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HAS NAFTA CONTRIBUTED TO ECONOMIC DEVELOPMENT IN MEXICO?[1]

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In the first half of the 1990s the North American Free Trade Agreement among Canada, Mexico and the United States (NAFTA) was widely discussed and received significant public attention in all three countries. Government officials, NGOs, firms, chambers of commerce, trade unions, and the academy, particularly economists, opined widely on the pros and cons of NAFTA. The intensity and breadth of the initial debate has since declined substantially.

The main objective of this Perspective is to discuss the impact of NAFTA on Mexico's economy. Whereas most of the debate to date has centered on generalities along polarized extremes – either for free trade or against neoliberalism, this Perspective analyzes the increasing process of integration between Mexico and the U.S., as well as specific economic issues concerning Mexico's economic development in recent years. The first part analyzes the general context of Mexico's economy before NAFTA, as it is not possible to examine the impact of NAFTA without understanding the significant socioeconomic and structural changes of Mexico's economy since 1988. The second part examines some of the more salient effects of NAFTA on Mexico's economy.

General Aspects

It is necessary to remember that at the end of the 1980s, the Mexican government began a new development strategy–a policy related to export-oriented industrialization, often referred to as economic liberalization strategy - which to date has been followed consistently. This liberalization strategy in place since 1988 assumes that the export-oriented private manufacturing sector will allow for growth and development. Concurrently, the state was to reduce significantly its socioeconomic activities ("lean state") and opted to concentrate on macroeconomic policies: the control of inflation and the fiscal deficit, as well as the attraction of foreign investments as the main financing source for the new strategy. In general, the new socioeconomic policy should be of "horizontal or neutral" character, i.e. affecting all households, firms, sectors and regions equally (Aspe Armella 1993; Dussel Peters 2000).

Consistent with its prior notion of development, the government of Mexico has changed substantially its socioeconomic policy since the end of the 1980s, particularly as compared to policies during 1940-1982: state-owned enterprises were massively sold to the private sector, foreign investment laws were almost completely liberalized, communal land-property was allowed to be sold, and import tariffs fell from levels above 200% to a maximum of 20%. Adding to these quick and profound changes, development banking and sector financing were relegated to the commercial financial sector. Those prior policies are consistent with the objective of reducing the fiscal deficit, as well as with generating "horizontal" policies.

What are some of the main effects of this strategy since its implementation? It is important, first, to recognize that the strategy has been successful *in its own terms*. As a result, inflation rates have fallen, with the exception of 1995-1996, to levels below 20% during the 1990s –considering inflation rates above 160% during the 1980s-, whereas the fiscal deficit has been reduced substantially and has even generated a surplus in some years. Finally, foreign direct investment (FDI) has accounted annually on average for more than 9.5 billion pesos during 1994-2000. However, the main structural change of Mexico's economy was reflected in the impressive export growth in absolute and relative terms in respect to GDP. For the period 1988-2000, exports increased from 20.6 billion to 166 billion pesos, with an average annual growth rate (AAGR) of 19%. Further, exports as a share of GDP increased from levels below 15% to levels of around 30% at the end of the 1990s. From this perspective, manufacturing exports –which account for 90% of total exports at the end of the 1990s- have become the only engine of growth of the Mexican economy since 1988.

In spite of the prior effects, Mexico's economy has reflected several structural limitations, including By Enrique Dussel Peters, Ph.D. 2

1. In general, Mexico's economy has gone through an increasing process of economic, social and regional polarization. As a result, since 1988, only a relatively small number of firms, households, sectors and regions have been able to benefit from the process of globalization and liberalization.

2. While exports have become the main and only engine of GDP, they have concentrated in a small number of firms: 300 exporting firms and around 3,500 maquiladoras have generated more than 95% of total exports during 1993-1999, while the rest of the 3.1 million firms' exports accounted for less than 5%.

3. During the 1990s, the Mexican economy has generated in average around 500,000 jobs annually, while the economically active population (EAP) has increased by around 1.3 million, that is, around 800,000 persons annually were not able to find a formal job in Mexico and had to migrate to the U.S. and/or to find employment in the informal sector. The main exporting firms and maquiladoras employed around 5% of the EAP and were not able to generate employment at the required levels.

4. The overvalued exchange rate –estimated at around 25% and 30% in 2000 and at levels similar to those before the crisis of 1995 (CEPAL 2000)- has become a constant of liberalization strategy as a result of controlling the inflation level. Exports have lost and imports have benefited, since a stronger Mexican peso allows for cheaper imports and more expensive exports. Particularly micro, small and medium firms (MSMF) have lost, because they must compete with relatively cheap imports.

5. During the 1990s the commercial financial sector in Mexico, privatized at the beginning of the decade, has been far from accomplishing its main goal: to provide resources to the productive sector in Mexico. Until 2000 financing to the private sector from the commercial banking sector –as a share of GDP- has fallen continuously since the crisis of 1995 and accounted for 23% of financing in 1994. As a result, all firms that depend on the Mexican

financial sector–with the exception of a segment of the export-oriented sector that is able to issue bonds and other financial instruments in international markets- have had serious problems obtaining resources, which added to the high costs of credits.

6. Manufacturing accounted for 4.8% AAGR of GDP during 1988-2000, and significantly higher than total economy, of 3.2%. However, this sector has constantly achieved high trade deficits. Since 1988, when import liberalization and the new strategy began, the ratio of trade deficit to GDP has increased from levels below 14% to levels above 30% in 1994, fell as a result of the crisis of 1995 and accounts for levels above 20% in the late 1990s. The prior tendency reflects, on the one hand, that structurally the manufacturing sector, the engine of liberalization strategy, requires increasing net imports, in order to grow as a fraction of GDP and exports, which results in significant ruptures of linkages with the national economy. On the other hand, manufacturing was the main source of the crisis of 1994-1995, accounting for a trade deficit of 32 billion in 1994. Massive bond issuance by the Mexican government in 1994 was a result of manufacturing sector's performance, since the government did not account for significant fiscal deficit during the 1990s.

7. Finally, there have been many victims of the development strategy. On the one hand, micro, small and medium firms have lost significantly: their share over total employment in manufacturing, for example, fell from levels above 51% in the beginning of the 1990s to levels below 42% at the end of the 1990s. Moreover, real minimum wages and wages in manufacturing in 2000 represent less than 30% and 60% of their levels of 1980, respectively. Added to regional polarization –if compared to Mexico City, GDP per capita income in states such as Chiapas, Guerrero, Hidalgo and Oaxaca represents less than 20% in 1998, with a falling tendency since the 1970s-, income distribution has worsened and has mainly benefited the highest and richest 20% of Mexico's population.

The Impact of NAFTA on Mexico's Economy

From this perspective, NAFTA has become an important instrument of the Mexican government and its implemented strategy since 1988: if the private export-oriented manufacturing sector was to be the main growth engine, the sector required a relatively secure export market. Otherwise, and even assuming that Mexico would have been able to increase its exports, the strategy would have failed.

From the Mexican government's perspective, expectations were very high regarding NAFTA: it was to produce new jobs, higher wages, higher economic efficiency through free trade, as well as better growth and development opportunities, added to an increasing economic and political stability. It has to be stressed that, at the same day NAFTA was implemented, January 1, 1994, the Ejército Zapatista de Liberación acional (EZLN) began its upraising in Chiapas, which reflects the highly socioeconomically polarized context of Mexico.

What has been the main impact of NAFTA in Mexico?[3] Strictly *in its own terms* –as an agreement between three countries regarding trade and investment issues- NAFTA has been relatively successful, and accomplished much more than expected. In general terms:

1. FDI from the U.S. to Mexico has increased substantially, from 4.7 billion in 1994 to levels above 5.8 billion since 1997. As a result, FDI from the U.S. accounts for more than 60% of Mexican total FDI for the period since 1994. In the case of maquiladoras, the share of U.S.-FDI over total Mexican FDI accounts for more than 75%.

2. In terms of trade growth, NAFTA has allowed for an increasing integration between Mexico and the U.S. Historically, the U.S. have always been the main trading partner of Mexico: imports and exports from Canada and the U.S. accounted for 72% and 78% of total external trade in the beginning of the 1990s, respectively. This share has increased significantly to above 92% and 75% in 2000. The integration process has been particularly relevant in the case of Mexican exports, which, added to their increasing orientation toward the U.S., increased from 34 billion in 1991 to around 150 billion in 2000. The performance of FDI and trade between Canada, Mexico and the U.S. has been much more positive than estimated even by the most enthusiastic NAFTA proponents.

3. Added to industry restructuring in the U.S., as discussed below, tariff reduction was one of the most important effects of NAFTA: in average tariffs on Mexican total exports to the US fell from 2% in 1993 to less than 0.40% in 1999. Countries such as China paid tariffs for their exports to the U.S. nine times higher than Mexico. For specific items –at the 8 or 10-digit level of the Harmonized Tariff System (HTS)- import tariffs can be more than 40 times higher then for Mexico and are an important cause for understanding Mexico's export success to the U.S.

4. As a result of the growth of Mexican exports to the U.S., Mexico has achieved a substantial trade surplus with the U.S.: while Mexico's surplus amounted to 13 billion during 1990-1993, it increased to 42 billion for 1994-1998. Although Mexico continued to have significant trade deficits with the rest of the world, export growth allowed for partial stabilization of some macroeconomic variables and of the exchange rate.

5. Moreover, NAFTA has had relatively few formal dispute settlements. As of early 2001, NAFTA has had 26 completed dispute settlements and 17 cases under review. This number is relatively small if we consider the differences among the three countries involved –including aspects such as trade, employment, GDP per capita and real wages, among many others. Several important issues, however, still remain unresolved, as discussed below.

6. NAFTA has been used as a model for other trade agreements, including negotiations at the World Trade Organization (WTO), regional trade agreements in America, as well as several Mexican trade negotiations with other countries.

Probably the most relevant success of NAFTA (and a process that began in the early 1990s and prior to NAFTA in cases such as the automobile industry) was the integration of several Mexican and U.S. sectors. This process has not been sufficiently studied. Generally, a few segments of Mexico's economy have become of critical importance to increasing the competitiveness of the U.S. manufacturing sector, particularly against Asian and Japanese competition. Sectors such as electronics, automobiles and auto parts, as well as garments and textiles, which represent 70% of total Mexican exports, have become an integral part of the U.S. economy. These export-oriented Mexican activities in the new North American industrial organization account of the lowest segments of the global value-added chain: the assembly of parts and components as a result of cheap labor force and geographical proximity. [4] Thus, integration globally and in the case of NAFTA, has resulted in an important growth of intrafirm and intrasectoral trade, while the specific activities represent low value-added transactions with very low technological and learning processes. Nevertheless, these activities are of critical importance to the U.S.-industry, since they include the last labor-intensive segments of the respective products: assembling parts and components and, in some cases, final distribution and shipping from Mexico directly to clients.

Independently of the former results, NAFTA has also generated contradictions and unresolved issues:

1. Institutionally, NAFTA has been extremely weak. Institutions such as the North American Development Bank (NADBANK), as well as other institutions related to NAFTA's side agreements regarding labor and environment, have not been coordinated among the three countries and lack resources and support.

2. NAFTA has also generated several disputes which have not been settled. Trade in the agricultural sector (sugar and sugar related products, for example), transport services, as well as the changes in custom services in all three countries have been particularly controversial.

3. It is not clear how, if at all, other countries can and will become part of NAFTA. NAFTA explicitly allows for this option. It is, however, difficult to imagine that future U.S. Administrations will be able to negotiate with potential new NAFTA members without the fast track option, added to the positions of Canada and Mexico.

4. NAFTA has directly affected significant segments of Mexican population. In the case of massive imports in specific sectors, for example, of agricultural products such as corn, around 18 million people will be affected.

Generally, acknowledging that NAFTA has allowed for the integration of a small segment of its economy, NAFTA has had little positive effects on Mexico's overall development; it might have even been responsible for increasing overall polarization in Mexico. NAFTA has allowed Mexican exports to target mainly the U.S., which might have been politically controversial or even impossible without NAFTA. However, it has not produced a significant positive impact on Mexico's development process.

The latter is a result of the specific activities that characterize Mexican exports: low value-added activities, dependent on low tariffs and low wages with a generally minimal diffusion process; FDI and exports in Mexico are highly linked to each other and produce few linkages with the rest of the economy. The level of "territorial endogeneity", that is, the possibility of a learning process regarding technological development and the option of upgrading the value-added chain to better jobs and higher wages, is minimal. In 1999, 84% of Mexican exports depended on programs which allowed importation and subsequent export of products (for example, maquiladoras), i.e. at least 84% of Mexican exports depended on low value-added activities that were not subject to tariffs nor taxes in Mexico.

From this perspective, a small segment of Mexico's economy has integrated since 1988, more profoundly in some sectors through NAFTA in 1994, the U.S. economy. Moreover, Mexico has benefited substantially from the booming U.S. economy in the 1990s. However, NAFTA has not allowed for improving basic socioeconomic indicators in Mexico, such as GDP per capita, employment, income distribution, and wages. Even further, NAFTA has allowed for deepening of the overall socioeconomic polarization at the firm, sectoral, household and regional level in Mexico. Issues such as the structural lack of employment generation, with around 800,000 persons annually having to search for a job in the informal sector or in the U.S., as well the structural instability of Mexico's balance of payments (reflected in massive chronic trade deficits of the manufacturing sector) should also be of interest and concern for other nations, including its main neighbor, the U.S.

Some of these issues go beyond NAFTA and represent the "core values" of liberalization strategy in Mexico, as well as in most of Latin America. The question is, what are the priorities of Mexico's development strategy: inflation or employment and wages, among many other variables? Is such a strategy, strictly in economic terms, feasible in the long run, in which a small export-oriented sector is highly dynamic and successful, while the rest of the domestic economy and its population does not "reap" the results of this performance? And, finally, how much further can such a strategy go? Is this continuous socioeconomic polarization sustainable in the medium and long run?

Endnotes

1. Prepared for The Center for International Finance and Development, University of Iowa College of Law, March 2001.

2. For a detailed analysis of the Mexican economy, see: De Maríay Campos (2000); Dussel Peters (2000\a), PEF (2000) and Villarreal (2000).

3. For a detailed analysis of the Mexican economy, see: De Maríay Campos (2000); Dussel Peters (2000\a), PEF (2000) and Villarreal (2000).

4. In the computer industry, for example, new industrial organization patterns require working in "real time." Buying through Internet with the guarantee of having the product in 48-72 hours in the U.S. requires a fast and secure configuration of computers. These activities, from testing of parts and components to the assembly of the whole PC, as well as to the specific configuration of the PC, are accomplished in Mexico, in Ciudad Juárez and Guadalajara. See Dussel Peters (2000/a).

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