NAFTA and the Mexican Economy 1994-2005

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Introduction[1]

In the early 1980s, in the aftermath of the most dramatic balance of payments crisis that Mexico had faced in decades, President De la Madrid started a structural reform to shift the economy away from its traditional state-led development growth path and protectionist trade strategy. Important elements of this reform were the deregulation/privatization of public enterprises and the opening of Mexico's domestic market to foreign competition.

In 1984 the government began to remove a number of tariff and non-tariff restrictions on imports. In 1986 a crucial step in this direction was taken by Mexico's becoming a full member of the General Agreement on Tariffs and Trade (GATT) and initiating a gradual elimination of some restrictions to foreign investment particularly in capital- or technology-intensive industries. By 1988 the coverage of import licenses as well as the average tariff rate had been sharply reduced. And official prices on imported goods had been totally cancelled. President Salinas's administration

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TABLE 1
SELECTED INDICATORS OF MEXICAN EXPORTS
TO THE OECD: 1985-2001

	1985	1990	1994	2001
Mexico's Market Share Of OECD Imports	1.78	1.52	2.03	3.62
Natural resources	3.08	2.10	1.98	2.65
Agriculture	1.30	1.28	1.37	2.09
Energy	4.60	3.26	2.99	3.29
Textiles, fibers, minerals and metal	1.89	1.48	1.57	1.49
Manufactures	1.10	1.29	2.02	3.85
Based on natural resources	1.23	0.96	1.03	1.26
Not based on natural resources	1.10	1.33	2.10	4.03
Others	1.61	2.54	2.70	4.12
Structure of Exports	100	100	100	100
Natural resources	58.6	33.6	21.4	14.7
Agriculture	9.7	10.3	8.2	5.1
Energy	45.9	21.0	11.8	9.1
Textiles, fibers, minerals and metal	3.0	2.3	1.4	0.5
Manufactures	39.1	62.5	74.9	81.4
Based on natural resources	3.4	3.4	2.5	1.5
Not based on natural resources	35.0	57.6	70.7	78.1
Others	2.3	3.9	3.7	3.9

Source: Authors' table using data from Comisión Económica para América Latina (CEPAL), *Competitiveness Analyzed of Nations* (CAN) *2003*.

(1988-1994) accelerated the economy's structural reforms. In 1989 a new regulatory framework on foreign investment was approved to eliminate restrictions to foreign capital participation in about 75 percent of all branches of economic activities. In December 1993, a new Law of Foreign Investment was enacted, simplifying administrative procedures and eliminating all restrictions on foreign direct investment (FDI) in manufacturing except in the production of explosives and basic petrochemicals.[2]

NAFTA negotiations started in 1990, and by then Mexico was already one of the world's most open developing economies. The tri-lateral agreement was signed two years later by Mexico, the United States and Canada and went into effect January 1, 1994 with the commitment to eliminate tariff and non-tariff barriers

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to most intra-regional trade and to ease restrictions on foreign investment over the next 10 years. NAFTA's importance was to formally institutionalize Mexico's trade liberalization strategy in an agreement with the United States, its key trading partner and the main player on the global trade scene.[3]

Exports Boom: From Oil Products To Manufacturing and *Maquiladoras*

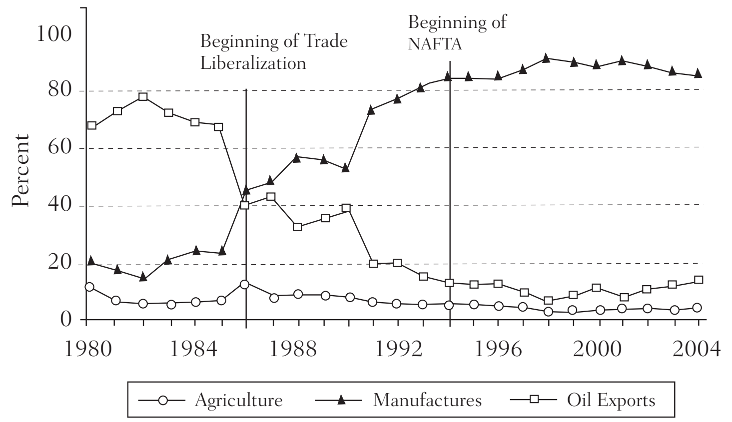
Mexico's trade liberalization, crowned by NAFTA, has been accompanied by a radical shift in its insertion in global markets, making it a dynamic player in non-oil exports. Though not always recognized, Mexico's export drive started nearly 10 years before NAFTA was put in place. In any case, 1994 is a turning point, as the launch of NAFTA opened an unprecedented window of opportunity to export to the United States, the world's largest market. A few years later, exports had increased approximately 20 percentage points as a proportion of Mexico's gross domestic product (GDP), reaching 30 percent.[4] Their dynamism repositioned Mexico in world trade. Having started in the early 1980s as a fundamentally oil-exporting economy, 20 years later more than 80 percent of its total exports were manufactures. The fast growth in exports of manufactured goods more than compensated for the decline in foreign sales of oil and agricultural commodities. As shown in Graph 1, a key element behind this dynamic performance was the in-bond industries called *maquiladoras*.

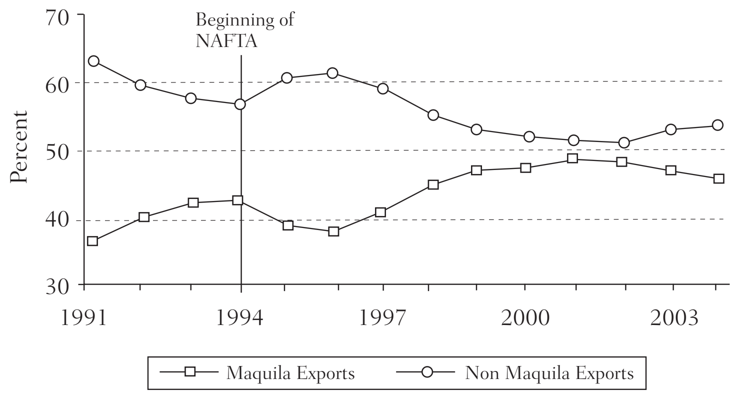
Indeed, it has become a standard fact of the Mexican economy that *maquiladoras* are responsible for about half of its manufacturing exports. The dynamic response of Mexico's manufacturing exports was helped by NAFTA but it was stimulated by a considerable real depreciation of the exchange rate of the peso *vis-à-vis* the U.S. dollar in 1995. In addition, as the Mexican economy plunged into a recession that year (real GDP decreased 6 percent), local firms were pressed to seek external markets in order to compensate for the collapse of the domestic market.

The preferential access granted by NAFTA led to a large increase in Mexico's exports, among them in garment, topping for many years other international competitors in the U.S. market. Key promoters of the overall boost in exports were the various foreign firms that already had a strong presence in Mexico (including *maquiladoras*). The arrival of foreign investment to selected sectors motivated by the opportunity or need to use Mexico as an export platform to the United States also helped. The export drive has been accompanied, within strict limits, by greater technological sophistication of Mexican products sold abroad. Traditionally they were mainly primary commodities. By the late 1970s, crude oil was the dominant export item. Today, as in the last 15 years, most of Mexico's sales abroad consist of manufactures.

Table 1 presents the structure of Mexican exports and their share in the OECD's total imports from 1985 to 2001, classifying them in three groups: 1) exports directly based on natural resources; 2) manufactures; and 3) other exports. In turn, manufactured goods are classified into two groups: those that are essentially the result of simple processing of natural resources and the rest. A key point to notice is that Mexico's penetration of the OECD market more than doubled during 1985-2001. Equally impressive is the considerable rise in the share

GRAPH 1
COMPOSITION OF MEXICAN EXPORTS, 1980-2004





Source: Authors' graphs using data from INEGI, 2005.

of Mexico's manufactures in OECD imports (from 1.1 percent to 3.8 percent). In this respect, note, too, the particularly rapid expansion of exports of manufactures *not based* on natural resources. Indeed, while in 1985 they represented 35 percent of Mexico's total exports, by 1994 their share had risen to 71 percent, and in 2001 they stood at 78 percent. Exports of natural-resource-based goods experienced a mild retraction in the OECD market, and saw their proportion of total Mexican exports collapse from 58.6 percent in 1985 to 14.7 percent in 2001.

However, the export-driven growth was not felt in all productive activities in Mexico. Indeed, since 1994, though some sectors gained an increased presence in international markets, others retreated. The impact at the micro-level of the firm is very unevenly distributed. According to some authors, the bulk of Mexico's non-oil exports comes from no more than 300 businesses, most of them linked to multinational corporations.[5]

The impressive performance of Mexican exports since NAFTA has been favorably reflected in the country's trade balance with its major

Table 2
Trade balance of mexico, 1994-2003
(billions of U.S. dollars)

	NAFTA TRADE			BALANCE OF *MAQUILADORAS*	NAFTA BALANCE WITHOUT *MAQUILA*	BALANCE WITH THE REST OF THE WORLD	TRADE BALANCE
	EXPORTS	IMPORTS	BALANCE				
1994	53.4	58.6	-5.2	5.8	-11.0	-13.3	-18.5
1995	68.5	55.4	13.1	4.9	8.2	-6.0	7.1
1996	82.8	69.4	13.5	6.4	7.1	-6.9	6.5
1997	96.6	84.1	12.5	8.8	3.6	-11.8	0.6
1998	104.8	95.7	9.1	10.5	-1.4	-17.0	-7.9
1999	123	108.5	14.5	13.4	1.0	-20.1	-5.6
2000	151.2	131.8	19.4	17.7	1.7	-27.4	-8.0
2001	143.6	118.3	25.3	19.3	6.0	-35.2	-9.9
2002	146.1	111.4	34.7	18.8	15.9	-42.6	-7.9
2003	149.8	110.2	39.7	18.3	21.4	-45.3	-5.6

Source: Authors' table using data from *Estadísticas de Comercio Exterior*, INEGI, 2005.

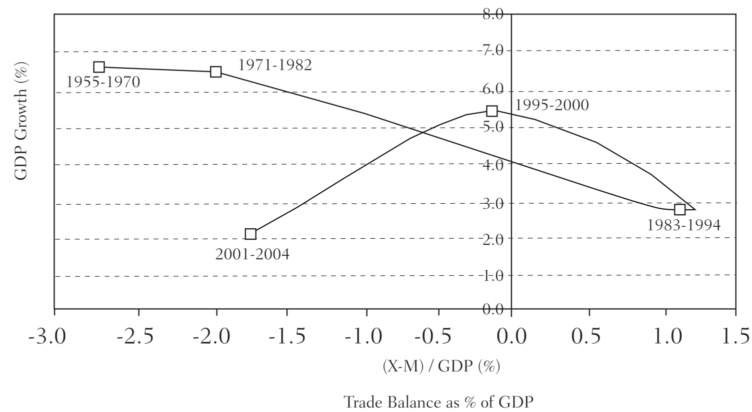
partner, the United States. Indeed, since 1995, Mexico has run trade surpluses with the U.S., but not with Canada. However, this surplus has been more than offset by its mounting trade deficit with the rest of the world. Indeed, except for periods of severe recession, Mexico has systematically registered trade deficits (see table 2).

The other favorable development in Mexico's economic performance, frequently associated with trade liberalization and NAFTA, is the vast inflow of foreign direct investment it has received. FDI, measured as a percentage of Mexico's GDP registered impressive growth since the early 1990s. By 2004, the majority of businesses in Mexico that had foreign capital were of U.S. origin.

Imports, Trade Balance And Long–term Economic Growth

To complete this —so far— favorable assessment of Mexico's trade and FDI performance after NAFTA, we must examine the evolution of its imports and its rate of economic expansion. After all, a key goal of NAFTA and the overall macroeconomic reform strategy was to put Mexico on a path of high and persistent growth. Parallel to the export and FDI boom that Mexico experienced, in the last 15 years trade liberalization has been accompanied by a massive penetration of imports. Given the decades of trade protection marked by high tariffs and strict controls on imports, the elimination of these trade barriers was bound to

GRAPH 2
TRADE BALANCE AND REAL GDP GROWTH IN MEXICO, 1980-2004



Source: Autors' graph using data from INEGI.

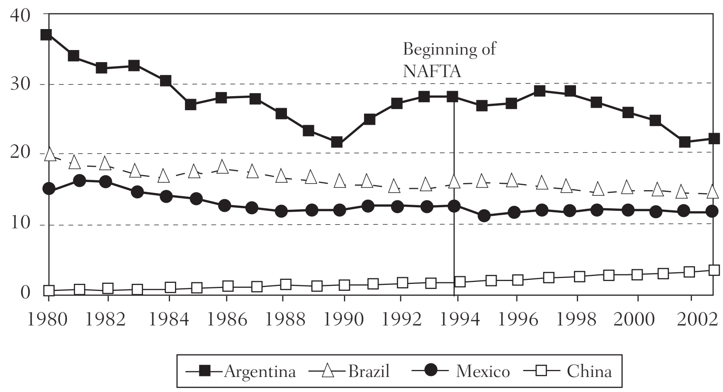
provoke an intense but in principle temporary flood of imports. It was assumed that, once Mexican consumers got adjusted to the new "menu" made available by trade liberalization that included the —until then— inaccessible foreign goods, purchases of imported goods would lose momentum. However, such a slowdown has not happened.

The first stages of this trade liberalization implemented in the late 1980s triggered an explosive increase of imports, expanding at annual rates over and above 30 percent. As a share of GDP, they climbed from 10 percent in 1982 to more than 30 percent by the mid-1990s.

The swift pace of Mexican imports since the second half of the 1980s was induced not only by the elimination of non-tariff barriers to foreign trade, but also by the expansion of domestic demand in a context of a persistent appreciation of the real exchange rate. The resumption of a facilitated access to external funds also played a role. Mexican consumers began to eagerly satisfy their pent-up demand for a wide variety of foreign goods and brands, after decades of a tightly restricted access to them. But, this import demand also mirrors to some extent the increasingly strong relationship that an important part of the exporting sector has with foreign suppliers. *Maquiladoras*, the most successful export sector, rely fundamentally on imported inputs and materials, with scant relations to local suppliers. Another factor that boosted import penetration of the domestic market, and that cannot be ruled out *a priori*, is the likely breakdown of some internal linkages in Mexico's domestic productive structure, as local producers have been put out of business by foreign competition.

Such a persistent and rapid increase in imports would sooner or later put enormous pressure on the economy's exports and other sources of foreign exchange. In fact, to keep the trade deficit from excessively increasing as a proportion of income, Mexican exports would have to expand at rates of at least 15 percent a year. Such dynamic behavior is not easy to sustain. During their most prominent and recent boom, 1988-1999, they expanded at an average annual rate of 10 percent, but imports expanded even faster (14 percent).

GRAPH 3
MEXICO AND OTHER COUNTRIES: REAL GDP PER CAPITA
(RELATIVE TO THE U.S.)
(U.S. GDP per capita = 100, measured in constant 1995 U.S. dollars)



Source: Autors' graph using data from World Bank, *World Development Indicators,* www. worldbank.org

Remarkably, and contrary to prior expectations, the dynamism of imports has barely subsided. The most recent data from January 2005 reports an annualized increase of 18 percent in Mexico's imports, while its real GDP expanded 4.4 percent.

If imports remain at these high levels, the external sector will continue to be a major obstacle in Mexico's struggle to enter a path of high economic growth and get away from recurrent balance of payments crises.

Graph 2 illustrates how trade liberalization and the process of macroeconomic reforms have not yet been able to put Mexico on a path of strong export-led growth. It shows that the relation between trade performance and economic growth has been deteriorating. Indeed, during the periods of 1955-1970 and 1971-1982, its real GDP expanded at an average annual rate of over 6 percent and registered a trade deficit of 2.7 percent and 1.9 percent of GDP, respectively. The international debt crisis and the collapse of the oil boom forced an economic slowdown in the 1980s concomitant with a trade surplus of 1 percent of GDP. The first five years after NAFTA saw real GDP expand at a 5-percent annual average rate. This recovery was short-lived.

The renewed appreciation of the peso eventually slowed down the export boom, and the recession of the U.S. economy starting in 2001 put an end to the dynamism of this short period of export-led growth. In 2001-2003, the Mexican economy barely grew (an average of 2 percent annually) and registered a trade deficit once again of 1.5 percent to 2 percent of GDP. Such slow expansion, most alarmingly, implied that per capita income fell for three years in a row. In 2004, GDP rose 4.4 percent, better than its performance in the recent past but still way below the rates of expansion that it had experienced before the 1980s and that it needs in order to absorb the vast number of people entering its labor market. In other words, with relatively similar amounts of foreign resources as a proportion of GDP as it received in the four decades before the oil collapse, the Mexican economy is now able to grow on average at only one-third of the annual rates it experienced between 1950 and 1980, before macroeconomic reforms were put in place.

Given the decades of trade protection marked by high tariffs and strict controls on imports, the elimination of trade barriers was bound to provoke an intense but in principle temporary flood of imports.

Put another way, trade and financial liberalization did result in rapid growth of exports and, though not sustained, of FDI. But Mexico's economic growth performance has been disappointing. In fact, instead of closing the gap of its real GDP per capita *vis-à-vis* the United States, it has widened it. As graph 3 shows, in the late 1980s Mexico managed to begin to moderately reduce this gap. However, the economic crisis suffered in 1995 widened it once more. And since then it has remained with minor changes. Its gap with the U.S. is currently at a level comparable to what it was in the 1950s!

Thus, and contrary to the expectations raised by NAFTA, Mexico has yet to see any significant convergence in its average income in real terms with its main regional trade partners. Blecker, examining not only GDP but also alternative measures of income concludes, "There is no evidence of any catch-up in average Mexican living standards to U.S. or Canadian levels under NAFTA."[6]

Sustaining high long-term economic growth should be a top priority on the national agenda. The Mexican economy needs to expand at least at average annual rates of 5-6 percent in real terms just to create the jobs required to absorb the 2.5 percent annual increase in its work force. Its economic expansion needs to be even stronger in order to significantly improve the living standards of the more than 13 million Mexicans who live in extreme poverty.

Conclusions and Perspectives

It is true that NAFTA, as part of the package of economic reforms implemented in Mexico, helped to produce an export boom of manufactures, an inflow of much needed foreign investment and, with it, some technology transfers. However, these positive phenomena had a limited impact on the domestic economy and did not really alleviate the fundamental constraints on Mexico's long-term economic growth. Some of them have actually become more binding. NAFTA's positive impact may have by now reached a point of exhaustion. It should be revamped. It was not the success expected either in terms of economic growth or of job creation. The direct impact of exports on domestic output was not strong enough due in part to its reliance on *maquiladoras* and in part to the breakup of backward linkages brought about by the massive inflow of imported inputs, many of them required for export production. NAFTA's future extension should, sooner or later, include the legal intraregional mobility of labor, as well as the implementation of a common external tariff. Ideally, and inspired in the European Union model, it should include the creation of a special fund to help promote and complement investment to restructure and develop the least advanced regions in each of the three countries. In this sense, and regardless of whether a new economic/labor agreement is reached sooner or later in North America, thus extending NAFTA, it should be recognized that Mexico is at a crossroads. It can no longer base its international competitiveness on low wages. But, at the same time, it has not yet proved itself able to successfully enter international markets based on knowledge-intensive, high value-added processes and products. If Mexico is to succeed in its so far unsuccessful quest to achieve high, sustained economic growth, there is an urgent need to rethink key elements of its overall development strategy. In particular, this may require new policies to promote innovation and technological development as well as a new wave of public investment to modernize and broaden infrastructure. It is also necessary and urgent to implement a policy to create jobs in the formal sector of the economy, in particular by providing income support and training to upgrade workers' skills and help them relocate to more qualified jobs in activities that are able to successfully compete with imports or in international markets. Without a fiscal reform these initiatives are simply not feasible. VM

NOTES

[1] The opinions expressed here are the exclusive responsibility of the authors and may not necessarily coincide with those of the United Nations or of Flacso. A longer version of this paper written with Juan Carlos Rivas will be published shortly in the *North Carolina Journal of International Law and Commercial Regulation*, School of Law, University of North Carolina at Chapel Hill.

[2] J.C. Moreno-Brid, "Mexico's Economic Growth and the Balance of Payments Constraint: A Cointegration Analysis," *International Review of Applied Economics*, 13 (2), 1999, pp. 149-159.

[3] P. Pacheco-López and A.P. Thirlwall, "Trade Liberalisation in Mexico: Rhetoric and Reality," *Banca Nazionale del Lavoro Quarterly Review* no. 229 (June), 2004, pp. 141-167. After NAFTA, Mexico signed many more trade agreements *inter alia* with the European Union, Japan and various Latin American countries.

[4] An important part of this change is explained by an increase in Mexico's exchange rate during the 1994-1995 crisis. Exports as a percentage of GDP measured in constant 1993 pesos showed an increase from 17 percent to 24 percent during 1994-1995.

[5] J. Mattar, J.C. Moreno-Brid and W. Peres, "Foreign Investment in Mexico after Economic Reform," K.J. Middlebrook and E. Zepeda, eds., *Confronting Development: Assessing Mexico's Economic and Social Policy Challenges* (Stanford, California: Stanford University Press, 2003); and E. Dussel, "La inversión extranjera en México," ECLAC Productive Development Series 80 (2000), pp. 1-100.

[6] R. Blecker, "The North American Economies after NAFTA: A Critical Appraisal," *International Journal of Political Economy*, forthcoming.