NAFTA at 10 Years: Lessons for Development

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The North American Free Trade Agreement (NAFTA) has raised Mexico's standard of living and helped bring the country closer to the levels of development of its NAFTA partners. Between 1994 and 2002, NAFTA made Mexico richer than it would have been without the agreement by about 4 percent of its gross domestic product (GDP) per capita (Lederman, Maloney, and Servén 2005). Statistical analyses suggest that the treaty resulted in a doubling of Mexico's global exports and an increase of 40 percent in foreign direct investment (FDI). As a result of the agreement, the amount of time required for Mexican manufacturers to adopt U.S. technological innovations was cut in half. Trade seems to be partially responsible for the moderate declines in poverty observed during the period and has likely had a positive effect on the number and quality of jobs. Nonetheless, NAFTA is not enough to ensure economic convergence among North American countries and regions because of limitations in its design and the need for crucial domestic reforms. These conclusions follow from careful empirical analysis of NAFTA's 10-year history.

Identifying NAFTA's effects is difficult for various reasons. First, only a relatively short time has elapsed since implementation of the agreement. Second, Mexico's post-NAFTA years started with the dramatic setback of the Tequila crisis in 1994–95, making it hard to disentangle the effects of the treaty on the Mexican economy. Third, care must be taken when extrapolating the NAFTA experience to the Central American Free Trade Agreement (CAFTA) or other FTAs in Latin America because of the considerable diversity of Latin American and Caribbean countries. The key priorities, necessary preparatory measures, and likely effects of accession thus differ considerably across countries.

The content of NAFTA

NAFTA eliminated most import tariffs and other restrictions to trade among Canada, Mexico, and the United States over its first 10 years. Mexico made the most substantial reforms, cutting average tariffs from about 12 percent in 1993 to 1.3 percent in 2001. U.S. tariffs on Mexican imports fell from 2.0 to 0.2 percent. In some instances, however, market access for Mexican exports remains inhibited by rules of origin, which set product- or sector-specific criteria for products to be considered as originating in a NAFTA country.

Like most trade agreements, NAFTA did not remove all trade distortions. While most agricultural imports from Canada and the United States have entered the

Mexican market duty free, Mexico's import-competing agriculture has benefited from income transfers and subsidies. Moreover, all member countries have continued to use anti-dumping and countervailing duties (AD/CVDs), and NAFTA allows the use of temporary safeguard duties when sudden import surges disrupt domestic production. For example, since 2003 Mexico has imposed temporary taxes on poultry imports from the United States. The agreement established various mechanisms to settle disputes related to the use of safeguards and AD/CVDs as well as other issues related to foreign investment and trade.

Beside trade-related measures, NAFTA includes a variety of provisions affecting investment flows, financial and other services, government procurement, and the protection of intellectual property rights. A full review of all these provisions was beyond the scope of the analysis upon which this note is based, but it is noteworthy that the agreement did not fully liberalize the financial system. In banking, the agreement allowed FDI to penetrate only up to a maximum of 25 percent of the banking system's aggregate capital. Although NAFTA did codify an open capital account for cross-border financial services, Mexico had already unilaterally liberalized its capital account prior to the implementation of the agreement in 1994.

The analytical challenge: identifying the impact of NAFTA

Mexican economic performance since 1980 has fluctuated widely, which partially explains the degree of controversy in the debate over NAFTA's impact on the Mexican economy. On the one hand, trade and FDI as shares of GDP were higher in the post-NAFTA period than in the previous years. But these rising trends also were evident during Mexico's unilateral trade reforms of the late 1980s. Moreover, trade grew quickly in the 1990s all over the world, and FDI rose in many other emerging markets. On the other hand, the growth of Mexican GDP per capita and real wages was unremarkable after NAFTA's implementation, and estimated poverty rates declined only after 1996. Of course, an important reason why growth and wages did not perform more favorably was the macroeconomic and financial crisis sparked by the devaluation of the peso in December 1994. Indeed, the evidence shows that trade and FDI cannot be blamed for the lackluster performance of wages, since wages in Mexico tended to be higher in sectors and regions that were and remain exposed to international competition and foreign investment.

Economic convergence in North America after NAFTA

Our research shows that trade liberalization has significantly benefited Mexico's economy, including the poor. NAFTA, along with the unilateral trade reforms of the 1980s, helped Mexico enter a process of economic convergence with respect to the United States, increasing trade, FDI, and growth. Real wages have recovered rapidly from the 1995 collapse, and the poverty rate has similarly improved. After 1995, the gap in per capita GDP between Mexico and the United States has evolved more favorably than for other Latin American and Caribbean economies.

However, NAFTA is not enough to ensure economic convergence in North America. Mexico still suffers from important deficiencies in institutions and in education and innovation policies that constrain its long-run ability to catch up with its northern neighbors. In fact, econometric analysis indicates that the gap in the quality of public institutions is the biggest single factor behind the income gap between the two countries. Furthermore, the combined influences of all other factors that determine income in the long run—principally Mexico's status as an oil producer—actually suggest that Mexicans would be richer than their northern neighbors were it not for the institutional gap. The importance of institutions, which are not the primary focus of trade agreements, in determining income puts in perspective the economic benefits that should be expected from such treaties.

For the rest of Latin America and the Caribbean, the situation is very similar: institutional gaps are the biggest obstacle to income convergence with the United States. Institutional reforms, especially those intended to improve the rule of law and fight corruption, are therefore critical for the future economic development of the region.

While Mexico's institutions improved after NAFTA's implementation, improvements were observed throughout the region, and especially in Chile and Central America. This indicates that institutional improvements are not automatic by-products of North–South free trade agreements. Substantial unilateral efforts will be required to revamp Latin American and Caribbean institutions and quicken income convergence in the Americas.

Macroeconomic synchronization and policy coordination

In addition to long-run effects on per capita income and wages, trade agreements also have potentially major implications for macroeconomic fluctuations in member countries and, therefore, for the design of their macroeconomic policies. Through increased economic integration, the macroeconomic cycles of partner countries may become more closely synchronized—although this need not be the case, especially if the countries involved are very different. In the post-NAFTA years, fluctuations in the United States have accounted for an increasingly large fraction of the variation in Mexico's GDP growth.

Trade integration

Mexico's trade liberalization under NAFTA followed closely the unilateral reforms begun in 1986, after the country joined the General Agreement on Tariffs and Trade (GATT). Trade negotiations among Canada, Mexico, and the United States began informally in 1990, and more formally in 1991 after the United States administration obtained "fast track" authority from its legislature. It is therefore difficult to separate the effects of NAFTA on Mexico's volume and composition of trade from those of the unilateral reforms, especially given that the mere announcement of NAFTA talks could have had an impact on economic outcomes. Whatever the cause, in the 1990s Mexico's trade volume as a share of GDP became one of the highest in the region. Since catching up with Chile in this indicator of economic integration Mexico is fast approaching the high trade shares (around 100 percent of GDP) that are typically found among smaller economies, such as Costa Rica.

But the rapid expansion of Mexico's trade began just prior to NAFTA, around 1993. That expansion was accompanied by a marked change in the composition of trade, indicating that structural changes had occurred before the trade agreement. (For example, Mexico became a net exporter of machinery in 1992–93.) Those structural changes may have been delayed effects of the unilateral reforms of the mid-1980s; they may also reflect enhanced credibility and confidence resulting from the anticipated passage of NAFTA. In any case, econometric evidence suggests that NAFTA did not significantly (in the statistical sense) affect aggregate exports and imports between the United States and Mexico, while Mexico's global exports did increase significantly after NAFTA. Consequently, it seems that NAFTA helped consolidate ongoing trends by removing Mexico's longstanding policy biases against trade.

Agriculture

Contrary to some predictions, NAFTA has not had a devastating effect on Mexico's agriculture. In fact, both domestic production (measured in metric tons) and trade in agricultural goods rose during the post-NAFTA years. The expected negative consequences did not occur for at least three reasons. First, aggregate demand in Mexico and the United States grew in the latter half of the 1990s, thus allowing for simultaneous increases in Mexican production and imports. Second, some segments of Mexican agriculture experienced increases in land productivity. (This was the case for irrigated lands, but not for rain-fed lands.) Third, whereas the total amount of subsidies and income support for traditional agriculture did not rise during the NAFTA period, Mexico's unilateral reforms improved the efficiency of such subsidies. In particular, the *Programa para el Campo* (PROCAMPO), which became the main source of income support provided by the government for farmers who had historically produced import-competing crops such as maize and other grains, delinked the amount of public support from current and future production decisions.

Antidumping and countervailing duties

NAFTA's Chapter 19, which provides a panel-review mechanism for assessing whether AD/CVD decisions by the competent national agencies have been properly applied, has had no significant impact on U.S. AD/CVD activity against Canada or Mexico. U.S. AD/CVD actions against Canada and Mexico have been infrequent in the last ten years, as they were before NAFTA. On the other hand, the United States has traditionally been a major focus of Mexican antidumping cases; since the implementation of NAFTA, Mexico has significantly reduced its antidumping activity against both the United States and Canada. Nonetheless, all three countries should review their AD/CVD practices and move toward a system that relies more on the use of safeguard actions rather than AD/CVD investigations since NAFTA provisions themselves have not reduced the use of AD/CVD investigations by the United States.

Trade diversion resulting from NAFTA

When NAFTA was being negotiated in the early 1990s, many countries voiced concern that their exports to the United States (and, to a lesser extent, to Canada and Mexico) would be displaced by intra-NAFTA trade, even though many producers in those countries were more competitive than NAFTA producers. We find little evidence of trade diversion at the aggregate level, a conclusion that agrees with previous studies of NAFTA reviewed in the book (Lederman, Maloney and Servén 2005). The absence of trade diversion is also suggested by the fact that Mexico's export share in non-NAFTA markets rose as much as, or even more than, its share in NAFTA markets. Likewise, the U.S. market shares of exports from other Latin American and Caribbean economies were not systematically affected during the post-NAFTA period.

Although NAFTA may have reduced Asian imports of textiles and apparel into the U.S. market, trends in apparel trade provide no solid evidence that neighboring countries lost market share because of NAFTA preferences. Although all countries in Central America and the Caribbean faced the same change in U.S. preferences relative to those enjoyed by Mexico, their post-NAFTA performances showed considerable diversity. Most Central American countries managed to raise their export share in NAFTA apparel markets; Caribbean economies fared less well. This suggests that factors other than NAFTA preferences are responsible for much of this diverse post-NAFTA performance.

Among such factors, export incentives granted by several countries in export processing zones (EPZs) may have played an important role. It is thus possible—although hard to verify—that the upward trend in the region's apparel export shares might have been achieved at significant costs, such as forgone fiscal revenues and other potential distortions often associated with EPZs.

Capital

In addition to increasing trade, an FTA may deepen the degree of financial integration of member countries, prompting a substantial rise in foreign investment. Indeed, higher FDI is often one of the main benefits that prospective members expect from upcoming trade agreements with the United States. Mexico's experience with NAFTA appears to validate these expectations: aggregate FDI flows to Mexico did rise significantly after the agreement was signed, and econometric analysis suggests that the agreement played an instrumental role in the rise. On the whole, however, Mexico's FDI performance in the post-NAFTA period was not significantly above the Latin American norm, except in the years immediately following passage, thus suggesting that the impetus for FDI was positive but transitory. A separate statistical analysis, however, suggests that the accumulated effect of NAFTA on FDI into Mexico was such that overall FDI would have been about 40 percent lower by the year 2000 without NAFTA.

There is little evidence that increased investment in Mexico came at the expense of other countries in the region—that is, that NAFTA led to investment diversion. The neighboring countries of Central America and the Caribbean, which stood to lose the most from a redirection of FDI flows to Mexico, did not suffer generally as investment hosts after NAFTA.

Labor

The lessons on labor markets emerging from Mexico are necessarily tentative, but the overall evidence warrants cautious optimism. There is some evidence of convergence toward U.S. wage levels, but inference is made very difficult by the collapse of Mexican real wages following the Tequila crisis. Although manufacturing wages increased after unilateral liberalization and rose sharply in the years following NAFTA, there is no strong evidence that this was substantially affected by increased trade. On one hand, wages are higher and have grown faster in states with more trade, FDI, and *maquilas.* On the other hand, the apparently tighter integration of wages along the border, in traded and nontraded industries alike, suggests an important role for migration in driving the limited convergence seen so far. Chile provides a longer-run precedent: after its very similar version of the Tequila crisis following unilateral liberalization in the early 1980s, the country generated impressive real wage growth of 3.2 percent a year from 1986 to the present, with large declines in poverty rates.

Despite popular perception, there is little ground for concern that NAFTA, or FTAs in general, will have a detrimental effect on the availability or quality of jobs. In Mexico and throughout the region, there is little indication of higher unemployment, increased volatility of the labor market (after the initial adjustments), or increased informalization associated with trade liberalization. As is true of firms of the region generally, Mexican firms that are more exposed to trade tend to pay higher wages (adjusted for skills), are more formal, and invest more in training. The (probably temporary) widening of the wage gap between skilled and unskilled workers observed throughout the region can be seen as reflecting a welcome increase in the demand for skilled workers by new and upgrading firms.[1]

When NAFTA was signed, the Mexican labor market was characterized by fluctuations in real wages, which partly accounts for the low levels of unemployment during periods of sectoral reallocations and the 20-year low reached by 1999. Even during the Tequila crisis, Mexico kept unemployment low by allowing inflation to erode pact-guided wages. Arguably, this flexibility in real wages is the critical difference from countries such as Argentina and Colombia, where relatively rigid real wages contributed to high and sustained unemployment during macroeconomic crises in the 1990s. The experience of Mexico and other industrialized countries suggests that neither prolonged spells of unemployment nor degradation of job quality are necessary or even likely results of increased trade or an FTA, and adjustments to trade-related or other shocks can be facilitated by higher degrees of nominal wage flexibility.

This discussion raises two questions about side agreements on labor issues. First, given that Latin American labor legislation is generous by *industrialized country standards,* would it not be better for agreements to facilitate the transition to systems that both protect workers better and promote dynamic growth, rather than to insist on the enforcement of archaic structures? Second, and more fundamental given the increasing evidence that foreign and trade-oriented firms offer higher wages and better working conditions, should not the effort to improve labor standards focus on all sectors of the economy and be freestanding (perhaps coordinated by an organization like the International Labour Organization) rather than linked to particular trade agreements? In light of the potential for protectionist abuse of side agreements, both questions merit careful debate as other FTAs go forward.

Notes

1. The regionwide trends in the quality and availability of jobs, as well as the skill premium and its determinants, are amply documented in reports from the World Bank's Latin America and the Caribbean Region (World Bank 2001 and 2002).

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