the Southwest
ECONOMY

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Potential Effects of a U.S.–Mexico Free Trade Agreement

The United States and Mexico have begun negotiations for a free trade agreement that could generate moderate-to-large economic expansion in Mexico and cause productivity increases in both countries. Negotiations follow the U.S. Congress' vote in May to allow talks to occur on a fast track. If successful, the negotiations with Mexico would produce the United States' third free trade agreement since the mid-1980s, following those with Canada and Israel.

An agreement will bring modest near-term benefits to U.S. producers overall, although there will be both winners and losers. The agreement may also benefit consumers in both countries by reducing production costs and prices. A review of the events preceding the current negotiations and the recent economic histories of both nations is helpful in understanding the potential impact of a U.S.–Mexico free trade agreement.

A Closer Look at Mexico

Mexico is a far larger country than many U.S. citizens realize. Geographically, Mexico is the 13th largest country in the world. In population, Mexico ranks 11th. Mexico is more populous than any country in Europe, including the unified Germany.

Mexico is the United States' third most important trading partner, after Canada and Japan. But historically, the government of Mexico has followed a policy of protectionism. Mexico's protectionism, evident in the high tariff rates that in 1985 included 46.8 percent for apparel, 39.2 percent for transportation equipment and 35.5 percent for electronics, was part of a growth strategy. Mexicans were concerned that, over time, world demand for raw materials would decline relative to the demand for manufactured goods. Policymakers believed any country that concentrated on raw materials production, as Mexico once had, would be left behind. Mexico adopted a strategy known as *import substitution*, which means attempting to generate income by manufacturing products in Mexico instead of importing them. To encourage manufacturing development, Mexico protected manufacturers behind high tariff walls and other trade barriers.

This strategy worked for a while (*Chart 1*). Aided by its protected manufacturing sector, Mexico grew rapidly during much of the post-World War II period. Expansion was very strong long before

I N S I D E

Economic Commentary: Free Trade Will Bring Better Jobs

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The United States Faces a Weak Recovery

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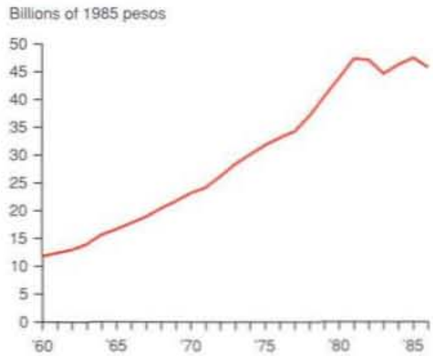
"Declining oil prices in the 1980s meant serious reductions in national income."

Chart 1
Mexican Real Gross Domestic Product



SOURCE: International Monetary Fund, *International Financial Statistics Yearbook* (English edition), 1989.

the oil boom of the 1970s. But during the 1970s, when rising oil revenues stimulated growth, the government spent its increased income by raising subsidies and other supports to domestic industries and by taking control of private firms that had become insolvent. By the time oil prices fell in the 1980s, Mexico's money-losing, state-owned enterprises were absorbing increasing amounts of government revenue. The country was in trouble. Protection, subsidies and the windfall of high oil prices had allowed the growth of industry, but much of what resulted was *inefficient* industry.

Declining oil prices in the 1980s meant serious reductions in national income. And because income from oil came from foreigners, each drop in oil prices lowered earnings of the foreign exchange that Mexico could use to pay its large foreign debt (*Chart 2*). To regain its inflows of foreign exchange, Mexico prepared to change its foreign economic policy.

Meanwhile, U.S. Trade Policy Changes

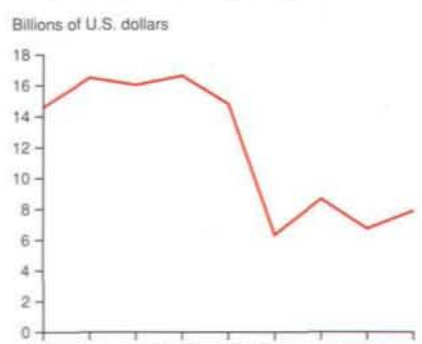
As these events unfolded in Mexico, other trade-related changes occurred in the United States. Since the end of World War II, U.S. policymakers had attempted to break down trade barriers through multilateral agreements, rather than negotiating with one country at a time. The United States followed this policy within the framework of the General Agreement on Tariffs and Trade (GATT). Under the GATT, the United States adhered to the *most favored nation principle*, meaning that any reciprocal tariff reduction negotiated between the United States and any of its trade partners applied to all U.S. trade partners. GATT negotiations also involved eliminating nontariff trade barriers.

But by the late 1970s, the United States had become frustrated with what it saw as widespread cheating among GATT participants and unfair trade practices by non-GATT members. The United States began to respond with *countervailing actions*. These measures, which included raising barriers previously lowered and filing charges of dumping, accelerated over time (*Chart 3*). The United States raised barriers to imports of steel and textiles and apparel. In sum, protectionism in the United States, in one form or another, has been increasing.

Mexico Turns Away from Import Substitution

The Mexican government, in need of foreign exchange and a jumpstart for its stalled economy, took steps to subvert U.S. protectionism by opening its own economy. Mexico lowered its

Chart 2
Value of Mexican Energy Exports



SOURCE: *Indicadores Economicos*, Banco de Mexico, various issues.

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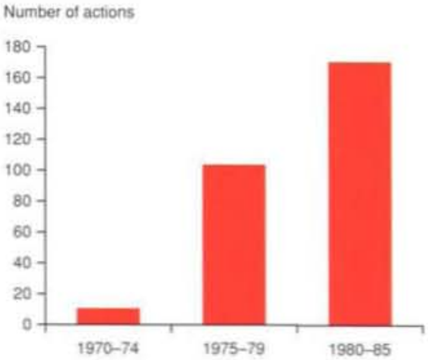
Chart 3
U.S. Countervailing Actions



SOURCE: Chong-Hyun Nam, "Export Promoting Subsidies, Countervailing Threats, and the General Agreement on Tariffs and Trade," *The World Bank Economic Review*, September 1987, p. 734.

import tariffs (*Chart 4*). If the Mexican economy opened, how could the United States—with its declared commitment to free trade—remain closed to Mexico? Mexico joined the GATT and took measures to open its economy even more rapidly than promised. In 1987, Mexico established a special negotiation framework for liberalizing its trade with the United States and, in 1989, amended that framework with more comprehensive guidelines.

A factor compelling Mexico to seek freer trade in the late 1980s was the need to earn the foreign exchange necessary to pay the nation's foreign debts and to revitalize its economy. Mexico's changing economic circumstances were forcing the country to rely on manufacturing rather than oil exports.

Mexico's import substitution strategy had enabled manufacturers to focus on domestic markets and leave exports alone. But as manufacturing became more important in Mexico's total export sales, that strategy could no longer work (*Chart 5*). Mexico responded to these new circumstances by proposing the free trade agreement now in negotiations.

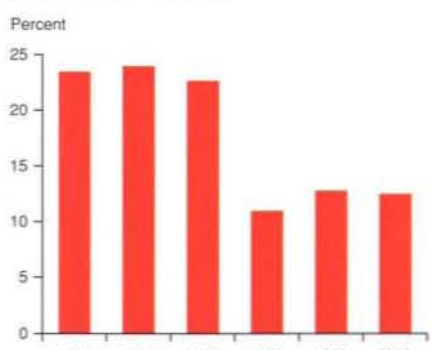
The Effects of Freer Trade

If negotiations between the United States and Mexico are successful, a free trade agreement could benefit both nations by lowering prices to consumers and increasing the efficiency of both economies. In each country, product prices that are artificially high will fall as artificial trade barriers disappear. Mexico will stop forcing Mexicans to buy expensive Mexican products when U.S. products are cheaper. The United States will stop forcing Americans to buy expensive U.S. products when Mexican products are cheaper. Firms will exist because they are efficient, not because they have captive markets.

Moreover, specialization will increase. If trade between the United States and Mexico becomes freer, each country will increase production of goods and services for which it has a comparative advantage. Generally, Mexico will produce more goods that benefit from a low-wage, low-skilled work force. The United States will produce more goods that benefit from large amounts of physical capital and a highly skilled work force. Not only will the United States and Mexico sell more to each other but, as their increasing efficiencies translate into more competitive prices, both the United States and Mexico can sell more to third parties.

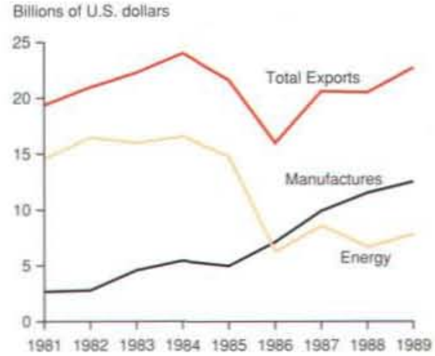
The increased certainty of open trade in the future will encourage investment in both countries. As each

Chart 4
Mexican Ad Valorem Import Tariffs (Weighted by Product)



SOURCE: Claudia Schatan, "Trade Bargaining: The Mexican Case" (Photocopy), 1991.

Chart 5
Mexican Exports



SOURCE: *Indicadores Economicos*, Banco de Mexico, various issues.

"The increased certainty of open trade in the future will encourage investment in both countries."

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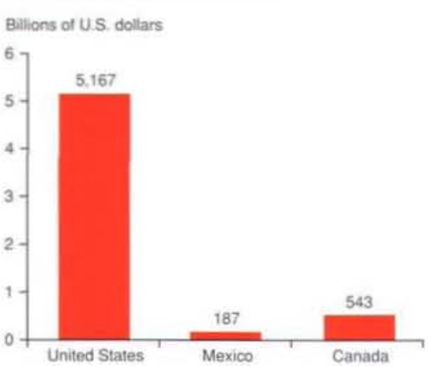
country reorganizes its productive capacity, investment will increase. A free trade agreement also will give Mexico insurance against future U.S. protectionism. Indeed, this protection is one of Mexico's principal motives for initiating this agreement.

The marked acceleration of U.S. exports during Mexico's trade liberalizations of the late 1980s suggests that the additional openings from a free trade agreement will have some positive effects for the United States. But near-term gains for the United States may be small. One reason U.S. gains will not be larger is because Mexico already has lowered many of its trade barriers.

Another reason the United States should not expect large near-term production increases from a free trade agreement is evident in Chart 6. While Mexico's population is about one-third as large as the United States', Mexico's gross income is only about 4 percent of the U.S. total. Most studies suggest that U.S. output will increase by no more than 0.1 percent or 0.2 percent under a U.S.–Mexico free trade agreement.

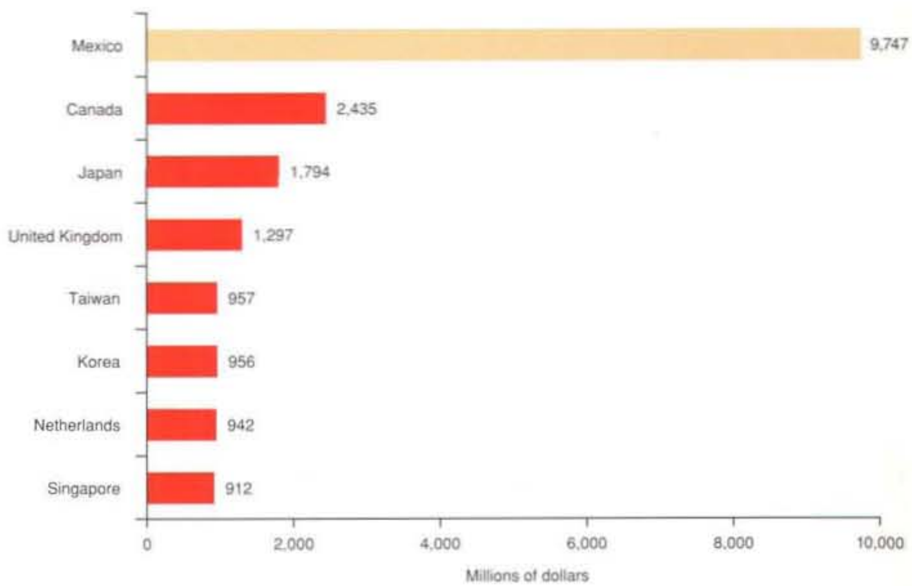
For Mexico, the impact may be far greater. Most studies suggest that a free trade agreement will increase Mexico's gross outputs between 3 percent and 10 percent.

Chart 6
Gross National Product in the United States, Mexico and Canada



SOURCE: Organization of Economic Cooperation and Development, *Main Economic Indicators* June 1990 for the U.S. and Canada; CIA, *The World Factbook* 1990 for Mexico.

Chart 7
Texas Exports, 1989



SOURCE: Texas Department of Commerce.

U.S. Winners and Losers

There is wide divergence in the predictions of outcomes for some industries. However, among U.S. industries, the most widely expected winners include chemicals, plastics, machinery, metals, instruments, food processing and—in agriculture—grains and oilseeds. But expected gains are not large for any of these industries. In one highly detailed study, the biggest winner was instruments, whose output rose a little more than 1 percent.[1]

U.S. losers will include citrus crops and vegetables, sugar, apparel, furniture, retail trade and lower-price glass products. The biggest loser could be the highly protected sugar industry, with a decrease in production of nearly 4 percent.

Analysts disagree about the effects of a free trade agreement on the electronics and computing equipment industries. The dispute focuses on whether the opening of Mexico's fairly restrictive markets in these industries will mean increased sales by the United States or whether the opening of U.S. markets will lead to greater use of maquiladoras, which would replace U.S. production with foreign production.[2]

If the direct effects of a free trade agreement are likely to be so small for U.S. producers, then why is the United States interested? A free trade agreement will lower trade barriers and, right now, Mexico's average tariff is about double that of the United States. But another reason is that Mexican income per capita, which is less than one-tenth that of the United States, is not likely to remain at its current low level. As the Mexican economy rationalizes through trade liberalization, through increases in foreign investment and through technological advances tied to an overhaul in Mexico's intellectual property laws—which may be an important subject in the trade talks—the nation's buying power will rise.[3] Productivity and income will increase not only because of these trade-linked changes, but also through the privatization of Mexico's public corporations and through the deregulation of the private sector.

In the long term, the more important implications of a U.S.–Mexico free trade agreement are

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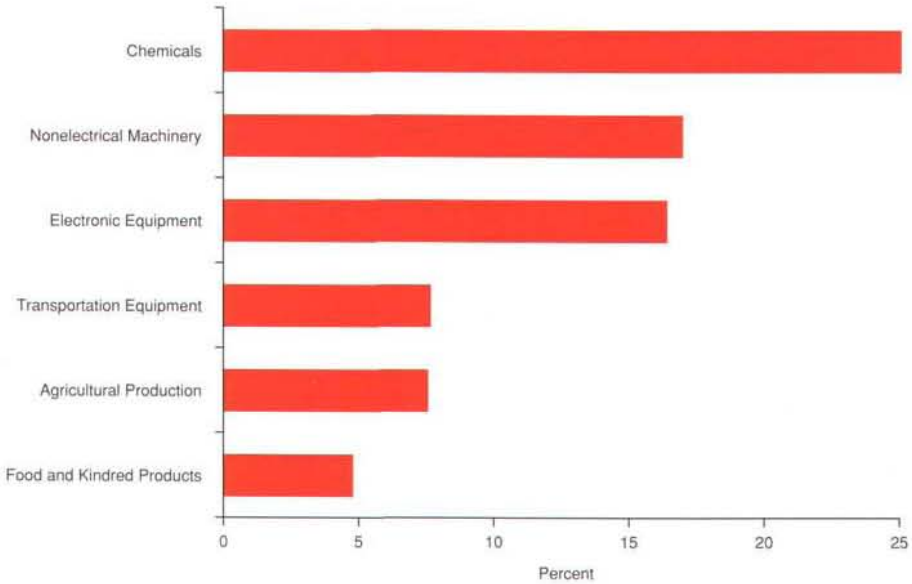
Chart 8
Texas' Top Six Export Sectors



SOURCE: Texas Department of Commerce.

those involving U.S. access to trade with a population the size of Mexico's and a government that is attempting to raise productivity and income through economic liberalization. Another incentive for the United States is that a free trade agreement means the fuller opening of Mexico as a base for U.S. manufacturing operations. Without the agreement, many of these operations would take place across the Pacific. Indeed, Federal Reserve Bank of Dallas research strongly suggests that many jobs in Mexican maquiladoras would be in Asia if the maquiladoras did not exist. When such jobs do go to Mexico instead of Asia, the United States benefits through higher sales of U.S. goods.[4]

The Impact on Texas

As a trading partner, Mexico is far more important to Texas than to the United States as a whole. Texas exports to Mexico are four times higher than exports to any other foreign market (*Chart 7*).

To some extent, gains and losses among Texas industries will mirror those in U.S. markets. If U.S. retailing loses overall, Texas will likely experience similar difficulties because Mexican shoppers contribute a significant portion of sales in South Texas, on the border and in Houston. In the long run, however, this threat should subside because of Mexico's growing economy and Texas' ability to offer higher income specialty retailing that probably will not soon be available in Mexico.

Horticultural production, which includes citrus fruits and winter vegetables, is also widely acknowledged to be a likely loser from a U.S.–Mexico free trade agreement. Aside from retailing and horticulture, the majority of the most widely acknowledged losers have light representation in Texas. These include apparel, which is an ebbing industry in the state.

Texas will likely emerge as a net winner under a U.S.–Mexico free trade agreement (*Chart 8*). Chemicals and nonelectrical machinery, Texas' two principal export products—and also its two most important manufactured products—will almost certainly benefit from the agreement. Food and kindred products, another probable winner nationally, is also important in Texas, as are the field crops that Mexico will be buying. Perhaps the most likely candidate for a net gain is the service sector, which includes transportation, business services, banking and finance.

Conclusion

In sum, freer U.S. trade with Mexico will benefit both countries. Many consumer prices will be lower, and overall output will be higher. The increased efficiency induced by freer trade will push up Mexican and U.S. sales to third countries. But the benefits of freer trade are not limited to economic gains. The United States, for example, will gain the advantage of greater political stability on its southern border. While each country will have some losers from freer trade, ultimately both the United States and Mexico will be winners.

—William C. Gruben

[1] KPMG Peat Marwick, Policy Economics Group, Executive Summary of "The Effects of a Free Trade Agreement Between the U.S. and Mexico" (Prepared for the U.S. Council of the Mexico–U.S. Business Committee, Photocopy, 1991).

[2] The Mexican *maquiladora sector* is a large and growing assemblage of foreign-owned manufacturing plants that produce chiefly for export to the United States.

[3] *Rationalization* refers to the use of scientific management and industrial organization in production.

[4] Gruben, William C. (1990), "Mexican Maquiladora Growth: Does It Cost U.S. Jobs?" Federal Reserve Bank of Dallas *Economic Review* (January).

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