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NAFTA, Mexican Trade Policy, and U.S.-Mexico Trade: A Longer-Term Perspective

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NAFTA, MEXICAN TRADE POLICY, AND U.S.-MEXICO TRADE: A LONGER-TERM PERSPECTIVE

SUMMARY

After two years of the North American Free Trade Agreement (NAFTA), the debate over liberalizing trade with Mexico continues. Because of congressional interest over the dramatic turnaround in the U.S. balance of trade with Mexico in 1995, this report considers trends in U.S.-Mexico merchandise trade in a longer term context. It does not address employment issues, which are the subject of other CRS reports. What becomes evident is that an open trade policy can facilitate trade, but macroeconomic problems can destabilize trade flows independently of trade policy or agreements.

U.S.-Mexico trade has grown and diversified as the two economies have become increasingly integrated. Yet, trade has not always expanded in a smooth upward direction. Many economic variables affect trade: economic performance of trading partners, capital flows, domestic economic policies, exchange rate policy, and trade policy. In 1982-83 and 1995, Mexico experienced severe recessions. Both were similar in that they were preceded by an overvalued peso, balance of payments crises, large capital outflows, and major peso devaluations. A critical variable that differed between the two setbacks was trade policy, which caused Mexico to act much differently in 1995 than it did in 1982.

Mexico was essentially a closed economy in 1982, but the debt crisis led the way to Mexican trade policy reform. Mexico began serious unilateral reductions in trade barriers after 1985 and made overt moves to integrate itself more completely with the world economic system by becoming a member of the General Agreement on Tariffs and Trade (GATT) in 1986 and the Organization for Economic Cooperation and Development in 1994. NAFTA, in this context, is the continuation of a long-term trade-opening process.

With Mexico's 1995 balance of payments crisis, the United States saw its bilateral trade balance fall into a large deficit position, as it did in 1982. However, U.S. exports to Mexico declined by only 11% in 1995, compared to 35% in 1982 and 25% in 1983. Yet, in 1995, Mexico's economy contracted much more, with GDP falling 6.9% compared to 0.6% and 4.3% in 1982 and 1983.

The difference points to Mexico's open trade policy, including NAFTA, which kept it from raising barriers to U.S. trade in response to the crisis. The decline in exports represents the fall in demand that accompanied the recession and the effects of the peso devaluation. *What the decline does not reflect is a formal policy to restrict the flow of imports from the United States, which was in place in 1982, but absent in 1995.* NAFTA solidified Mexican commitments to an open trade policy and actually cushioned U.S. exports from more serious effects. Although this is scant comfort to those who are concerned with the 1995 trade deficit with Mexico, the deficit is not a *major* economic problem for the United States and is smaller than it might have been without NAFTA. Also, under freer trade economists generally expect U.S. exports to Mexico to recover more quickly than they did from the 1982 crisis under a closed trade policy.

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After two years of the North American Free Trade Agreement (NAFTA), the debate over liberalizing trade with Mexico continues. Many hold NAFTA responsible for both Mexico's sudden economic collapse and the resulting bilateral U.S. trade deficit, concluding that NAFTA was a bad deal for the U.S. economy.[1] Economists generally dispute this position based on two fundamental propositions. First, a bilateral trade deficit with Mexico does not present a major economic problem for the United States, and second, trade policies and particularly trade agreements do not cause trade deficits. In short, free trade agreements can affect the long-term *level* of trade, but not sharp fluctuations in the *balance* of trade. Finally, it is worth reiterating that the benefits of freer trade are not measured by annual trade balances, but by broader economic changes that unfold over longer periods of time.[2]

Nonetheless, the public policy debate continues over short-term movements in U.S.-Mexico trade. This report considers trends in U.S.-Mexico merchandise trade over two decades to help place recent events into a historical economic context.[3] To evaluate the role NAFTA may have had on the current economic and trade situation in Mexico, it is instructive to revisit the "debt crisis" period of 1982-83, when Mexico had a closed trade policy, and contrast it with the 1994 peso devaluation, when Mexico operated under an open trade policy. As shall be seen, rather than trade policy or agreements, politics, macroeconomic problems, and policy responses proved to be the short-term destabilizing forces of long-term trade trends in both cases. By contrast, changes in Mexican trade policy, including adopting NAFTA, may have actually cushioned U.S. exports from even steeper declines in 1995, given Mexico's worst recession since the 1930s.

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[1] The major criticisms revolve around loss of jobs and U.S. exports. For example see: Buchanan, Patrick J. Mexico: Who Was Right? *The New York Times.* August 25, 1995 and Public Citizen. *NAFTA's Broken Promises.* September 4, 1995.

[2] For an economic discussion of the "gains from trade" see: U.S. Library of Congress. Congressional Research Service. *Trade Policy in an Economic Perspective.* Report No. 95-529 E, by Craig K. Elwell. March 9, 1995.

[3] This report will not delve into employment issues; for a discussion of the employment effects see: U.S. Library of Congress. Congressional Research Service. *NAFTA: U.S. Job Effects and Industry Trends After Two Years.* Report No. 96-176 E, by Mary Jane Bolle. February 27, 1996 and *United States-Mexico Economic Relations: Has NAFTA Made a Difference?* Report No. 95-398 E, by J. F. Hornbeck. March 15, 1995.

UNITED STATES-MEXICO TRADE: 1977-1995

The United States and Mexico have had a long and sometimes tempestuous economic relationship. Although freer trade with Mexico raises concerns in the United States, Mexicans have also expressed reservations about being overwhelmed by the economic colossus to its north. Because trade occurs between a comparatively large and small economy, there is a disproportional aspect to the relationship.

The United States is by far Mexico's most important trading partner, accounting for approximately 85 percent of Mexico's exports and 72 percent of its imports in 1995. Although Mexico is the United States' third largest trading partner, it accounted for only 10 percent of U.S. exports and 7.5 percent of imports in 1995. This is an important distinction because despite concerns over U.S. exports to Mexico, the U.S. economy is not greatly affected overall by the economic fortunes of Mexico. To the contrary, Mexico's economy is much more vulnerable to U.S. economic trends.

Despite this discrepancy in relative trade importance, bilateral trade expanded briskly and for the most part evenly over the past two decades. Between 1977 and 1995, trade turnover (exports plus imports) between the United States and Mexico grew over ten fold from $9.5 billion to $107 billion (see figure 1 and appendix 1.) The U.S. balance of trade shifted from surplus to deficit, reflecting changing economic fundamentals in both countries.

At least three distinct periods can be seen in figure 1. First, the late seventies show a pattern of balanced trade growth, supported in Mexico by the oil boom. A second period followed in the 1980s characterized by a decline and stagnation of trade following the global recession, collapse of world oil prices, and increase in world interest rates that triggered Mexico's 1982 debt crisis. U.S. exports fell substantially after 1981, requiring seven years to recover. Beginning in 1986, a third period of nearly balanced trade growth resumed largely, as shall be seen, because of Mexico's trade reforms. Finally, 1995 may or may not portend the beginning of a fourth period, perhaps similar to 1982, in which Mexico's balance of payments problems result in a severe decline in U.S. exports.

In addition to the volatility in U.S.-Mexico trade over the past two decades, the composition of trade between the two countries changed rather dramatically, particularly Mexican exports. In the early 1980s, Mexico was, above all else, an oil exporter, with oil accounting for over two-thirds of total export revenue. Some 40 percent of exports to the United States consisted of oil at that time. By 1995, although still an important sector, oil production had not increased from 1983 levels and accounted for only 12 percent of total Mexican exports and 9 percent of exports to the United States (see appendix 2.)[4]

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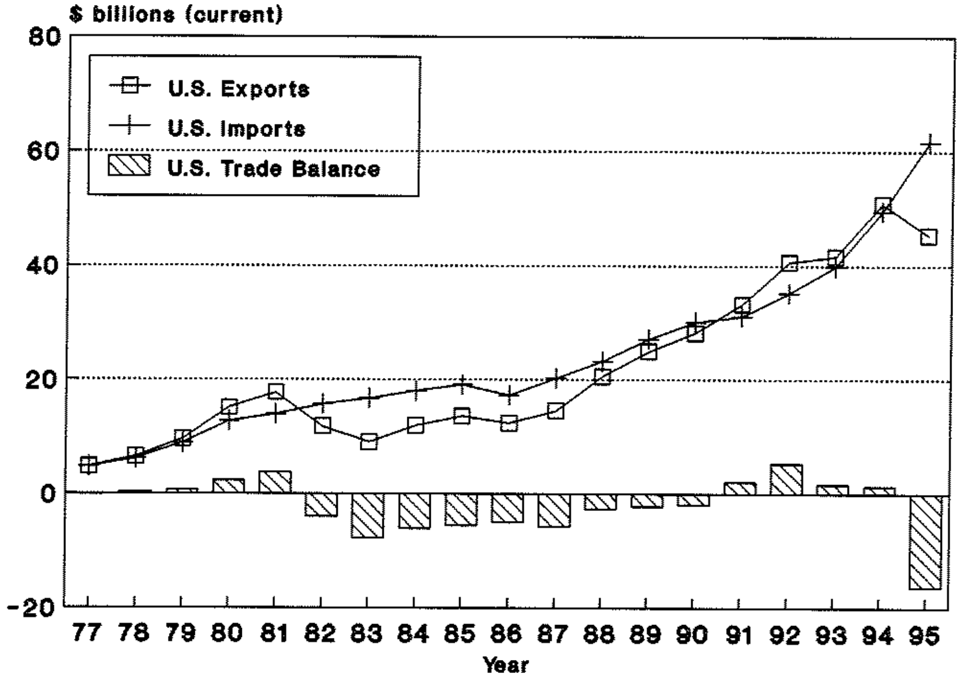
[4] Weintraub, Sidney. *A Marriage of Convenience: Relations Between Mexico and the United States*. New York, Oxford University Press, 1990. pp. 86 and 119 and U.S. Department of State. U.S. Embassy, Mexico. *Mexico, Economic and Financial Report*. Fall 1995. p. 80.

FIGURE 1. U.S.-Mexico Merchandise Trade (1977-1995)



Source: U.S. Department of Commerce.

As Mexico diversified its export base away from oil toward manufacturing, the United States became an even more important trading partner. In the early 1980s, the United States accounted for 55 percent of Mexico's exports. This ratio rose to 65 percent in 1987 and 85 percent by 1995. Approximately 80 percent of Mexico's exports are now manufactured goods, 70 percent of which end up in the United States. Maquiladoras, through joint production operations, play an important role in this trade, with half of all manufacturing exports coming from these firms. Motor vehicles, electrical instruments, and electrical appliances constitute most of the maquiladora exports.[5]

As important as the maquiladora relationship is to Mexico, the fundamental changes in Mexico's export composition also reflect shifts in non-maquiladora production. As seen in table 1, the ratio of manufactured exports to total manufacturing output tripled from 1982 to 1994 (column 3) and the ratio of manufactured exports to total non-maquiladora exports quadrupled (column 4). Also evident in this table is the growing importance of exports to the economy (column 2) and the declining relative importance of petroleum (column 5).

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[5] Weintraub, Ibid, pp. 73-75 and U.S. Embassy Mexico, Ibid, pp. 80 and 83. Maquiladoras are foreign-owned assembly plants in Mexico, which produce for export (mostly to the United States). U.S. and Mexican trade laws provided preferential treatment for inputs and finished goods related to maquiladora production even prior to NAFTA. U.S. Library of Congress. Congressional Research Service. *Mexico's Maquiladora Industry.* Report No. 93-1050 E, by M. Angeles Villarreal. December 14, 1993.

Table 1. Structural Changes in Mexican Exports (in percent)

Year	Total Exports/GDP	Mfg. Exports/Mfg. GDP	Mfg. Exports/Total Exports*	Petroleum Exports/Total Exports*
1982-83	14.7	10.5	17.5	74.5
1986-87	17.3	23.6	37.7#	50.9#
1994	20.6	32.0	68.9	21.2

* Total exports excluding maquiladora production. # 1985-87
Source: Jorge Mattar, El Indicador Bursatil, in U.S. Department of State. *Mexico: Economic and Financial Report,* Fall 1995. p. 80.

Between 60 and 70 percent of Mexico's imports tend to be intermediate goods, or goods that are further processed. Capital goods, used to manufacture other goods, account for approximately 20-25 percent of Mexico's imports, with consumer goods ranging from 5 percent during recessions to 15-20 percent during periods of economic growth. The dominance of intermediate goods again points to the importance of the maquiladora relationship as partially manufactured goods are sent across the border for further assembly and then returned to the United States. Intermediate goods support non-maquiladora manufacturing as well. The largest categories of imports from the United States are various types of tractor/automotive and electrical parts. Imports from the United States are highly diversified with the top 25 import commodity groups accounting for only one-third of the total (see appendix 3).

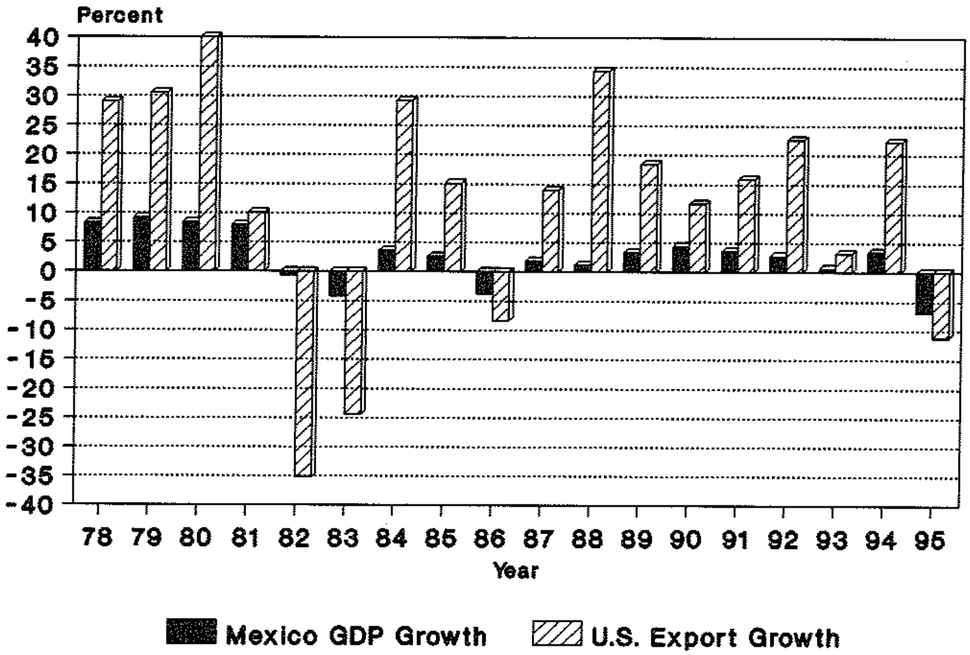
ECONOMIC FACTORS AFFECTING TRADE

As seen above, U.S.-Mexico trade changed considerably over the past two decades. The long-term trend is one of growth and diversification as the two economies become increasingly integrated. Yet, trade has not always expanded in a smooth upward direction, and in an effort to discern NAFTA's possible role in Mexico's economic problems, it is essential to understand some of the factors that affect short-term fluctuations in trade including economic performance, exchange rate policy, and capital flows. Because events causing the collapse of the 1994 peso are reminiscent of those in 1982, the two periods are contrasted.

TRADE AND ECONOMIC PERFORMANCE

Trade between two countries can fluctuate over the short-term as the economies move through their respective business cycles, which is particularly evident among major trading partners where economies are more highly integrated, such as the United States and Mexico. When economies are growing demand increases, including the demand for imports. When economies enter recessions, demand falls, often abruptly, which also diminishes demand for imports. These short-term swings can affect trade balances irrespective of trade policy or agreements.

FIGURE 2. Real Growth in Mexican GDP and U.S. Exports to Mexico (1978-1995)



CRS calculations, Dept of Commerce data.

To highlight the relationship between trade and short-term economic performance, figure 2 contrasts real annual growth of Mexico's gross domestic product (GDP) with real annual growth of U.S. exports to Mexico from 1978 to 1995. Figure 2 shows the potential for volatility in annual trade balances based on the vagaries of the Mexican business cycle. In particular, growth in U.S. exports to Mexico was highest in the late 1970s during a period of strong economic growth (8-9 percent annually) and decidedly negative when the economy fell on hard times in 1982-83, 1986, and 1995.

The decline in U.S. exports to Mexico is most evident for the 1982-83 and 1995 recessions. In 1982 and 1983, Mexico's GDP dipped by 0.6 and 4.2 percent, respectively, for a total fall in GDP of nearly 5 percent over the two years. At the same time, U.S. exports to Mexico fell by 35 and 25 percent for a total decline of approximately 50 percent. In the wake of the 1994 peso devaluation, Mexican GDP fell 6.9 percent in 1995 alone, the largest single year decline since the Great Depression and fully two-thirds more than in 1983. Yet, U.S. exports to Mexico fell only 11 percent or only about half the decline witnessed in 1983. This raises an interesting question (to be explored in the next section) of why U.S. exports to Mexico declined much less in 1995 than might have been expected given such a sharp contraction in the Mexican economy and the previous experience of 1982-83.

EXCHANGE RATES, CAPITAL FLOWS, AND TRADE BALANCES

Exchange rate policy and capital flows can also affect trade balances. Over the long run, stable and predictable exchange rates promote confidence in the future value of a country's currency, which in turn encourages trade and investment and discourages speculation and the potential for sudden large shifts in the flow of capital. Exchange rate stability, however, is not always easy to achieve. In a floating exchange rate system, market forces determine the exchange rate. In a fixed exchange rate system, policy sets the value of a country's currency in keeping with broader economic goals. Both can generate stability, but in Mexico's case, its fixed exchange rate policy became suspect when very large inflows of foreign capital caused the peso to become overvalued and Mexican economic policy did not make the necessary adjustments.

In 1987, as part of a long-term anti-inflation policy, Mexico pegged the "nominal" or current market value of the peso to the dollar and then in 1989 adopted a "crawling peg" exchange rate. The "crawling" aspect of this concept refers to what amounts to a constant nominal mini-devaluation of the currency, ideally at a rate that would be equal to the inflation differential with the country to which the peso is pegged (the United States.) In 1991, Mexico employed a band or defined trading range within which the peso could be traded, while continuing the regular mini-devaluation by widening the band.[6]

When a country pegs its currency, exchange rate credibility rests on adopting macroeconomic policies similar to those of the country to which the currency is pegged (the United States in this case) to avoid currency misalignments. Policy coordination is all the more critical in Mexico's case because the United States is both its primary trading partner and a much larger economy. Two problems often emerge when a country adopts a fixed exchange rate, both of which can raise the specter of devaluation. First, when the difference in inflation rates is not fully closed, the "real value" (adjusted for inflation) of the pegged currency (the peso in this case) tends to appreciate. As the real value of the peso appreciates, the "nominal value" becomes increasingly less credible, raising concerns about a possible devaluation.[7]

The second and related problem arises when domestic economic policy diverges from that of the country to which the peso is pegged, which, as mentioned above, raises questions about the credibility of maintaining the fixed

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[6] Because of the similarities between 1982 and 1994, only the latter period is discussed. Prior to 1982, Mexico had a fixed exchange rate compared to a "crawling peg." For all practical purposes, the crawling peg became a fixed exchange rate by 1994 so these technical differences did not affect the final outcome, which was devaluation in both cases.

[7] Not adjusting fully for the inflation difference was a matter of broader and deliberate Mexican policy involving wage and price controls. On the pitfalls see: Dornbusch, Rudiger and Alejandro Werner. Mexico: Stabilization, Reform and No Growth. *Brookings Papers on Economic Activity*. No. 1, 1994. p. 271-76 and Dornbusch, Rudiger, Ilan Goldfajn, and Rodrigo O. Valdes. Currency Crises and Collapses. *Brookings Papers on Economic Activity*. No. 2, 1995. p. 250-53.

nominal exchange rate. In 1982, Mexico's economic policies were overtly expansionary, contributing to inflation, the peso appreciation, and impending crisis. Similarly, in mid-1994 the Mexican government adopted looser fiscal and monetary policies, albeit rather subtly, as a matter of presidential politics. If macroeconomic policy becomes expansionary and relatively more expansionary than in the United States, which was actually moving in the opposite direction with the Federal Reserve raising interest rates throughout 1994, then the inflationary gap between the United States and Mexico discussed above grows and the nominal fixed exchange rate becomes suspect.[8]

Capital inflows into Mexico were a driving force that led to the overvalued currency, rising current account deficit, and Mexico's financial problems within the context of a pegged exchange rate system. As Mexico recovered from the debt crisis of the 1980s and achieved market-based economic reforms, investors came to believe that long-term stable growth might once again be possible. With rising interest in the potential for large returns in so-called "emerging markets," investors committed capital accordingly. Capital began to trickle into Mexico in 1989, and as documented in table 2, rushed in thereafter until 1994.

Table 2. Net Capital Inflows into Mexico, 1989-95 ($ billions)

Investment Type	1989	1990	1991	1992	1993	1994	1995 1/2 year
Portfolio	0.4	3.4	12.7	18.0	28.9	8.2	-11.5
Direct	2.8	2.6	4.7	4.4	4.4	8.0	2.6
Total	3.2	6.0	17.4	22.4	33.3	16.2	- 8.9

Source: IMF, *International Financial Statistics*, February 1996.

When capital moves into a country that maintains fixed exchange rates, the domestic money supply increases, prices tend to rise, and the exchange rate tends to appreciate.[9] The real appreciation of the peso lowers the price of imports and raises the price of exports, so Mexico began to run large trade and current account deficits that matched the capital inflows.[10] When these capital

[8] Dornbusch, Goldfajn, and Valdes, Ibid, p. 240. It has been argued that had Mexico been able to retain international credibility in its anti-inflationary policy, it might have avoided this latest crisis. See: Obstfeld, Maurice and Kenneth Rogoff. The Mirage of Fixed Exchange Rates. *Journal of Economic Perspectives*, v. 9, Fall 1995. p. 84.

[9] One view argues that an extremely high level of capital inflows, particularly in a small economy, is simply not a realistic equilibrium level over the long run and should be treated as a short-term phenomenon at the outset. See: Edwards, Sebastian. Comments and Discussion. *Brookings Papers on Economic Activity*. No. 2, 1995. p. 277.

[10] Another indication of the growing deficit may be seen by comparing table 2 with figure 1. Growth in foreign capital investment in Mexico from 1991 to 1994 coincided with Mexico's trade balance with its major trading partner, the United States, turning from a surplus to a deficit.

flows suddenly slow or reverse themselves, they can present serious problems for the recipient countries. This occurs because the country then has a large current account deficit, an overvalued exchange rate, and often insufficient foreign exchange reserves relative to possible capital outflows. This happened to Mexico during 1994.

Rising U.S. interest rates were responsible, in part, for the initial decline in capital inflows. Mexico would have had to adjust its economic policy in like manner to continue to attract capital, but Mexico found it difficult during an election year to change policy in response to the change in capital flows. In effect, it no longer subordinated domestic monetary and fiscal policy to the maintenance of a fixed exchange rate with the United States. In fact, as Mexico lost foreign exchange reserves, they were replaced by central bank purchases of Mexican government debt so that the economy would not have to deflate or allow the money supply to contract, which would slow growth and risk recession.[11]

In addition to higher U.S. interest rates, noneconomic factors sparked capital flight from Mexico. Concern over political stability was a key issue leading to investor uneasiness. In January 1994, a peasant revolt occurred in the state of Chiapas. March proved to be an even more unsteady month with the assassination of a presidential candidate. These events triggered a major speculative attack on the peso in late March, which Mexico defended by selling its foreign exchange reserves. Other political disturbances and tighter monetary policy in the United States continued throughout 1994 and in November Mexico faced another run on the peso as the fear of devaluation spread.[12]

Although changing political and external economic events encouraged investor withdrawal, it was Mexico's economic policy that doomed the peso to devaluation. In the absence of political and economic uncertainty, Mexico's impending financial crisis would probably have occurred in any event, although the timing might have been different. By mid-1994, Mexico loosened both its fiscal and monetary policies precisely when the United States was tightening its monetary policy. This decision was tantamount to encouraging higher inflation relative to the United States, which, with a pegged exchange rate, meant that the real appreciation of the peso would accelerate to potentially untenable levels, further exacerbating the current account deficit.

Mexico faced one of three unattractive options: (1) raise interest rates to match U.S. policy and continue to attract foreign capital; (2) devalue the peso; or (3) do nothing and head toward more serious financial difficulty. Option one proved unacceptable because it risked almost a sure recession prior to a presidential election. Option two was apparently debated, but discarded because

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[11] Dornbusch, Goldfajn, and Valdes, *Currency Crises and Collapses*, p. 240-41.

[12] For a summary of events see: U.S. Library of Congress. Congressional Research Service. *Mexico: Chronology of a Financial Crisis*. Report No. 95-1007 E, by Patricia A. Wertman. September 27, 1995.

Mexico staked its economic reputation on defending the peso.[13] Option three unfolded by default.

Investors, both foreign and domestic, actually realized the tenuous nature of the peso throughout much of 1994 and abandoned it by moving toward a dollar-indexed investment instrument known as the *tesobono*.[14] This amounted to "currency flight" prior to the final capital flight that occurred in November and December. When investors finally fled in late 1994, Mexico defended its currency with foreign reserves as long as it could before devaluing and eventually floating the peso. Mexico's refusal to face the inconsistency of its macroeconomic and exchange rate policies ultimately set events into motion. Mexico could not continue to peg the peso to the dollar and follow divergent macroeconomic policy from the United States. When an adjustment did not occur, it was only time before markets forced the peso's devaluation.

The debate over the proper Mexican response continues today.[15] For this report, it is sufficient to note that a fixed exchange rate policy combined with large capital inflows and Mexico's unwillingness to adopt necessary adjustment policies led to an overvalued peso and large current account deficits. As the peso lost credibility and capital fled Mexico, a devaluation became inevitable with dramatic and predictable effects on trade balances: Mexican exports increased, imports fell, and the balance of trade with the United States went from a surplus to a deficit. The key points are that the seeds of this problem were planted years before NAFTA was contemplated and that the final collapse of the peso occurred irrespective of trade policy.[16] Mexico faced this problem in 1982 under a closed trade policy and again in 1994 under a highly open trade policy.

MEXICAN TRADE POLICY

The preceding discussion points to many interconnected economic problems that can disrupt long-term trade patterns. The effect of Mexican trade reform, by contrast, should be evident over longer periods of time and promote stability in trade relations. To recap, in 1982-83 and 1995, Mexico experienced severe recessions (see figure 2.) Both were similar[17] in that they were preceded by an

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[13] Dornbusch, Goldfajn, and Valdes, *Currency Crises and Collapses*, p. 241.

[14] Tesobonos grew from 6 percent of total public sector internal debt in April 1994 to 55 percent by the time the peso was devalued in December. They proved to be only a stopgap measure in the attempt to halt capital flight.

[15] The two main camps are: (1) Mexico should have tightened fiscal and monetary policies to avoid devaluation, and (2) Mexico should have devalued the peso much earlier.

[16] Anticipation of NAFTA, however, may have contributed to the high expectations that drove large capital flows into Mexico after 1989.

[17] U.S. Library of Congress. Congressional Research Service. *Mexican Financial Crises, 1982 and 1995: Similarities and Differences*. Report No. 95-239 E, by Patricia A. Wertman. 6 p.

overvalued peso, balance of payments crises, capital outflows, and major devaluations, causing U.S. exports to fall. One of the critical variables that differed between the two setbacks was trade policy. As will be shown, a more open policy in 1995, solidified by NAFTA (and GATT), kept Mexico from reverting to import restrictions that were so prevalent in 1982. This policy change actually protected U.S. exports from worse declines when faced with a severe economic setback in Mexico.

CLOSED TRADE POLICY AND THE 1982 CRISIS

In 1982, the Mexican economy was considerably more closed to trade than it was in 1995. Mexico had long followed an import substitution approach to development, which by maintaining high tariffs and other barriers to imports, protected domestic industry from foreign competition. In 1981, the average tariff rate was 27 percent, 83 percent of imports required licenses, and domestic content requirements covered key industries such as automobile and computer manufacturing.

The sole purpose of these policies was to restrict imports in order to facilitate domestic industrial development in Mexico. Given the wealth effect of new found oil reserves in the late 1970s, there was little financial or political pressure to change policies.[18] As the 1980s approached, Mexico's economy continued to grow based on heavy external borrowing backed by seemingly unlimited oil revenues. This trend gave way to large current account deficits.

The 1982 balance of payments crisis occurred because Mexico overborrowed and could not meet growing international debt service payments given rising world interest rates and falling world oil prices. Mexico devalued the peso twice in 1982 and immediately faced economic decline: inflation climbed to nearly 100 percent and economic growth fell by nearly 5 percent over two years.[19]

To resume meeting its debt obligations, Mexico increased barriers to imports in order to earn foreign exchange. The primary tool was the import license (*permiso previo*), which in 1982 was extended to 100 percent of imports. Exchange rate controls were also introduced and tariffs raised, but as one observer points out, "Under this import structure, it was fatuous to speak of average tariffs levels in Mexico. Denial of a *permiso previo* was the equivalent of an infinite tariff."[20] The result for the United States was a dramatic fall in exports to Mexico, as seen in figure 2.

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[18] Lustig, Nora. *Mexico: The Remaking of an Economy.* Washington, D.C., The Brookings Institution, 1992. pp. 114-15.

[19] The details can be found in chapter 1 of Lustig, Ibid.

[20] Weintraub, Sidney. The Promise of United States-Mexican Free Trade. *Texas International Law Journal*, v. 27, Summer 1992. p. 555.

TRADE REFORM IN THE 1980s

Despite the initial raising of import barriers, one outcome of the debt crisis was reform in Mexican trade policy. Mexico began gradual unilateral reductions in trade barriers after 1982. These accelerated after 1985 when Mexico made overt moves to integrate itself more completely with the world economic system by becoming a member of the General Agreement on Tariffs and Trade (GATT) in 1986 and the Organization for Economic Cooperation and Development in 1994. Becoming a party to NAFTA was a logical step in this progression.[21]

Mexico's specific trade reform policies included reducing licenses from 100 percent of imports in 1982 to 36 percent in 1985, 27 percent in 1986, and 22 percent by the end of 1988. Mexico also simplified its tariff schedules, with maximum tariffs falling from 100 percent in 1982 to 20 percent in 1988. The trade-weighted average tariff rate continued downward and today stands at approximately 10 percent. By 1987, these and other policy changes "transformed Mexico from an extremely closed economy into one of the most open ones in the world."[22] All this transpired seven years before NAFTA took effect.

Because Mexico instituted major trade policy reform before entry into NAFTA, the trade agreement may be seen as the continuation of a long-term process, at least as it affects the United States and Canada. Under NAFTA, Mexico's few remaining import license requirements were converted to a system of tariff-rate quotas that will be phased out. Tariff rates remain low and will also disappear as the free trade agreement is fully implemented. Importantly, as shall be seen, NAFTA consolidated Mexico's position on free trade with the United States. The effect of Mexico's trade liberalization on trade volume with the world is well documented. From 1982 to 1994, Mexican exports grew over 150 percent to $60.9 billion. Perhaps most telling is that oil, as a percent of total exports, fell from 77.6 to 21.4 percent. Over the same time period non-oil export revenues (mostly manufactured goods) increased by over 450 percent. Mexican imports also rose dramatically from 1982 to 1994, rising over 360 percent to $79.4 billion.[23]

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[21] Lustig, *Mexico: The Remaking of an Economy*, p. 39 and CRS, *United States-Mexico Economic Relations*, p. 4. It should be noted that trade liberalization affected primarily manufactured goods; agriculture, services, and other important areas are still protected and will be opened up under NAFTA.

[22] Tornell, Aaron. Are Economic Crises Necessary for Trade Liberalization and Fiscal Reform? The Mexican Experience. In Dornbusch, Rudiger and Sebastian Edwards, eds. *Reform, Recovery, and Growth: Latin American and the Middle East.* Chicago, University of Chicago Press, 1995. p. 53. See also: U.S. International Trade Commission. *Review of Trade and Investment Liberalization Measures by Mexico and Prospects for Future United States-Mexican Relations*. Publication 2275. April 1990. pp. 4-1 to 4-5 and USITC. *1995 National Trade Estimate Report on Foreign Trade Barriers*. pp. 229-236.

[23] Tornell, Aaron and Gerardo Esquivel. *The Political Economy of Mexico's Entry to NAFTA*. Working Paper 5322. Cambridge, National Bureau of Economic Research, October 1995. Tables 2-3. International Monetary Fund. *International Financial Statistics Yearbook, 1995*, p. 541.

Because the United States is Mexico's most important trading partner, shifts in trade policy are particularly noticeable. As seen in figure 1, the level of trade between the United States and Mexico experienced steady growth between 1983 (the beginning of Mexican trade policy reform) and 1994 (NAFTA); both imports and exports rose dramatically, at a time when the Mexican economy grew at an average annual rate of only 2 percent. In fact, real GDP per capita did not grow at all.[24]

Table 3. U.S.-Mexico Trade Turnover and U.S. Exports To Mexico as a Percent of Mexican GDP, 1982 and 1994

	1982	1994
Trade Turnover/Mexican GDP	15.8	28.3
U.S. Exports/Mexican GDP	6.8	14.4

Source: IMF, *International Financial Statistics Yearbook*, 1995.

The ratios of total bilateral trade and U.S. exports to Mexico's GDP also provide a indication of trade openness. As seen in table 3, in 1982, U.S.-Mexican trade turnover (imports plus exports) was 15.8 percent of GDP and U.S. exports alone amounted to 6.8 percent of GDP. By 1994, these ratios rose to 28.3 and 14.4 percent respectively. Clearly, trade with the United States has become a more important factor in Mexico's economy. This growth in the level and importance of trade is what would be expected of freer trade policies and it is no coincidence that this growth occurred precisely at the same time that Mexican trade policy reforms were implemented.[25]

OPEN TRADE POLICY AND THE 1995 CRISIS

The economic crisis in 1995 differed from 1982 in some technical aspects, but Mexico faced the same fundamental problem: the inability to cover its international obligations. Political events, higher U.S. interest rates, speculative attacks on the peso, and Mexico's deteriorating economy eventually eroded investor confidence. By 1995 the large current account deficit became a liquidity crisis. Dollars fled north (held by both Mexicans and foreigners), foreign reserves dwindled, and Mexico was forced to devalue and then float its currency. As Mexico's largest trading partner, the United States saw its bilateral trade balance fall into a large deficit position. Mexican imports to the United States continued to climb as U.S. exports to Mexico fell. However, U.S. exports declined by only about 11 percent in 1995. As mentioned above this was a much

[24] In 1990 dollars, Mexico's per capita GDP was $3,090 in 1985 and only $3,041 in 1994. Inter-American Development Bank. *Economic and Social Progress in Latin America: 1995 Report*. Washington, D.C., The Johns Hopkins University Press, October 1995. p. 263.

[25] Exchange rate policy and capital flows, as discussed earlier, were contributing factors.

smaller decrease than experienced in 1982 (35 percent) and 1983 (25 percent) despite a much larger contraction in Mexico's economy.

The difference points to Mexico's more open trade policy, including acceding to NAFTA, which kept Mexico from raising barriers to U.S. trade in response to the crisis. Hence, the decline in exports represents the fall in demand that accompanied the deep recession and the effects of the peso devaluation, as would be expected. *What the decline does not reflect is a formal policy to restrict the flow of imports from the United States, which was in place in 1982, but absent in 1995.* NAFTA, for its part, helped solidify Mexican commitments to an open trade policy and actually cushion United States exports from more serious repercussions.

In fact, it has been argued that this is one of the more important achievements of NAFTA. Not only could Mexico not fall back on a protectionist trade regime, but it is committed to continuing liberalization of trade policies in agriculture, services, and other areas.[26] Although this is scant comfort to those who are concerned with the 1995 trade deficit with Mexico, a bilateral trade deficit is not a major economic problem for the United States and in any case, the deficit is smaller than it might have been under a less open trade regime. Additionally, under freer trade economists generally expect U.S. exports to Mexico to recover more quickly than they did from the 1982 crisis under a closed Mexican trade policy.

CONCLUSIONS AND OUTLOOK

Mexico remains a natural, and over the long run, growing market for U.S. goods, which will become more evident when the Mexican economy recovers and the long-term trend of trade and investment growth reemerges. This is a trend that has been evident for decades and one that is dependent on Mexico's economic stability and its willingness to maintain an open trade policy, an option for which NAFTA may serve as an insurance policy. The Mexican case supports the contention that trade liberalization, relative to a closed trade policy, supports growth in trade and provides greater stability during times of economic setbacks, other things being equal.

One problem is that other things are not always equal and it is these other things that often cause short-term disruptions to long-term trade trends. Mexico periodically experiences macroeconomic problems that are common among developing economies, and in 1994 Mexico repeated many mistakes made in 1982, except for trade policy. Its primary economic policies focus on resolving such basic problems as tempering runaway inflation, maintaining a stable exchange rate, managing current account balances, and attempting to achieve long-term savings rates necessary for development. Mexico, like most developing countries, looks abroad for resources to take up any slack in domestic savings. Given Mexico's tendencies toward exchange-rate and indebtedness problems,

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[26] Tornell and Esquivel, *The Political Economy of Mexico's Entry to NAFTA*, p. 27.

often induced by policy decisions, balance of payment or liquidity problems can arise periodically that eventually disrupt trade and investment flows. Importantly, these problems can exist under either an open or closed trade regime.

Although trade policy can encourage trade growth over the long run, it is only one economic policy tool and not the most influential in managing macroeconomic problems. In this case, trade agreements such as NAFTA are not the cause of Mexico's current recession. Additionally, long-run policy goals might consider the fact that Mexico's recovery and the continuation of U.S. export growth to Mexico would be complementary events.

Finally, it is worth reiterating the limitations of trade agreements. They are intended to reduce barriers to trade. They cannot guarantee any particular level of trade flows among countries, nor can they guarantee that all businesses will prosper. They do hold out the promise that business and trade success or failure will be less affected by deliberate policies to block imports, as was evident in Mexico in 1982, but not 1995. Despite the unhappiness voiced by many over NAFTA, moving back to a more closed trade posture with Mexico not only would risk losing broader gains from freer trade, but also would not guarantee the United States of being insulated from Mexican economic problems, as a comparison of the 1982 and 1994 crises demonstrates.

APPENDIX 1. U.S. MERCHANDISE TRADE WITH MEXICO, 1977-1995

($ millions)

Year	U.S. Exports	U.S. Imports	Trade Balance	Trade Turnover	% Growth in U.S. Exports	% Growth in U.S. Imports
1977	4,733	4,769	-36	9,502	-----	-----
1978	6,542	6,197	345	12,739	38.2	29.9
1979	9,667	8,983	684	18,650	47.8	45.0
1980	15,145	12,774	2,371	27,919	56.7	42.2
1981	17,789	14,013	3,776	31,802	17.5	9.7
1982	11,817	15,770	-3,953	27,587	-33.6	12.5
1983	9,082	16,776	-7,694	25,858	-23.1	6.4
1984	11,992	18,020	-6,028	30,012	32.0	7.4
1985	13,635	19,132	-5,497	32,767	13.7	6.2
1986	12,392	17,302	-4,910	29,694	-9.1	-9.6
1987	14,582	20,271	-5,689	34,853	17.7	17.2
1988	20,628	23,260	-2,632	43,888	41.5	14.7
1989	24,982	27,162	-2,180	52,144	21.1	16.8
1990	28,279	30,157	-1,878	58,436	13.2	11.0
1991	33,277	31,130	2,147	64,407	17.7	3.2
1992	40,592	35,211	5,381	75,803	22.0	13.1
1993	41,581	39,917	1,664	81,498	2.4	13.4
1994	50,844	49,494	1,350	100,338	22.3	24.0
1995	45,401	61,705	-16,304	107,106	-10.7	24.7

Source: U.S. Department of Commerce. Exports measured F.a.s; Imports measured on customs basis.
Note: Figures are in current dollars so growth rate calculations vary slightly from those adjusted for inflation in figures 2.

APPENDIX 2. TOP 25 U.S. IMPORTS FROM MEXICO
($ millions)

	1983	1986	1989	1992	1995
Total all commodities	16,776	17,302	27,186	35,184	61,705
78120--Motor vehicles, transport of persons, nes	13	433	1,175	2,591	5,821
33300--Crude oil from petroleum/bituminous minerals	7,521	3,262	4,014	4,362	5,417
77313--Ignition wirng sts, used in vehicls, etc	207	560	1,148	1,620	2,718
76110--Television receivers, color	183	222	853	1,281	2,493
93100--Special transactions & commod	283	500	1,020	1,166	2,072
78219--Motor vehicles for the transport of gds	7	151	119	442	1,772
71322--Recip pist engs, cyl cap exceedng 1000 cc	441	756	660	671	1,557
78439--Pts, access: tractor, mtr veh, spec purpse	127	248	565	896	1,053
76211--Radiobroadcast receivers com sound, extern power	76	270	531	543	1,010
78432--Brakes, servo-brakes, pts for motor vehicles	65	179	398	862	953
76493--Pts: tv rec, radiobroad rec, sound record	483	544	663	793	941
75997--Parts:auto data proc mach/opticalreaders	60	124	278	415	812
76431--Transmission apparatus, tv, radio etc	105	129	149	155	807
82119--Parts of seats nes	50	119	133	458	765
84140--Trousers, overalls, shorts etc, men/boys	22	96	168	267	650
75260--Input/output units: data processing sys	25	56	103	214	557
00119--Bov animals not pb breeding animals,live	139	282	284	341	546
71631--Electric motors exceeding 37.5 w, ac	55	106	207	299	529
87325--Speedometers, tachometers, stroboscopes	0	2	8	26	525
07111--Coffee, not roasted, not decaffeinated	251	540	434	224	508
77259--Electrcl app for switch or protect	11	14	176	212	490
98400--Est of low valued import transactions	131	86	213	320	425
87465--Regulating & controlling inst & appts nes	6	9	66	260	418
05440--Tomatoes, fresh or chilled	225	324	222	133	406
77641--Digital monolithic integrated units	50	106	133	133	385
Total of items shown	10,533	9,117	13,719	18,682	33,629
Total other	6,243	8,185	13,467	16,502	28,076

U.S. Department of Commerce. Tradenet. Imports reported customs value. SITC 5 digit level.

APPENDIX 3. TOP 25 U.S. EXPORTS TO MEXICO
($ millions)

	1983	1986	1989	1992	1995
Total all commodities	9,079	12,379	24,969	40,598	45,401
78439--Pts&access: tractor and motor vehicle	205	417	1,116	1,802	1,636
99400--Est. low value shp; canadian low value	69	178	676	1,375	1,625
78432--Brakes & pts for motor vehicles	87	189	611	1,542	1,389
75997--Parts: auto data proc mach & optical readers	142	263	392	447	740
89399--Articles of plastics	23	33	184	342	669
76493--Pts of tv rec, radiobroad rec, sound record	94	142	594	823	629
77611--Television picture tubes, color	0	10	103	247	570
77313--Ignition wirng sets, for vehicles, etc	114	333	490	660	560
77129--Pts of elec pwr machry (not rotating ele plnt)	25	49	238	374	547
33411--Gasoline incl aviation (except jet) fuel	11	0	93	573	516
77649--Elec integratd circts & microassemblies	26	43	40	37	507
77259--Electrcl app for switch or protect nes nt ex 1000	22	41	72	143	501
22220--Soybeans	239	179	309	450	485
77282--Pts of elec app for switchng, protectng elec circt	30	65	354	398	454
64211--Cartons, boxes & cases, corrugated paper or board	29	47	157	239	444
77220--Printed circuits	47	74	114	91	439
82119--Parts of seats nes	5	5	80	392	426
71322--Reciprocatng pist engs, cyl cap exceedng 1000 cc	1	7	1	348	418
77643--Nondigital monolithic integrated units	10	19	8	20	399
69969--Articles of iron or steel, n.e.s.	4	9	70	101	372
04490--Maize (not including sweet corn) unmilled, no seed	644	137	438	138	365
77867--Fixed capacitors, n.e.s.	14	8	9	66	342
71391--Parts, for use wt spk-ig int com eng	122	184	252	267	324
89319--Articles for conveyance/packing of goods nes, plst	9	23	92	179	315
75260--Input or output units for data processing systems	13	27	69	189	315
Total of items shown	1,984	2,484	6,559	11,241	14,986
Total other	7,095	9,895	18,410	29,357	30,415
Source: U.S. Department of Commerce. Tradenet. Exports reported F.a.s. SITC 5 digit level					

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