Cato Institute Foreign Policy Briefing No. 9: A Mexican View of North American Free Trade

May 21, 1991

Roberto Salinas-León

Roberto Salinas-León is academic director of the Center for Free Enterprise Research, Mexico City.

Executive Summary

The primary purpose of free trade is to increase social and economic prosperity. That is the rationale behind the trilateral initiative to craft a North American Free Trade Agreement (NAFTA) among the United States, Mexico, and Canada. A NAFTA would bring multiple and mutual benefits to the three nations, forging a huge open market with a population of 360 million and a total output of $6 trillion--a priceless commercial opportunity that no nation can afford to pass up.

Free trade and prosperity are goals that Mexicans are now yearning for. The reasons are clear. Few nations with such explosive economic potential and privileged geographical position have suffered so much under a regime of protectionism, import substitution, and overwhelming state intervention in economic life. In Mexico the 1980s are characterized as a "lost decade." A NAFTA promises prosperity based on sustained and stable economic growth. It is regarded as a fundamental key to a new and better decade.

The economic and institutional conditions necessary for creation of a NAFTA already exist. Three-way trade among the three countries last year topped $225 billion. The United States signed a free-trade agreement with Canada in 1989 and has its first- and third-largest trading partners north and south of its borders. And as a result of trade liberalization in Mexico, trade has tripled between Mexico and the United States since 1986, and U.S. exports to Mexico doubled in the same period.

Furthermore, the United States is, by far, Mexico's most important trading partner. More than 70 percent of Mexican imports come from the United States, and more than 60 percent of Mexican exports flow into the United States. Also, 65 percent of total foreign investment in Mexico derives from the United States. The recent wave of significant market-oriented reform has prepared Mexico to seek integration with the U.S. economy.

Such an unquestionably beneficial opportunity for a brighter commercial and economic future should meet with no rational opposition. Nonetheless, prominent spokesmen for organized labor and environmental organizations have conducted a vocal campaign against a NAFTA, in general, and free trade with Mexico, in particular--making highly emotive claims that a NAFTA would bring massive job losses in the United States and increased child labor atrocities and ecological disasters in Mexico.

Mexico and Protectionism: Before and After

An estimated two-thirds of Mexico's population is under the age of 25. Those people represent the nation's new generation, yet they have grown up hearing of nothing but crisis, debt dependency, capital flight, and stagnation. Few of them realize that Mexico enjoyed three decades of continued prosperity before the introduction in the 1970s of protectionism and state direction of the economy. Annual growth rates averaged 6 percent, per capita incomes grew, and real wages rose at steady paces. Further, inflation averaged single-digit rates, and the peso was a solid 12.5 to the

U.S. dollar.

In 1970, however, the Mexican government launched a new series of public policies based on import substitution and centrally planned industrial development. The government of President Luis Echeverria defended that departure from the highly successful strategy of "desarrollo estabilizador" (stabilizing development) on the grounds that it would enable Mexico to attain economic sovereignty and an equitable distribution of income. The subsequent years saw progressive growth of the federal budget and government programs. The number of state-owned companies multiplied, from some 350 in 1970 to a peak of 1,200 in 1982. Similarly, while the Mexican population grew by 25 percent between 1975 and 1983, the bureaucracy increased by 85 percent.(1) Financing that exploding bureaucracy and state interventionism required huge growth in federal deficit spending and external borrowing. Monetary expansionism and oil-backed foreign indebtedness became the principal instruments of economic growth. In 1982 the banks were nationalized, signaling the state's unequivocal assumption of a central role in the economy.

We see today the results of that highly protectionist and state-dominated economy. By 1988 inflation hit an all-time high of 159 percent, the exchange rate fell to 2,800 pesos per U.S. dollar, and foreign debt skyrocketed from $4 billion to $107 billion. Negative growth rates became the rule rather than the exception. Real wages lost over 45 percent of their purchasing power. Not surprisingly, that widespread instability occasioned an enormous exodus of capital. It is estimated that flight capital currently amounts to more than $80 billion(2)--86 percent of Mexico's total foreign debt.

In short, the protectionist experiment of shielding the economy from "excessive" foreign investment and of financing the establishment of a national industrial base transformed Mexico into a nation addicted to foreign borrowing and dependent on bailouts and debt renegotiations. That, in turn, provoked the worst economic crisis in the country's contemporary history. Had Adam Smith lived in Mexico from 1970 to 1988, his famous book likely would have been titled On the Origins and Causes of the Poverty of Nations.

"Salinastroika" and Trade Liberalization

The current administration, headed by President Carlos Salinas de Gortari, has developed an ambitious drive toward "modernization" based on a market-oriented program of structural economic reform. It includes four fundamental aspects: fiscal discipline and financial austerity; aggressive deregulation of many sectors of society; privatization of state-owned enterprises; and substantial reduction of tariff and nontariff trade barriers.

The results of that four-part program of structural reform are, thus far, positive and encouraging. Inflation has fallen to 25 percent annually, and capital repatriation is beginning to gain momentum. The fiscal deficit in 1991 is projected to be 1.9 percent of the gross domestic product (GDP), down from 16.9 percent in 1987. Last year was the first in over a decade that the rate of economic growth (3.9 percent) surpassed the rate of population growth (2.6 percent). Salinas's economic reform program has resulted in substantial flows of foreign capital into Mexico. Accumulated foreign investment in Mexico now totals about $33 billion.(3)

In 1990 President Salinas de Gortari decided to seek a free-trade agreement with the United States and Canada because he believes that closer commercial ties with Mexico's two northern neighbors will "lock in" his reforms and bring Mexico's full recuperation from the disastrous protectionist experiment. Indeed, a NAFTA would be the capstone of the current administration's efforts to do away with "statal giantism" through privatization and other liberalizing reforms.(4) It took a crisis of unprecedented proportions and a "lost decade" for Mexico to learn its lesson and recognize that free trade is better than no trade.

More reforms need to be undertaken to make Mexico a free-market society. The oil and electricity monopolies are still within the exclusive domain of the state, and laws guaranteeing private ownership have yet to be established. Nonetheless, Mexico is aggressively turning away from paternalism and the statist model and toward internal liberalization. A NAFTA is essential to consolidating the movement toward a free economy.

The relative success of market-oriented reform in Mexico has made the pursuit of economic integration with Canada and the United States a very feasible policy. Canada and the United States already enjoy the benefits of a free-trade agreement, signed in 1988. And commercial relations among the three countries are better than ever. A trilateral FTA would create the biggest and most significant open market in the world: three countries with three-way trade of over

$225 billion; a vast consumer market; a wealth of natural, human and capital resources; and an aggregate gross output 25 percent larger than that of the 12 nations of the European Economic Community.

The Benefits of Free Trade for Mexico

A NAFTA would bring multiple mutual benefits to all nations involved. Indeed, free trade is based on a fundamental principle of economic exchange: when trade of goods and services is free and voluntary, all parties benefit, regardless of the economic differences among them. Trade is not a zero-sum game of gains and losses. That characteristic of free trade in the context of a North American trading zone has been aptly described by the U.S. academic coalition Scholars for Free Trade with Mexico as a "win/win/win situation for the three countries involved."(5)

A NAFTA would offer tremendous advantages for Mexico. Unrestricted commercial access to the largest market in the world would create a stable source of new jobs for the 1 million citizens who join Mexico's workforce every year. The development of new commercial opportunities and the inevitable rise in real wage rates resulting from expanded growth and a wider output of goods would constitute a crucial force for stemming illegal immigration to the United States. High technology and capital investment from the United States would complement Mexico's pool of cheap labor and enable U.S. and Mexican companies operating in Mexico to modernize their means of production, thereby becoming more competitive both domestically and abroad. The predictable repatriation of enormous sums of flight capital now deposited overseas would also add impetus to the job-creating potential of trade liberalization and commercial integration. That is the essence of the Salinas government's motto that trade would allow Mexico to "export goods, not people."

There is ample precedent for such developments. The flourishing "in-bond," or maquiladora, industry in Mexico has supplied almost half a million jobs to date. The maquila scheme involves assembly in Mexico--for export to the United States--of cars, auto parts, electronic goods, and other manufactured items. Production inputs from the United States receive duty-free treatment. The finished goods, upon entry into the United States, are taxed only on their added value. The manufacturing plants are usually 100 percent foreign owned. In general, they are miniature examples of a free-trade scheme between Mexico and the United States. A NAFTA would merely take the maquiladora framework one giant step further.

Mexico's best chance of abandoning its "less developed" status, and of transforming its vast natural resources into real wealth, is to pursue trade with its rich northern neighbors. Of the three, it is the country that stands to benefit most. A NAFTA would ensure the potential for sustained growth in Mexico, enabling it to maximize its comparative advantages in such varied sectors as citrus and fish, cement and steel, leather goods and beer.

More important, the creation of a NAFTA would add a powerful impetus to the market-based reforms now under way in Mexico. Thus, it would become possible to privatize the "strategic" sectors of the economy, particularly the rich oil industry and the inefficient electricity monopoly. Trade liberalization since Mexico joined the General Agreement on Tariffs and Trade (GATT) in 1986 has already resulted in several important joint ventures with foreign companies in those politically sensitive areas, as well as in reform of the very backward, collectivist agrarian system. Such initiatives were unimaginable only a few years ago, yet they are preludes to more profound liberalization.

Free Trade Will Wean Mexico from Aid Dependence

A NAFTA would help Mexico reduce its stifling addiction to foreign borrowing, replacing government-backed loans and grants with private investment and free trade. The Salinas administration reached a landmark debt reduction agreement under the so-called Brady Plan in 1989, which effected forgiveness of some 20 percent of Mexico's foreign debt to private creditors and cut its annual debt service burden by some $3 billion for the next four years. Nevertheless, far from encouraging more reliance on private capital investment, that relief strategy has delayed radical and urgently needed reforms in agriculture and the federal electricity and oil monopolies. As a consequence, Mexico remains highly dependent on foreign aid to finance those costly state-run con-cerns.

For example, the oil monopoly, known as PEMEX, is currently suffering a financial and investment crisis in its productive infrastructure. It is the 10th-largest oil company in the world, yet it channels a meager 0.3 percent of every dollar obtained from oil-related sales into new capital equipment.(6) In fact, studies show that without massive capital investment in exploration and extraction, in amounts of no less than $4 billion, PEMEX will be unable to service rising internal demand. That means that Mexico, eighth in the world in proven oil reserves, could turn into a net importer of crude by the middle of the next century.(7)

In mid-1990, the Bush administration authorized $5.6 billion in loans from the U.S. government's Export-Import Bank to alleviate the financial crisis afflicting the ailing petroleum industry in Mexico. The proper approach would have been to encourage the Mexican government to end its oil monopoly--a precondition for attracting private capital to finance technological improvements and new refineries. PEMEX lacks resources to fund its own projects, in part, because it must hand over 30 percent of its revenues to the state treasury.

Similarly, loans from the World Bank have not diminished in the wake of Mexico's 1989 Brady Plan debt reduction package. In fact, Mexico continues to borrow substantial amounts to finance inefficient state concerns. In 1990 alone, the World Bank approved new loans to Mexico totaling an unprecedented $2.6 billion; in 1989 it approved $2.2 billion. In fact, Mexico has borrowed nearly $10 billion from the World Bank since 1983. The seven 1990 loans include $450 million for "electricity distribution" and $150 million for agriculture projects.(8) Yet in 1990 the agricultural commodities supply board, CONASUPO, and the federal electricity monopoly, CFE, required up to 55 percent in government transfers to cover their annual expenses.(9) That year CONASUPO's outlays alone grew by over 43 percent, absorbing over $1.5 billion in transfer subsidies.(10) CFE came in second, with outlays growing by 20 percent and transfers increasing by some $500 million.(11)

The problem in those ailing sectors is not a lack of funds but a systemic mismanagement of funds as a result of the lack of competition and open markets. The liberalization of those areas would attract the technology and private capital investment required to modernize equipment and productive infrastructure. That is precisely what free trade with eager northern investors would help bring about.

In short, a NAFTA would help Mexico move from debt- dependent underdevelopment to trade-based growth. Mexico's commerce secretary, Jaime Serra Puche, recognizes that fundamental potential in his new motto--Mexico needs "trade, not aid."

Benefits for the United States and Canada

The potential benefits of a NAFTA for the United States and Canada are equally great. Mexico has a population of over 80 million, which is projected to grow to 100 million by the year 2000. With over 1 million individuals joining the workforce every year, a NAFTA is likely to transform Mexico into an excellent customer for U.S. and Canadian exports.

The trade liberalization initiatives undertaken in Mexi- co over the past five years have made that nation the third-largest trading partner of the United States; total two-way trade reached a high of $58 billion in 1990. U.S. exports to Mexico have doubled over the same period. A NAFTA would spur U.S. external commerce via the gradual elimination of all remaining tariff and nontariff barriers. Also, free trade with Mexico would enable the United States to join its technological advantages with widely available, low-cost labor and remain globally competitive by producing high-quality items at lower costs.

Moreover, improved U.S. exports would mean new jobs for Americans. The maquiladora example shows the beneficial job- creating impact of free trade on a miniature scale. It has accounted for some 100,000 jobs in the United States. Similarly, the increase of exports that would result from free trade could be expected to create a significant number of new jobs for U.S. workers. A new book published by the Vancouver-based Fraser Institute, Continental Accord: North American Economic Integration, estimates that Mexican imports from the United States will grow from about $20 billion annually today to about $50 billion annually five years after the implementation of a NAFTA.(12) Using the U.S. Department of Commerce's calculation of 22,800 new U.S.jobs created for every $1 billion increase in U.S. exports, a NAFTA would add about 680,000 jobs to the U.S. job market in the short run.

In addition to those compelling economic reasons for the United States to pursue free trade with Mexico, the denial of "fast-track" authorization to negotiate a NAFTA and the consequent deterioration of commercial ties could well provoke Mexico to return to the bad old days of "anti-gringo" paternalism, thereby initiating a resurgence of stagnation and instability. It is estimated that approximately 10 million illegal aliens would then seek to emigrate north.(13)

Finally, a NAFTA would help Mexico modernize its oil sector, thus ensuring a stable and friendly source of oil and petrochemical products for the United States.

U.S. Protectionist Mythology: Self-Defeating Arguments There are four basic arguments that figure prominently in numerous U.S. groups' opposition to a NAFTA. None with- stands analysis. In fact, once put in proper perspective, they all lead to the opposite conclusion.

Myth no. 1

A NAFTA, labor spokesmen claim, will cause massive unemployment as a result of jobs fleeing south into a low-wage economy.

While it is true that Mexico's average hourly wage rate of $2 differs greatly from the $9 average in the United States, it is also true that capital and technology seek not just low-cost labor but productivity as well. Otherwise, low wages in places such as Haiti, Colombia, or Bangladesh would have spurred American investment in those regions. That is why, without a NAFTA, U.S. capital will most likely be invested in the medium-wage and highly productive economies of the Pacific Rim. Skills are as fundamental to production as low wages.

The experience of trade liberalization in Mexico during the past five years thoroughly refutes the fear of mass migration of jobs south of the U.S. border. In fact, Mexico's imports from the United States have doubled since 1986, rising from $12.4 billion in that year to $28.8 billion in 1990. That translates into 377,000 new export-related jobs in the United States.

The introduction of a NAFTA would mean a further dramatic rise in U.S. exports. Mexican tariffs, now averaging 10 percent, would be gradually eliminated; nontariff barriers would also be eliminated. Every 1 percent increase in Mexico's growth rate represents an extra $300 million in U.S. exports and hence some 7,000 new jobs in the United States.(14) The potential for growth under free trade is, for Mexico, explosive. Those who fear job migration also seem to overlook the fact that the maquila industries--nothing more than islands of free trade--have generated some 100,000 jobs for American citizens. Thus, the arguments used by organizations such as the AFL-CIO suggest the very opposite of the conclusion they aim to derive.

To be sure, a NAFTA would negatively affect several labor-intensive manufacturing industries in the United States, particularly in the northern states. Yet such industries represent only 23 percent of America's GNP and employ only 18 percent of the U.S. labor force. The true negative impact is bound to be minimal because the entire Mexican economy is only 1/25th that of the United States. The fears simply do not find support in such facts.

The prospect of mass unemployment, in fact, is more credible in the event that a NAFTA is rejected. Without it, Mexico may well regress back to a closed economy, hurt the U.S. export market and its job-generating potential, and occasion a substantial flow of illegal immigration. Less U.S. investment in Mexico implies less hard currency earned by Mexican firms and individuals with which they can purchase foreign goods. In the end, everyone would lose--especially the U.S. worker.

Myth no. 2

Some people claim that the Mexican consumer market is too depressed to benefit the U.S. external sector. Annual per capita income, after all, averages $2,000 in Mexico-- seven times less than the present average in the United States. As AFL-CIO president Lane Kirkland wrote in a recent Wall Street Journal op-ed, "What do [advocates of free trade with Mexico] propose we sell to people who earn $27 a week?"(15)

That reasoning ignores some elementary facts about the U.S.-Mexican commercial relationship. U.S. exports to Mexico have already doubled since trade liberalization began south of the border. In its trade with the United States, Mexico has surpassed such economic powerhouses as West Germany to become America's third-largest trading partner. The Mexican economy obtains 70 percent of its total imports from the United States.

Free trade will expand the Mexican consumer market. While real wages have experienced a sharp decline (as a result of economic closure and statist policies) in the past decade, over 20 million Mexicans can still afford U.S. products. That is roughly two-thirds of Canada's population. Unrestricted access to the largest market in the world would increase two-way trade for all three nations, thus bringing increased purchasing power to all North American consumers. It would also provide a powerful incentive for Mexican flight capital to return home.

On the other hand, imagine what would happen if the United States closed its border to trade with Mexico. That would precipitate a systemic decline in Mexican and American consumers' purchasing power. It would also initiate a resurgence of profitable contraband trade among the three nations. In fact, that "informal" type of trade developed extensively during the height of economic protectionism in the 1970s and 1980s and became the third-largest source of hard currency for Mexico. It is instructive that even under such adverse conditions Mexicans could buy American products.

Myth no. 3

It is asserted that ecological deterioration along the U.S. border will accelerate as American companies relocate just south of the border to take advantage of Mexico's lax environmental standards. Similarly, it is alleged that the inevitable process of cross-border "harmonization" of some regulations will result in a "dangerous weakening" of U.S. environmental legislation. For example, the National Wildlife Federation claims that, as "currently structured," the NAFTA will "affect" U.S. citizens by forcing them "to lower their environmental standards in order to compete economically with Mexican industry."(16)

That point of the opposition is also contradicted by the facts. It is clearly true that Mexico must undertake many radical initiatives to improve its environment. But the environmental laws of Mexico, far from being lax, are on occasion stricter than those of the United States. The problem is that the protectionist import-substitution policy that Mexico followed from 1970 to 1988 impoverished the nation-- leaving it without the resources to enforce its environmental laws. The solution is sustained economic growth, which a NAFTA will ensure.

The prospect for ecological reform under a NAFTA is strong. Ecological preservation is a luxury that only developed countries can afford without sacrificing economic well-being. Liberalizing reforms in Mexico have already been responsible for important environmental initiatives. Thus, under a NAFTA, the likelihood of dangerous weakening of U.S. laws is minimal. In fact, it is probable that Mexican ecological, health, and safety standards will evolve toward U.S. standards.

The opposition to "fast-track" authority for the Bush administration to negotiate a NAFTA, as currently represented by organizations such as the National Wildlife Federation and Friends of the Earth, seems to ignore the fact that economic prosperity is a necessary condition for a healthy environment. The guaranteed poverty of a closed economy would bring about true ecological deterioration south of the border. On the other hand, with a NAFTA Mexico will begin to generate the resources required to enforce existing environmental legislation and repair the ecological damage caused by excessive government control. For example, the lack of property titles in rural farming areas has forced peasants to turn to burning the rich forests in southern Mexico in search of new arable land. And the prevailing inefficiency of the oil monopoly has brought with it production of one of the most polluting gasolines in the world. That gasoline is now the source of almost 80 percent of Mexico's air pollution.(17) The use of environmental concerns to oppose free trade is logically naive. It is free trade, in fact, which can occasion real ecological improvement.

Myth no. 4

U.S. labor leaders who oppose a NAFTA regularly decry child labor in Mexico, as if to suggest that child labor will not be affected--or may even increase--with a NAFTA in place. AFL-CIO president Lane Kirkland recently referred to child labor in Mexico as rivaling "any of the well-publicized disasters of the worst Stalinist regimes."(18)

A front-page Wall Street Journal article recently reported the story of Vicente Guerrero, a gifted 12-year-old boy, who was forced to leave school to go work under abysmally unhealthy conditions in a Mexican shoe factory, earning a meager salary of $34 a week.(19) U.S. labor groups, such as the AFL-CIO, are citing that story as evidence of societal problems in Mexico that a NAFTA would exacerbate.

Mexican law forbids employing anyone under the age of 14, and anyone under 16 can work for no more than six hours per day. Yet there are now an estimated 10 million child laborers in Mexico. Why? Again, the answer is lack of resources to enforce current law. The employment of children is a spontaneous response to the stifling policies of paternalist protectionism in the 1980s. It is part of a vast "informal" economy, which exists outside the activities prescribed by law and is, therefore, free of labor regulations. The denial of a NAFTA would perpetuate the horrors of child labor, whereas with free trade commercial opportunities will expand and far fewer families will have to resort to sending their youngsters to work.

It is sometimes said that child labor is better than no children at all. While that is true for Mexico, admitting so provides no answer for the problem. A NAFTA, however, does: real wages would rise, and with them the well-being of Mexicans. Incidentally, Vicente was fired as a result of the bad international publicity his case received, much to his ailing family's regret. If the AFL-CIO truly cares about child labor in Mexico, and about Vicente and his kin, it should recognize that prosperity and free trade will minimize the use of child labor.

Conclusion

A free-trade agreement with the United States and Canada has been widely embraced by Mexicans. Over 80 percent of individuals surveyed favor economic integration with the north.(20) Over 70 percent of companies surveyed concur with that consensus.(21) With over 1 million Mexicans entering the workforce every year, the only hope for a bright economic future lies in unrestricted trade with the largest economy in the world.

We Mexicans view a NAFTA as a priceless window of opportunity that we cannot afford to have closed on us. It is, indeed, ironic that while Mexico has turned toward free trade and free markets, many in the United States want to prevent Mexico from becoming a prosperous, market-oriented economy-- the model that the United States represents to the rest of the world.

Should the U.S. Congress deny "fast-track" negotiating authority to the Bush administration, Mexicans would perceive that as a symbolic vote of "no confidence" in their nation, as well as an unjustified denial of the critical legislative proceedings that preceded the negotiation of free-trade agreements with Canada and Israel. The ensuing fallout of anti-"gringo" sentiment might well steer Mexico back into a closed, state-dominated economy. That would mean another lost decade for us.

Mexico learned its lesson and has accepted its mistakes. In recent years, it has made significant progress in internal structural reforms and in external liberalization. In particular, Mexicans are now widely recognizing the key principle of free trade--when exchange is free and voluntary, everybody benefits.

George Bush recently posed the question, "What do anti- FTA people have against Mexican prosperity?" To that one might add "and Canadian and American prosperity?" Indeed, the president of the United States should have asked, "What do the NAFTA's opponents have against North American prosperity?"