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NAFTA, Mexican Trade Policy, andU.S.-Mexico Trade: A LongerTerm Perspective

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Summary

The North American Free Trade Agreement (NAFTA) has been in place for over three years, and Congress continues to evaluate it as part of the trade policy process. "Free trade" is a contentious debate and has become even more complicated in the NAFTA context because of Mexico's 1995 economic crisis. Many critics consider the sudden shift from surplus to deficit in the U.S. trade balance with Mexico a clear indication of NAFTA's failure. Others see NAFTA as a positive force supporting U.S. exports. To sort out the effects of trade agreements, this report evaluates the U.S.-Mexico trade relationship over the past two decades to place recent events and NAFTA in a broader economic context.

Over time, U.S.-Mexico trade has grown and diversified as the two economies have become increasingly integrated. Yet, trade patterns have been volatile at times for many reasons, including economic downturns in Mexico. To understand the role of trade policy and agreements on trade flows, it is instructive to compare Mexico's 1982 and 1995 economic crises because in the first Mexico operated under a closed trade policy and in the second it had recently acceded to NAFTA as part of a long-term transition to an open trade policy. Both downturns had similar antecedents: an overvalued peso, a balance of payments crisis, large capital outflows, and a currency devaluation. Both were also severe, but the trade effects on the United States proved much worse in the first instance.

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 34% in 1982 and 23% in 1983. Yet, in 1995, Mexico's economy had contracted more severely than earlier, with GDP falling 6.2% compared to 0.6% and 4.3% in 1982 and 1983. A critical difference in the trade effects between the two periods was Mexico's change in trade policy, particularly adopting NAFTA, which kept Mexico from raising barriers to U.S. trade in response to the crisis.

The 1995 decline in U.S. exports to Mexico was due to the recession-induced fall in demand and the price effects of the peso devaluation. *What the decline does not reflect is a trade policy bent to restricting 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 a more serious fall. Further, the trade deficit with Mexico has not been a major economic problem for the United States as a whole given its global trading position. Finally, under freer trade conditions, economists generally have expected U.S. exports to Mexico to recover more quickly from the 1995 decline than they did from the 1982 crisis under a closed Mexican trade policy, which so far seems to be the case.

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The North American Free Trade Agreement (NAFTA) has been operating for over three years and Congress continues to evaluate its effects as part of the trade policy process. Many hold NAFTA responsible for the dramatic events that unfolded in 1994-95: the peso devaluation, Mexico's economic collapse, and shift from surplus to deficit in the U.S. balance of trade with Mexico. On the other hand, others cite NAFTA as a major factor in opening Mexican markets to U.S. goods, thereby contributing significantly to continued growth and prosperity of the U.S. economy. As is frequently the case in polarized debates, neither extreme is fully vindicated by economic theory or evidence.

In evaluating extreme changes in trade balances between two countries, it is important to understand the fundamental economic forces at work. In the case of the most recent U.S. trade deficit with Mexico, two major economic questions are frequently posed. First, what role did trade policy and particularly NAFTA play in causing the sudden shift in the U.S. trade balance with Mexico? Second, does a bilateral trade deficit with Mexico present a major economic problem for the United States?

This report considers trends in U.S.-Mexico merchandise trade over two decades to evaluate how NAFTA may have affected the economic situation in Mexico and U.S. trade. To gauge the effects of the agreement, it is instructive to revisit the "debt crisis" period of 1982-83, when Mexico had a closed trade policy, and contrast it with the repercussions of the 1994 peso devaluation, when Mexico operated under a more open trade policy. What shall be seen is that trade agreements can affect the long-term *level* of trade, but do not cause sharp fluctuations in the *balance* of trade, which are largely defined by domestic economic conditions and policies.[1] Finally, it is worth repeating that the benefits of freer trade are not measured in terms of annual trade balances, but by broader economic changes that unfold over longer periods of time.[2]

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[1] This report does not delve into employment issues. See: U.S. Library of Congress. Congressional Research Service. NAFTA: Economic Effects on the United States After Three Years. Report No. 97-612 E, by Arlene Wilson. June 13, 1997, NAFTA: Estimated U.S. Job "Gains" and "Losses" by State. Report No. 96-788 E, by (name redacted). September 25, 1996, and Weintraub, Sidney. NAFTA at Three: A Progress Report. Washington, D.C., Center for Strategic and International Studies, pp. 5 and 11-15.

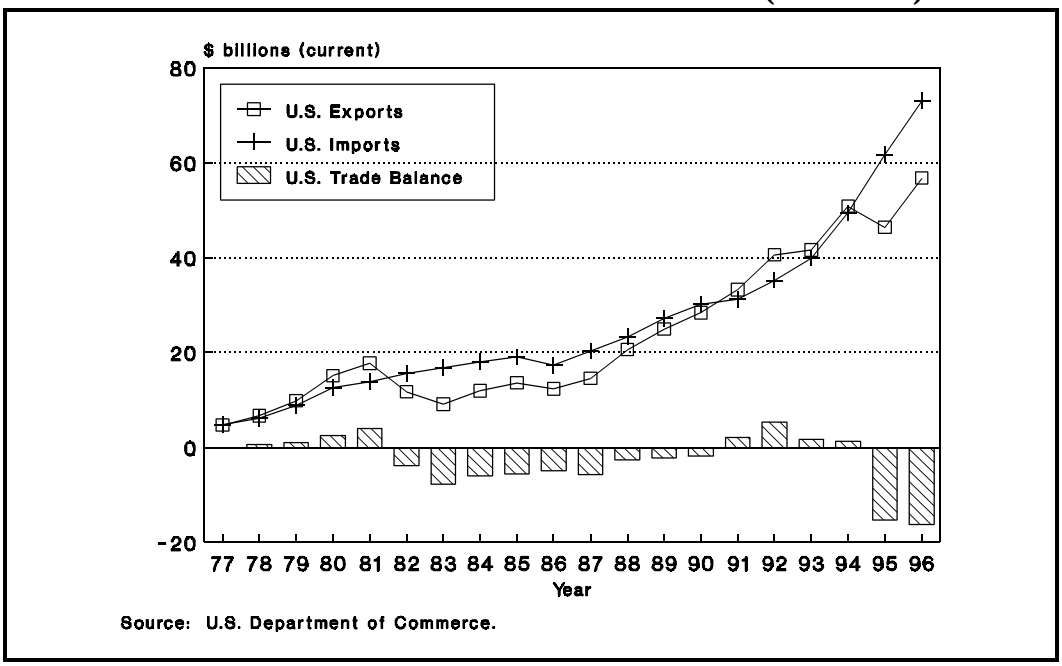
[2] For an economic discussion of the "gains from trade" see: U.S. Library of Congress. Congressional Research Service. Trade Policy in an Economic Perspective. Report No. 95-529 E, by (name redacted). March 9, 1995.

United States-Mexico Trade: 1977-1996

The United States and Mexico have had a long and sometimes stormy economic relationship, and so the movement toward freer trade with Mexico continues to raise concerns in the United States. Mexicans also have expressed reservations about being overwhelmed by the "economic colossus" to their north. Because trade occurs between a comparatively large and small economy, there is a disproportional aspect to the relationship that should be recognized.

The United States is by far Mexico's most important trading partner, accounting for approximately 83 percent of Mexico's exports and 77 percent of its imports in 1996. By contrast, Mexico is the United States' third largest trading partner, but accounted for only 9 percent of U.S. exports and imports in 1996.[3] This is an important distinction because despite ongoing interest in the level of U.S. exports to Mexico, the U.S. economy is not greatly affected overall by the economic fortunes of Mexico. To the contrary, because Mexico is dependent on the large U.S. economy as its primary export market, it is far more vulnerable to changes in U.S. economic trends.

FIGURE 1. U.S.-Mexico Merchandise Trade (1977-1996)



Despite this discrepancy in relative trade importance, bilateral trade for the most part expanded evenly, if not briskly at times, over the past two decades. Between 1977 and 1996, trade turnover (exports plus imports) between the United States and Mexico grew from $9.5 billion to $130 billion (see figure 1 and appendix 1.) The U.S. balance of trade shifted back and forth from surplus to deficit, reflecting changing economic fundamentals in both countries.

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[3] International Monetary Fund, Direction of Trade Statistics, June 1997. p. 135 and U.S. Department of Commerce trade data.

At least four 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, 1995-96 reflect Mexico's most recent recession and incipient recovery. Although U.S. exports to Mexico plunged in 1995, they actually grew faster than U.S. imports from Mexico in 1996 and the first half of 1997.

In addition to the shifting fortunes in U.S.-Mexico trade over the past two decades, the composition of trade between the two countries has changed rather dramatically, particularly for Mexican exports. In the early 1980s, Mexico was, above all else, an oil exporter, with oil accounting for nearly 60 percent of total export revenue (see table 1). Half of all oil exports went to the United States at that time. A major goal of Mexico's trade liberalization was to diversify production and exports away from such heavy dependence on oil. By 1996, although still an important sector, oil production had not increased much from 1984 levels and accounted for only 12 percent of total Mexican exports and 9 percent of exports to the United States (see appendix 2.)[4]

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

Export Type	1984	1987	1990	1993	1996
Agriculture, Livestock, and Fishing	5.0	5.5	5.3	4.8	3.8
Oil and Minerals	58.9	33.4	26.3	14.8	12.6
Manufactures	36.1	61.1	68.4	80.4	83.6

Source: Banco de Mexico. *The Mexican Economy 1997*. Table 47.

Interestingly, despite Mexico's once heavy dependence on oil exports to the United States, as it diversified its export base away from petroleum 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 83 percent by 1996. Some 84 percent of Mexico's exports are now manufactured goods, 70 percent of which end up in the United States.[5]

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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 Banco de Mexico, The Mexican Economy 1997, tables 13 and 47.

[5] Weintraub, ibid, pp. 73-75, Banco de Mexico, The Mexican Economy 1997, table 47, and Vargas, Lucinda. The Maquiladora Industry: Still Going Strong (Part 2). Business Frontier, (continued...)

Maquiladoras, through joint production operations, play an important role in this trade, with half of all Mexican manufacturing exports coming from these firms. Maquiladoras are domestic- or 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 imported inputs and capital goods related to maquiladora production even prior to NAFTA. The three largest maquiladora industry sectors are electric and electronics equipment, transportation equipment, and textiles/apparel.[6]

On Mexico's import side, between 70 and 80 percent tend to be intermediate goods, or goods that are further processed. Capital goods, used to manufacture other goods, account for approximately 15-25 percent of Mexico's imports, with consumer goods ranging from 5 percent during recessions to 15-20 percent during periods of economic growth.[7] The dominance of intermediate goods again points to the importance of the intra-industry 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 has been one of growth and diversification as the two economies have become increasingly integrated. Yet, trade has not always expanded in a smooth upward direction, and to discern NAFTA's possible role in Mexico's recent economic problems, it is essential to understand some of the factors that affect short-term fluctuations in trade including economic growth, exchange rate policy, and capital flows. Because events causing the collapse of the 1994 peso are reminiscent of those in 1982, and because Mexico was operating under different trade policies, the two periods are contrasted.

Macroeconomic Performance

Trade between two countries can fluctuate over the short-term as their 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,

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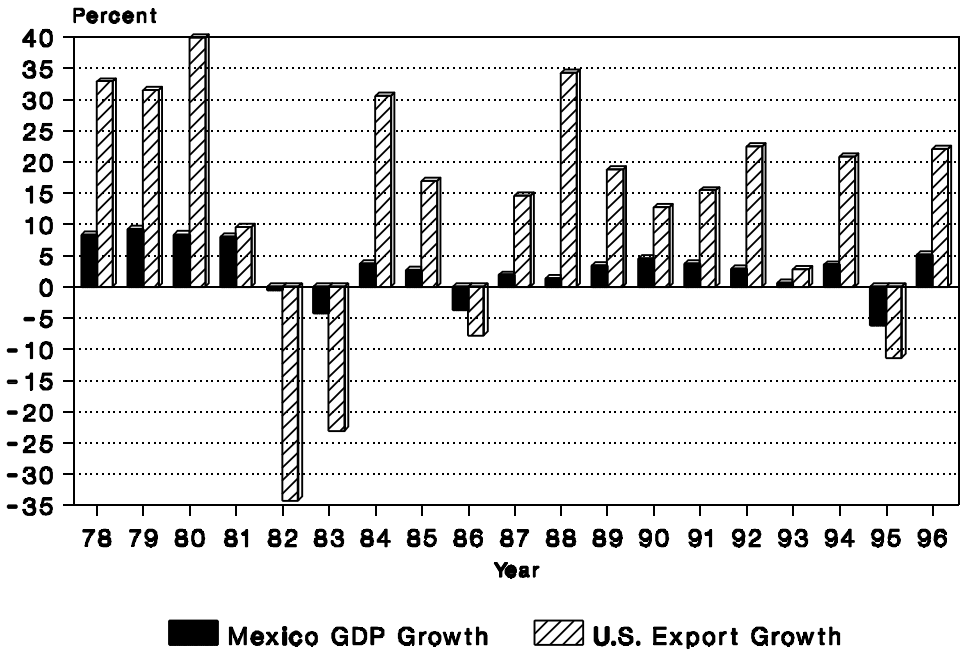
[5] (...continued)
Issue 4, 1996. Federal Reserve Bank of Dallas, El Paso Branch.

[6] Ibid.

[7] Banco de Mexico, The Mexican Economy 1997, table 47.

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 (1978-1996)



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 1996. Figure 2 shows the potential for volatility in annual bilateral 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 1996 recovery shows expected return to growth of U.S. exports to Mexico.

Sudden declines in U.S. exports to Mexico are clearly 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 34 and 23 percent for a total decline of approximately 50 percent. In the wake of the 1994 peso devaluation, Mexican GDP fell 6.2 percent in 1995 alone, the largest single year decline since the Great Depression and 50 percent more than in 1983. Yet, U.S. exports to Mexico fell only 11 percent in 1995 or about half of the decline witnessed in 1983. This suggests that in both cases the recession was an important factor affecting U.S.-Mexico trade, but 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 Rate Policy and Capital Flows

Exchange rate policy and capital flows can exert a major influence on 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 in 1994 when very large inflows of foreign capital caused the peso to become overvalued and Mexican economic policy did not make the necessary adjustments.[8]

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.

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) 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 tends to appreciate. As the real value of the peso appreciates, the "nominal value" becomes increasingly less credible, raising concerns about a possible devaluation.[9]

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[8] Because of the similarities between 1982 and 1994, emphasis is placed on the latter period. Prior to 1982, Mexico had a fixed exchange rate compared to a "crawling peg" used prior to the 1994 devaluation. For all practical purposes, the crawling peg became a fixed exchange rate by 1994 (if not earlier) so these technical differences did not affect the final outcome, which was devaluation in both cases.

[9] 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.

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 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.[10]

Capital flows into Mexico were also 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 adopted 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 generously. Capital investment began to trickle into Mexico in 1989, and as documented in table 2, rushed in thereafter until 1994.[11]

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

Invest Type	1989	1990	1991	1992	1993	1994	1995
Direct	2.8	2.6	4.7	4.4	4.4	11.0	7.0
Portfolio	0.3	-4.0	12.1	19.2	28.4	7.6	-10.8
Other	-2.0	9.9	8.3	3.4	1.0	-2.8	-7.9
Total	1.1	8.5	25.2	27.0	33.8	15.8	-11.7

Source: IMF, *International Financial Statistics*, August 1997, p. 474.
Other = currency and deposits, loans, and trade credits.

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. The real appreciation of the peso lowered the price of imports and raised the price of exports, so Mexico began to run large trade and current account deficits that matched the capital inflows. When circumstances change, capital flows can suddenly slow or reverse themselves, particularly portfolio capital (stocks and bonds),

[10] 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.

[11] 1994 was the turnaround year. The $7.6 billion in portfolio capital is deceptive because it reflects an inflow of capital at the beginning of the year followed by a large capital outflow the rest of the year.

which is highly liquid compared to direct foreign investment (plant and equipment). The sudden reversal of capital flows in 1994 presented serious problems for Mexico because it then had a large current account deficit, an overvalued exchange rate, and insufficient foreign exchange reserves to defend the exchange rate, which was under downward pressure from the massive capital outflows.[12]

In addition to exchange rate policy and capital flows, 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. Further political turmoil led to a final run on the peso in November 1994 as the fear of devaluation spread.[13]

Economic Policy

Although changing economic and political events (shocks) encouraged capital flight, it was Mexico's economic policy that doomed the peso to devaluation. Rising U.S. interest rates were responsible, in part, for the initial decline in capital inflows. Mexico would have had to tighten its monetary policy in like manner to continue to attract capital, but during an election year Mexico found it difficult to raise interest rates to maintain its relative competitiveness in the international capital market. In effect, it no longer subordinated domestic monetary and fiscal policy to the maintenance of a fixed exchange rate with the United States.[14] This decision was tantamount to allowing 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.

At this point, Mexico faced three unattractive options: (1) raise interest rates to match U.S. policy and continue to attract (or slow the retreat of) foreign capital; (2) devalue the peso; or (3) do nothing to buy time, but risk more severe financial difficulty in the future. Option one proved unacceptable because it risked almost a sure recession prior to a presidential election. Option two was apparently debated, but discarded because Mexico staked its economic reputation on defending the peso.[15] Option three unfolded by default.

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[12] 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.

[13] 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 (name redacted). September 27, 1995.

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

[15] Ibid, p. 241.

Investors, both foreign and domestic, actually realized the tenuous nature of the peso in 1994 and began abandoning it when given the opportunity to move toward a short-term, dollar-indexed investment instrument known as the *tesobono*.[16] 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 helped cause the peso's undoing. Under adverse conditions, Mexico could not continue to peg the peso to the dollar and follow a 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 unresolved debate over the proper Mexican response continues and the two main camps are: Mexico should have tightened fiscal and monetary policies to avoid devaluation, or it should have devalued the peso much earlier and accepted the consequences before they became so severe. In any event, as Mexico was forced to adjust to dwindling capital, its trade deficit had to correct, so exports rose and imports fell. Accordingly, the balance of trade with the United States went from a surplus to a deficit. The key points are that the seeds of this broad problem were planted years before NAFTA was contemplated and that the final collapse of the peso resulted more from domestic economic rather than trade policy reasons.[17] In fact, Mexico faced this problem in 1982 under a closed trade policy and again in 1994 under a more open trade policy.

Mexican Trade Policy

The preceding discussion points to many interconnected economic factors 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 in that they were preceded by an overvalued peso, balance of payments crisis, capital outflows, and a major devaluation, causing U.S. exports to fall.[18] 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), had no significant effect on the macroeconomic situation given other factors, but had a noticeable trade effect by keeping Mexico from imposing import restrictions on the United States as it did in 1982.

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[16] 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.

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

[18] U.S. Library of Congress. Congressional Research Service. Mexican Financial Crises, 1982 and 1995: Similarities and Differences. Report No. 95-239 E, by (name redacted). 6 p.

Closed Trade Policy and the 1982 Crisis

Prior to the 1982 crisis, 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.[19]

As the 1980s approached, Mexico's economy continued to grow based on heavy external borrowing backed by seemingly unlimited oil revenues, resulting in large current account deficits. The 1982 balance of payments crisis occurred because Mexico overborrowed and could not meet growing international debt service payments when world interest rates rose and oil prices plummeted. 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.[20]

To resume meeting its debt obligations, Mexico raised 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 experienced observer has pointed 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."[21] The result for the United States was a huge fall in exports to Mexico, as seen in figure 2.

Trade Reform in the 1980s

Despite the initial strengthening 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 also a logical step in this progression.[22]

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

[20] The details can be found in chapter 1 of Lustig, ibid.

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

[22] Lustig, Mexico: The Remaking of an Economy, p. 39. It should be noted that trade liberalization affected primarily manufactured goods; agriculture, services, and other

(continued...)

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 (5 percent under NAFTA). By 1987, these and other policy changes "transformed Mexico from an extremely closed economy into one of the most open ones in the world."[23] 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 its trade volume with the world is easily documented. From 1982 to 1996, Mexican exports grew from $24.1 to $96.0 billion or nearly 300 percent. Perhaps most telling is that oil, as a percent of total exports, fell from 77.6 to 12.6 percent. Over the same time period, Mexican imports rose over 400 percent from $17.0 to $89.5 billion.[24]

Because the United States is Mexico's most important trading partner, shifts in trade policy are particularly noticeable in the bilateral trade data. 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 had not grown at all.[25]

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[22] (...continued)
important areas are still protected and will be opened up under NAFTA.

[23] 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.

[24] International Monetary Fund. International Financial Statistics Yearbook 1996, p. 543 and Banco de Mexico, The Mexican Economy 1997, table 47.

[25] 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.

Table 3. U.S.-Mexico Trade Turnover and U.S. Exports To Mexico as a Percent of Mexican GDP, 1982-1996 (Selected Years)

	1982	1987	1992	1994	1996
Trade Turnover/Mexican GDP	15.7	25.3	22.7	26.8	44.7
U.S. Exports/Mexican GDP	6.7	10.6	12.2	13.6	19.6

Source: IMF, *International Financial Statistics Yearbook*, 1996 and U.S. Department of Commerce. TPIS.

Data in table 3 also show the growing importance of U.S. trade to Mexico's economy. In 1982, total trade between the United States and Mexico, or trade turnover (imports plus exports), equaled 15.7 percent of Mexico's GDP and U.S. exports to Mexico alone amounted to 6.7 percent of its GDP. By 1994, these ratios rose to 26.8 and 13.6 percent, respectively. Clearly, trade with the United States has become a more important part of 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.[26] (The large jump in these ratios for 1996 reflect these same trends, but also the effect of the 1995 recession on GDP, which served to lower the ratio's denominator.)

Open Trade Policy and the 1995 Crisis

The details of the economic crisis in 1995 differed from 1982 in some respects, but Mexico faced the same fundamental problem: the inability to cover its international obligations. By 1995 the large trade and current account deficits had to be corrected and as Mexico's largest trading partner, the United States saw its bilateral trade balance reverse to 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 smaller decrease than experienced in 1982 (34 percent) and 1983 (23 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 tariff increases ranging from 20 to 35 percent that Mexico imposed on many goods from countries with which it had no equivalent

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

agreement. The U.S. trade deficit therefore, was smaller than it might have been under a less open trade regime.[27]

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.[28] Although this is scant comfort to those who are concerned with a trade deficit with Mexico, a bilateral deficit is not a major economic problem for the United States given its broad global trade relationships.[29] Additionally, under freer trade conditions economists generally expected U.S. exports to Mexico to recover more quickly than they did from the 1982 crisis under a closed Mexican trade policy, which figure 1 and appendix 1 suggest has so far been the case.

Conclusions and Outlook

Mexico remains a natural, and over the long run, growing market for U.S. goods, which will become more evident as the Mexican economy recovers and the long-term trend of trade and investment growth reemerges, as it appears to be doing. 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 (economic and political shocks) 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, often exacerbated by policy decisions, balance of payment or liquidity problems can arise periodically that eventually disrupt trade and investment flows. Importantly, these problems can arise under either an open or closed trade regime.

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[27] United States Trade Representative. 1996 Foreign Trade Barriers. Washington, D.C. p. 239.

[28] 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. p. 27.

[29] For a discussion of the significance of the entire U.S. trade deficit, see: U.S. Library of Congress. Congressional Research Service. U.S. Trade Performance: Recent Trends and Policy Options. Report No. 97-487 E, by (name redacted). April 24, 1997.

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, a trade agreement such as NAFTA was not the cause of Mexico's 1995 recession, but it was able to reduce, although not eliminate, the recession's negative trade effects on the United States. Only with Mexico's recovery, which depends more on Mexico than a trade agreement, will U.S. export growth continue its upward climb.

Finally, it is worth reiterating the limitations of trade agreements. They are intended to reduce barriers to trade and encourage growth in trade between countries. This has occurred with Mexico and the United States. Trade agreements, however, cannot guarantee any particular balance of trade between 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 doubts 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, 1977-1997

($ 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	6,678	6,100	578	12,778	41.1	27.9
1979	9,843	8,829	1,014	18,672	47.4	44.7
1980	15,141	12,573	2,568	27,714	53.8	42.4
1981	17,780	13,799	3,981	31,579	17.4	9.8
1982	11,739	15,566	-3,827	27,305	-34.0	12.8
1983	9,079	16,776	-7,697	25,855	-22.7	7.8
1984	11,978	18,020	-6,042	29,998	31.9	7.4
1985	13,628	19,132	-5,504	32,760	13.8	6.2
1986	12,379	17,302	-4,923	29,681	-9.2	-9.6
1987	14,570	20,271	-5,701	34,841	17.7	17.2
1988	20,633	23,277	-2,644	43,910	41.6	14.8
1989	24,969	27,186	-2,217	52,155	21.0	16.8
1990	28,375	30,172	-1,797	58,547	13.6	11.0
1991	33,276	31,194	2,082	64,470	17.3	3.4
1992	40,597	35,184	5,413	75,781	22.0	12.8
1993	41,635	39,930	1,705	81,565	2.6	13.5
1994	50,840	49,493	1,347	100,333	22.1	23.9
1995	46,401	61,705	-15,304	108,106	-8.7	24.7
1996	56,761	72,963	-16,202	129,724	22.3	18.2
1997(P)	65,430	81,846	-16,416	147,276	15.3	12.2

P = preliminary numbers annualized from 1997 mid-year (six month) trade data.
Note: Figures are in current dollars so growth rate calculations vary some from those adjusted for inflation in figure 2.
Source: U.S. Department of Commerce. TPIS. Exports measured F.a.s; Imports measured on customs basis.

Appendix 2. Top 25 U.S. Imports From Mexico

($ millions)

	1984	1987	1990	1993	1996
Total all commodities	18,020	20,271	30,172	39,930	72,963
78120–Motor vehicles/transport of persons, nes	34	1,176	2,164	3,084	7,902
33300–Crude oil petroleum/bituminous minerals	6,700	3,520	4,822	4,245	6,356
78219–Motor vehicles/transport of goods, n.e.s.	59	90	229	543	3,052
77313–Ignition wirng sts, etc, used in vehicls	312	731	1,216	1,878	3,014
76110–Television receivers, color	179	338	916	1,589	2,749
93100–Special transactions & commod not classif by kind	326	622	1,008	1,335	2,241
71322–Reciprocatng pist engs, cyl cap exceedng 1000 cc	533	823	543	749	1,626
75230–Digital processng units	0	68	151	54	1,263
78439–Pts & access of tractor, mtr veh, spec purpse, nes	212	317	582	957	1,187
78432–Oth pts & access of motor veh bodies (includ cabs)	93	226	507	1,155	1,143
76431–Transmission apparatus, tv, radio etc.	117	152	199	183	1,095
76211–Radiobroadcast receivers com sound, extern power	137	437	520	601	1,079
82119–Parts of seats nes	70	137	115	532	938
75997–Parts of auto data proc mach & optical readers etc	93	86	265	485	924
76493–Pts of tv rec, radiobroad rec, sound record	486	487	672	806	844
84140–Trousers, overalls, shorts etc, men/boys, not knit	45	120	154	335	833
71631–Electric motors exceeding 37.5 w, ac	73	131	209	355	612
75260–Input or output units for data processing systems	39	99	120	209	604
05440–Tomatoes, fresh or chilled	169	159	371	304	580
84260–Trousers etc, women/girls, textile fab, not knit	41	35	88	162	507
98400–Estimate of low valued import transactions	139	127	292	359	498

	1984	1987	1990	1993	1996
84540–T-shirts, singlets & oth vests, knit or chrochet	3	7	6	65	495
77121–Static converters (e.g., rectifiers)	116	177	130	160	480
74159–Parts for air conditioning machines of hd 741.5	14	55	60	133	479
77315–Elec conductrs, exc 80 v nt exc 1000 v	15	187	325	269	476
Total of Items Shown	10,005	10,307	15,664	20,547	40,977
Total Other	8,015	9,964	14,508	19,383	31,986

Source: U.S. Department of Commerce. TPIS. Imports reported customs value SITC 5 digit level.

Appendix 3. Top 25 U.S. Exports To Mexico

($ millions)

	1984	1987	1990	1993	1996
Total all commodities	11,978	14,570	28,375	41,635	56,761
78439–Pts & access of tractor, mtr veh, spec purpse	356	511	1,812	1,779	2,343
99400–Est. low val shp; can low value & n.i.k. (exports)	97	339	1,110	1,412	1,952
78432–Oth pts & access of motor veh bodies (includ cabs)	152	231	807	1,574	1,188
04490–Maize (not including sweet corn) unmilled, no seed	402	275	402	43	1,014
75997–Parts of auto data proc mach & optical readers etc	255	340	403	656	933
77611–Television picture tubes, color	0	16	142	360	927
89399–Articles of plastics nes	27	38	214	399	891
78120–Motor vehicles for the transport of persons	5	11	183	122	865
22220–Soybeans	485	220	211	421	859
77282–Pts of elec app for switchng, protectng elec circt	59	66	349	372	703
77313–Ignition wirng sts, etc, knd used in vehicls	179	401	374	815	701
75230–Digital processng units	21	24	99	189	628
77643–Nondigital monolithic integrated units	17	20	12	17	576
77259–Electrcl app for switch/protect nes nt ex 1000	41	43	83	182	545
77220–Printed circuits	66	84	103	102	541
69969–Articles of iron or steel, n.e.s.	5	13	88	132	539
33411–Gasoline including aviation (except jet) fuel	2	33	197	457	530
77645–Hybrid integrated circuits	13	20	117	167	503
69421–Screws, bolts, nuts, threaded, iron or steel	13	23	63	130	476
64211–Cartons, boxes, cases, corrugated paper/board	44	60	170	271	476
77129–Pts of elec pwr machry (oth rotating ele plnt)	37	68	305	437	446
82119–Parts of seats nes	13	6	181	458	443
77641–Digital monolithic integrated units	81	103	123	212	419

	1984	1987	1990	1993	1996
71391–Parts, n.e.s. suitbl for spk-ig int com eng	207	151	199	242	405
76493–Pts of tv rec, radiobroad rec, sound record	133	170	623	750	401
Total of Items Shown	2,710	3,266	8,370	11,699	19,304
Total Other	9,268	11,304	20,005	29,936	37,457

Source: U.S. Department of Commerce. TPIS. Exports reported F.a.s. SITC 5 digit level