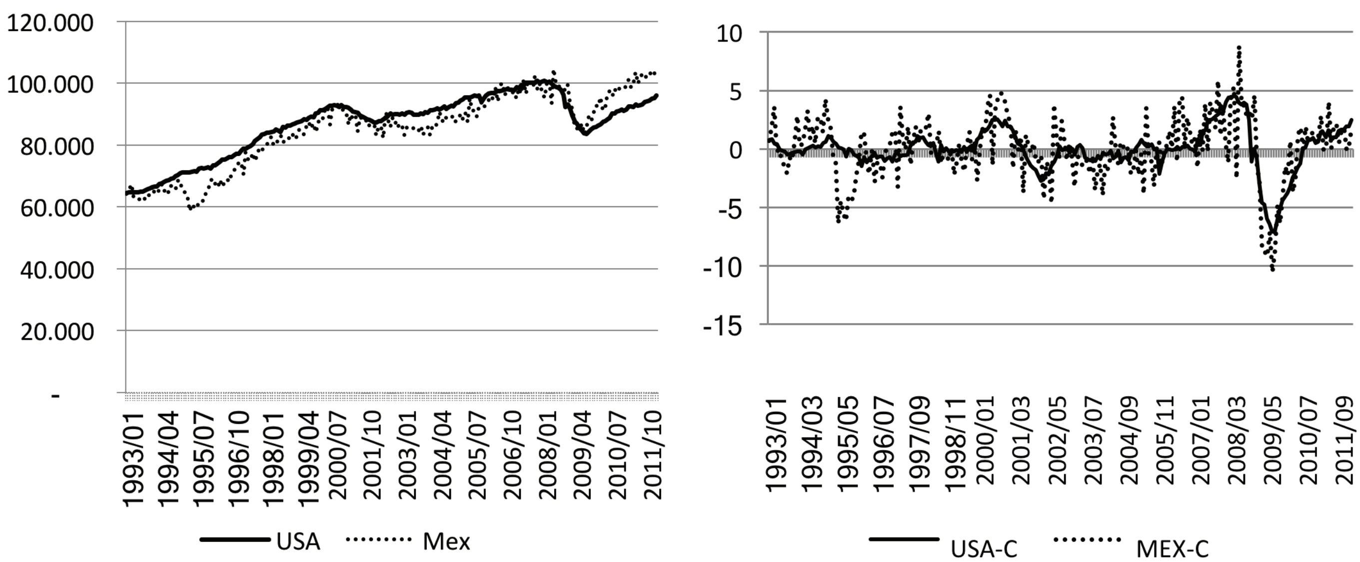
Table 1. Mexico and United States Real GDP Growth, Period Averages

Period	United States	Mexico
1960-1982	3.3	6.2
1983-2013	2.9	2.2
1994-2013	2.5	2.5

Source: Author's calculations with data from INEGI, Banco de Información Económica (BIE), http://www.inegi.org.mx/sistema/bie/; and U.S. Department of Commerce, Bureau of Economic Analysis, http://www.bea.gov/industry/index.htm#annual.

"What does that mean?" Romero asked. "Looking at industrial production, actual and using Prescott decomposition between trends and cycles (figure 1), we see that Mexico's index almost mimics that of the United States. That means that the only source of growth for Mexico now is the United States economy."

Figure 1. Mexico and United States Industrial Production, Actual and Cycles: 1993-2011



Source: Author's calculations.

"What worries me the most," Romero concluded, "is that NAFTA does not have a broad strategy as a bloc." He explained that the United States has its own growth strategy that does not include Mexico or Canada. For Mexico, the United States is almost its entire world, but for the United States, Mexico is only one of many partners—and not one of its priorities. "My own thinking," said Romero, "is that Mexico cannot continue with this economic performance for long." He emphasized that the situation must change before social unrest develops**.**

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