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A NEW PARADIGM OF THE POLITICAL ECONOMY: CORPORATE FOREIGN DIRECT INVESTMENT STRATEGIES UNDER NAFTA

by

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Abstract

This paper examines the role played by foreign direct investment (FDI) in economic development and trade strategies following the North American Free Trade Agreement (NAFTA). The process of global competition parallels the process of domestic competition. In the context of world economy, foreign direct investment is a part of the competition between producers within and across industries. A theoretical attempt is made to explain the behavior of multinational corporations(MNCs) with respect to their investment strategies and impact of FDI in a liberalized North American market.

FOREIGN DIRECT INVESTMENT UNDER NAFTA

INTRODUCTION

Bringing Mexico into partnership, the 1993 North American Free Trade Agreement (NAFTA) furthers the effort of the prior Canada-U.S. Free Trade Agreement (FTA) in liberalizing trade in North America. Without a doubt, by creating a single North American market of 377 million consumers with more than $7.5 trillion in goods and services, NAFTA facilitates the free flow of trade in goods and investment capital throughout North America. Moreover, the three economies are already closely linked by an extensive network of trade and investment. Both Canada and Mexico host substantial U.S. investment, while the United States benefits from sizable Canadian direct investment.

Trade liberalization is by no means the only characteristic of NAFTA. Such NAFTA provisions as rules of origin and national treatment are trade protectionist measures discriminating against nations outside the NAFTA trading bloc. Proactive actors in the global economies, the U.S. and Canadian multinational corporations must carefully redesign the outlays of investment in different areas under NAFTA and continuously lobby for trade liberalization in North America and/or protection against non-NAFTA countries when necessary. Direct investment as opposed to portfolio investment is a unique form of international capital flow in that it can take a number of different forms including equity joint ventures, cooperative joint ventures and wholly foreign- owned enterprises. Multinationals are facilitating institutions which are able to capitalize on changes in exogenous variables so as to organize world production to optimally exploit comparative advantage. Most direct investment passes between industrial countries. However, multinationals tend to go first to countries most familiar and nearby: U.S. firms go to Canada, Canada to U.S., German firms to European neighbors. They tend to locate in large countries because establishing a manufacturing plant or a distribution network always involves multi-plant economies of scale. The U.S. Department of Commerce defines foreign investment as direct when a single foreign investor acquired 10 percent or more equity in a U.S. firm. The 10 percent figure, while arbitrary, was chosen because it was deemed to represent the minimum stake required by foreign investors to wield long-term influence over the management of a firm in question. Although finance, insurance, and real estate combined represent the largest dollar value and proportion of foreign direct investment (FDI) assets in the United States and Canada by both countries, much of the FDI related to these components is acquisitions, rather than construction of facilities and production or trade. Thus this study is confined to the manufacturing, transportation components, and service sector like hotel.

NAFTA represents an historic policy shift, one that raises a variety of theoretical and practical questions many of which are familiar. Why do countries pursue greater economic integration? The agreement sets in motion the elimination of all tariff and many non-tariff barriers among member nations within ten years of implementation. Under the agreement, Canada and the U.S. gain access to Mexico's highly protected automobile market, and Mexico gains access to the United States and Canadian protected textile and apparel markets.

NAFTA has been in effect for only three years. While there are insufficient official statistics to evaluate the impact of NAFTA and it is getting harder to tell where the political ends and the trade begins, this study examines the broad implications of a NAFTA for trade and investment.

THE POLITICAL ECONOMY OF NAFTA

A conceptual framework is needed to analyze and understand adapting corporate strategies to economic transitions and the role of multinational corporations (MNCs) with respect to regional integration and liberalization. The extent to which a country's trade is FDI-related will depend on the size and propensity to trade of its own MNCs abroad and on those it hosts. As happened in the European Community, intraregional investment drove the process of economic integration and the NAFTA agenda as companies positioned themselves to operate in a large and competitive market.

In NAFTA each country has pursued their respective policy objectives. For the United States the prime motive is political -- "to help insure an economically strong Mexico as a model to the hemisphere and especially the heavily indebted or politically unstable Latin American and Central American countries" (Randall 1992: 27). Mexico's objective is an increased flow of foreign direct investment. It was reasoned that, with the assurances of NAFTA, foreign investors would be willing to invest in export-oriented industries and larger projects in Mexico (Krueger 1995: 72). Canada's purpose is to create a "hub-and-spoke" approach where the United States or "hub" benefits from access to the markets or "spokes". In this way Canada may receive many of the trade benefits of the United States. The primary incentives for Canada's participation were guaranteed access to U.S. markets, and relief from protectionist measures, while the U.S. was primarily driven by the desire to obtain guarantees from Canada regarding the flow of energy.

As Canada moved to join the U.S. and Mexico in the NAFTA, most critics argued that jobs would be lost to Mexico because of the cheaper labor and production costs, that NAFTA was not necessary because most of Canada's trade was already free (approximately 80% of Mexican imports to Canada already enter duty free), and that the new agreement would be an opportunity for the U.S. to get from Canada what they were unable to secure in the bilateral agreement . The Canadian government, on the other hand, felt that participating in the new agreement provided extensive economic benefits in terms of new markets in Mexico. Canada was already Mexico's fifth largest foreign supplier at the time NAFTA was being negotiated, and the government applauded the economic reforms in Mexico. In their view, there was mutual interest by all three countries to achieving expanded export opportunities (Ritchie 1991: 82). In addition, Canada expected to realize from the NAFTA was an ability to influence the process of setting such rules as the rules of origin in specific sectors and issues (Hufbauer and Schott 1992: 339). In all, Canada has done better in recent years than the United States, whose trade deficit with Canada growing each year. The Trade matters more to Canada than it does to the United States. For instance, the mere increase in exports to the United States from Canada in 1993 ($12.4 billion) was close to the total of Canada's exports to the European Union and Japan combined ($14.4 billion). In 1994, trade among the partners increased by 17 percent (over $50 billion). U.S. merchandise exports to Canada and Mexico grew twice as fast as U.S. exports to the rest of the world (16.4 percent versus 7.5 percent), signaling the importance of these two trading partners. The estimated U.S. trade deficits with Canada and Mexico for the year 1996 would be around $40 billion (U.S.) which has quadrupled since 1993, with Canada enjoying the substantial surplus (Canadian *Economic Observer*, October 1996). If we include "service" trade comprised of finance, insurance, and real estate with Canada, however, the account will be about evenly balanced.

All three NAFTA signatories are federations. While state and provincial governments are not signatories of NAFTA, they are not insulated from NAFTA's jurisdictional reach since the parties are subject to obligations to secure subnational compliance. State governments, however, play an important role in setting the economic and regulatory framework that affects direct investment in their territories. Indeed, the availability of dependable utilities, sound and extensive transportation facilities and good educational systems are of prime importance in selecting an investment location.

The NAFTA agreement allows for companies to challenge the standards and regulations adopted by federal and subnational governments to protect human life, workplace safety, and the environment. If a standard in one country is higher than the standard in another country, such regulation could be challenged as "technical" or "non-tariff" barriers to trade. Once challenged, it is to be adjudicated by an arbitration panel in order to determine the question whether or not its regulation is based on scientific principles or trade barriers in disguise. The "free trade" aspect of NAFTA enhances the mobility of capital, goods and services, while at the same time providing corporations with extensive protection of their investments. NAFTA may be considered as an investment agreement, not a trade agreement in the sense that it frees corporations from government regulation which would constitute a barrier to trade (Bernard 1995: 66-68). The question of the appropriate response of the nation toward the opportunities and threats posed by international trade and multilateralism is one of the concerns of political economy. Growing economic interdependence constitutes a challenge to national sovereignty since we are dependent on forces that may be beyond our control. If this happens, job safety and a clean environment would have to be sacrificed in order to maintain income and employment. To this extent, interdependence and openness can erode the autonomy of political decision-making of a sovereign state and constrain the nation's capacity to decide for itself and pursue its ends.

The concept of the sovereign corporation becomes real when NAFTA undermines the control and limits that a government can impose on corporation and commercial power. The Canadian national health care system will illustrate the case in point. Canadians have a universal, single payer national health care system financed through their tax system. Thus U.S. automakers like GM and Chrysler in Canada do not have to bargain with the Canadian auto workers over rising health care costs because of the free (American automakers) Canadian health care system. This results in a $950 saving per car by producing in Canada. It may be argued that one country's social programs can be another country's government subsidy which could be viewed as a violation of the trade agreement. The environmental issue is also linked to the sovereignty issue. The regulatory trend under NAFTA is to regulate product not process. Why is regulating product versus process a problem? Here is an example. Regulating product means that if you grow agricultural products or fruits and use pesticides or other chemicals that are banned in the states, we cannot prohibit those imports. They can be inspected at the border to assure that any chemical residue is within legal limits. In other words, " process" as to how a product is grown can not be regulated (Bernard 1995: 69).

New Strategies

The fact that U.S. firms make decisions concerning where to produce based not on the benefits or harms to the U.S. economy but on the likely impact of the decision on the firm's profitability is indicative of government's limitations to control its economic destiny. Since where firms sell does not determine where they produce, the home market becomes less important than the ability to exploit a global market. Because of this, the interests of a firm can diverge from those of nation.

The process of global competition parallels the process of competition between domestic producers. One affects regional development within a nation while the other affects development across nations. In the context of world economy, international investment/trade is a part of the broader problem of the location of industry and the competition between producers within and across industries. In the last few years Canada has begun to shift the emphasis of its trade policies away from agreements with the U.S. which focus on lowering tariffs and trade barriers. Instead, Canada is positioning itself to capitalize on emerging opportunities in other regions - - primarily Latin America and Asia. A recent joint statement by both Canada's Foreign Minister and International Trade Minister indicated that the country is seeking a jobs-oriented foreign trade policy which opens new links with those areas as well as reestablishing links with Europe. The Minister also stated that the government would begin explicitly protecting Canadian culture from U.S. domination (Williams 1995). Both statements reflect the current feeling in Canada that complete reliance on the U.S. for trade is economically and culturally risky.

Joining NAFTA was only the first step in Canada's outreach toward Latin America, and more recently the government has emphasized its support for the economic reform in those countries and the Caribbean. Over the next decade the population of those areas should become a much bigger market as well as competitor for Canada (Crane 1994: 2). Therefore the government has been focusing on bringing these countries into NAFTA to make it a hemispheric trade agreement. Chile is already in negotiation to join in near future.

While the Prime Minister has rebuffed other Latin American and Caribbean countries from entering on a temporary basis right now, he has agreed tp help prepare their economies through technical and financial assistance so they can quickly gain membership. He has been meeting extensively with leaders in that region to discuss the process and goals for their future in the trade agreement. In this effort, Canada is trying to build strong alliances with those countries in order to counter the influence of the U.S. in an expanded NAFTA (Marotte, January 31, 1995).

MNC STRATEGIES AND RELATED TRADE THEORIES

NAFTA contains important and innovative provisions for liberalizing direct investment. It includes broad liberalization based on the principles of national treatment and non-discrimination, protection for foreign investors, dispute settlement procedures for both state-to-state and investor-to-state disputes. These considerations suggest that models that put the role of international capital mobility at the center of analysis are more likely to illuminate e issues. NAFTA is ground breaking in that it is both the first Cold War trade agreement and the first trade agreement negotiated between developed countries and a developing country. Wage rates in Mexico are extremely low. In such key sectors as autos, steel, and textiles - wages in Mexico are only about one-tenth of levels in the United States.

First, we examine theories of multilateralism and competition to analyze North American MNCs' foreign direct investment moves in reaction to a liberalized North American market. Secondly, it will deal with changes in MNC strategies in three economic sectors—automotive, textile and apparel, and energy—to illustrate possible MNC strategies in response to this multinational free trade agreement. It focuses on the adjustments of the U.S. and Canadian MNCs' investment strategies made in response to the provisions of NAFTA as well as how they use NAFTA's institutional mechanism to improve their welfare and competitiveness.

NAFTA is designed to be a prelude to regional integration. It is postulated that large firms can rationalize their production with three or four manufacturing sites in the hemisphere. That will provide economies of scale and raise standards of living. On the investment side, integration will create a penalty if a country does not follow the free market, because capital will flow to where it is welcome and profitable. The emerging importance of MNC activities shows a logical extension of the domestic development. At first, business pursued scale and scope within its domestic developments; however, factors like competition at home, opportunities abroad, the need to reduce financial and other risks, and foreign barriers to imports led to an increasing number of firms to first establish and then expand overseas operations. In the past, taking advantages of low-cost labor, proximity to energy, and other factors of production were the main criteria when MNCs located their operations.

Besides the aforementioned factors, opening manufacturing firms in host countries can also reduce transportation and inventory costs of finished products, adjust products to meet distinctive differences in consumer taste, and better meet host governments' specific requirements. To ensure a sufficient volume of sales, many MNCs invest in national and international marketing and distribution organizations. Apart from niche marketing, MNCs utilize management information systems and organizational design that are developed to reduce the resources devoted to coordination and monitoring by the firm. As a result, MNCs gain advantages by responding to time and cost more efficiently. These kinds of multinational intrafirm business activities have brought companies and nations into even more direct competition. As a result, the theory of comparative advantage, which focuses mainly on factor endowments, is proved to be insufficient to explain contemporary MNCs' activities.

Industry Globalization and Competitive Advantages of Nations

Globalization of industries happens as competitive positions among industries are different due to shifting of technology, consumer needs, government policy, or country infrastructure. Economic development should not be bound by a country's comparative advantages alone. Rather, firms can create their own competitive advantages by adopting appropriate strategies. Hence, the industry, not the country, becomes a basis unit of analysis for understanding global competition. Being a part of a global industry, a MNC's competitive position in one nation significantly affects its position in others. According to Porter, there are five embedded competitive forces for any industry. They are the threat of new entrants, the threat of substitute products or services, the bargaining power of suppliers, the bargaining power of buyers, and the rivalry among the existing competitors (Porter 1990: 33-75). Hence, firms' competitive advantages can be affected by such attributes as factors of production, demand, the presence of related and supporting industries, and firm strategy (Yoffie and Gomes-Casserres 1994: 22). A profitable firm finds it comparable buyer value (the amount buyers are willing to pay for its product or services) exceeds the collective cost of performing all the required activities. To excel in the global market, therefore, a firm must either provide comparable buyer value with cheaper costs than its competitors or create product differentiation that enables its privileges access to assets (Dunning 1995: 39). Therefore, only those MNCs that continuously develop R&D, employ new procedures, new technologies, or different inputs, and connect interdependent activities through linkage can survive in the global market.

Besides, not only do MNCs need to achieve competitive advantages, they also need to sustain them by using such strategies as activity configuration, global coordination, and alliances with other MNCs. A good case in point is Cemex (a Mexican cement company). It has become the world's fourth-largest cement maker by using profits from a near-monopoly in its booming home market to buy up firms in the United States, Europe and South America. If Cemex is a monopolist, it is also a reasonably efficient and inventive one. The production cost of about $30 per tonne at Cemex's Mexican plants is the lowest in North America. And this advantage is built on more than cheap labor. Cemex has invested heavily in robots and computers. The best evidence that Cemex can function in a competitive market comes from abroad. It competes well against world leaders such as France's Lafarge Coppé and Switzerland's Holderbank.

Internalization

The theory of internalization can be viewed as an extension of the theory of competitive advantage. MNCs react to changes in their environment and act to shape their environment to make it more advantageous to themselves. According to Rugman and Gestrin (1993: 21), internalization is one of the managerial strategies adopted by MNCs to obtain ownership of know-how advantage which becomes essentially firm specific advantage (FSA). MNCs may achieve this goal by generating assets through undertaking R&D activities at their own facilities, acquiring a firm that already owns these assets or collaborating with another firm to jointly develop them (Dunning and Narula 1995: 23). These FSAs, which can enhance firms' competitiveness, further encourage MNCs to seek worldwide markets through the process of FDI. The intangible capital that makes it advantageous for MNCs to extend their operations internationally may also make them more likely to dominate the markets in which they operate (Caves 1982: 27).

Once MNCs can establish these FSAs, they will maintain proprietary control over them so that the economic rents associated with these advantages do not accrue to other firms. Not only can MNCs internalize their FSAs, they can also internalize country-specific advantages (CSAs) that are the advantages of national economies. Thus comparative advantage is a "territorial" concept, applicable to regions, countries, etc.; it is not a "national" concept. Theoretically, CSAs are generated from natural factor endowments such as labor, natural resources, and capital within national boundaries. But in today's global marketplace, national and multinational government policies such as NAFTA can influence CSAs. Therefore, internalization theory serves to explain and predict how MNCs will react to environmental changes as a result of changing national and multinational trade policies. For instance, NAFTA can benefit those U.S.- and Canadian-based MNCs that manage to internalize CSAs. In fact, NAFTA provisions concerning elimination of trade barriers within the North American trading bloc become CSAs for North American MNCs. On the other hand, NAFTA's liberalization measures toward the three signatories, which can also be viewed as the protectionist measures against nonsignatories, create regional-specific advantages to protect North American MNCs in less competitive sectors.

MAJOR PROVISIONS RELATED TO INVESTMENT AND TRADE

This section will discuss some NAFTA provisions that affect North American MNCs' investment strategies by minimizing investment risk and securing new market access. These provisions act as institutional mechanisms to strengthen North American-based MNCs' competitiveness vis-a--vis their non-American-based counterparts. In terms of Canada and the U.S., the investment section of NAFTA picks up where the Free Trade Agreement (FTA) left off. Principle provisions of the earlier agreement remain. The extent to which NAFTA will actually liberalize the North American investment regime depends largely on character of the likely impact of specific sectors on the economies of the three countries. Furthermore, the impact of the tit for tat reservations, and the treatment of investment review in the NAFTA will also come into play.

Canada's sectoral reservations are concentrated in three areas. The first is natural resources, where the government has made one weak reservation in agriculture and five relatively more restrictive reservations in energy and fishing. The second broad area is social services. Social services and minority affairs have been exempted by all three countries from the agreement. The third general area is transportation. Foreign interests are excluded from all forms of air transport along with heavy restrictions on foreign interests of cabotage and heavy restriction upon foreign involvement in the maritime sector. A tit for tat reservation is designed to give the Canadian government the right to treat U.S. investors in Canada water transport as unfairly as Canadian investors are treated in this sector are treated in the United States. The inclusion of this reservation in the NAFTA may, however, be seen as a positive step forward in trade liberalization as transportation has long been one of the most restricted sectors in North America. The same principle holds for U.S. - Mexico and Canada - Mexico. Under NAFTA, U.S. express delivery companies - like United Parcel Service - were accorded national treatment and the right to use large-size vehicles to move packages. To protect domestic carriers, however, the Mexican government has simply ignored the American delivery companies' requests for permits to use large trucks, leaving Americans at a severe competitive disadvantage. Consequently, American express package delivery companies are forced to move goods by caravans of small-package vans or contract out to Mexican competitors with permits. The first-ever U.S. dispute resolution with Mexico under the trade agreement was over this transportation issue in 1995. Unfortunately, little progress has been made. Mexico's recalcitrance on this issue was met by American ban on Mexican trucks in U.S. interior under the disguise of safety issues.

Problems also remain in Canada with respect to grain transportation. Given the distances involved, the railways seem well-positioned to facilitate their traffic between Canada and Mexico. This is particularly in the potential for rail movements of grain from western Canada to Mexico. The enthusiasm for north/south rail connections is tempered by longstanding problems that have hampered rail transport to Mexico. The interlining U.S. and Canadian rail carriers must deal with a state-owned, antiquated Mexican railway monopoly. Although this sector remains highly restricted, its inclusion in the treaty and the liberalization of some of its subsectors, marks a starting-off point for further liberalization.

The several tit for tat reservations put forward in the annexes of the NAFTA will also have commercial repercussions. Tit for tat reservations state that restrictions upon foreign investment in another party's territory will be met with mirrored treatment for the offending party's investors in the home country's sectors. Retaliation in this manner will not only have equivalent effects but also will lead to substantially greater commercial effects. If domestic discriminatory measures inhibit the free flow of foreign investment to a particular sector of the Canadian economy, the addition of a tit for tat reservation by the U.S. against the country holding this measure will reinforce the original disincentive to invest in the economy in question.

Liberalization of the North American investment environment is also affected by the NAFTA's investment review process. The investment review procedures and outcomes of these are excluded from review under NAFTA dispute-settlement process. Canada has protected its cultural industries (e.g., publishing, television, and cinema). By applying special criteria to its investment review process in a few limited sectors. Otherwise, only acquisitions worth more than $150 million can be reviewed. The United States, in contrast, does not list any investment review procedures in its reservations, instead relying on using national security criteria which effectively does the same thing. The positive contributions of NAFTA can be seen as the greater transparency in the rules governing the treatment of foreign investment in North America.

The magnitude of the international presence in Canada reflects one of the most open policies in the world toward foreign investment. There has been a rebound on the flow of FDI from the U.S. since the FTA was signed in 1989 (Nymark and Verdun 1994: 124). Moreover, Canada's specific goals regarding investment were to ensure further liberalization of the Mexican investment regime and to retain Canadian policies in particularly sensitive sectors such as culture and social services.

By 1990, U.S. - Canada direct investment was already substantial. Market values of Canadian FDI in the United States were estimated to be $43 billion; U.S. FDI in Canada had reached an estimated $106 billion (Hufbauer and Schott 1992: 71). However, FDI flows to Canada since the FTA and NAFTA reveals two interesting trends. First, FDI by the U.S. firms shifted away from other sectors in favor of manufacturing. While the U.S. share of FDI in Canada has decreased over time, the U.S. share of net FDI directed to the manufacturing sector increased. The performance of MNCs is another important aspect of the NAFTA's impact on investment in Canada. A joint research by Economic Council of Canada and Investment Canada conducted a study of productivity and trade performance of foreign-controlled and Canadian-controlled MNCs in the manufacturing sector. Analysis of the study indicated foreign-controlled MNCs had higher propensity to export and to import than Canadian counterparts, and also had a very high level of intrafirm trade (Rugman and Gestrin 1994: 140). Three-way trade of $360 billion represents roughly $1,000 in trade for each of NAFTA's 377 million consumers.

The U.S. exports to Canada and Mexico grew twice as fast as U.S. exports to the rest of the world (16.4% vs. 7.5%), accounting for half of the 1994 gain in U.S. exports. Moreover, the increase in U.S. exports to the NAFTA partners in 1994 and 1995 was larger than total U.S. exports to any single country, with the exception of Japan and the United Kingdom (U. S. Department of Commerce 1996, Document No. 4003: 2). NAFTA is helping shift U.S. resources to the more productive export sector.

Mexico has now recognized the need to establish globally competitive investment frameworks. Indeed, NAFTA was designed in part to funnel investment from around the world into North America. For example, by requiring "local content" provisions in many industries, NAFTA in effect pressured the world's producers to put their plants in North America if they want to sell here. It is called "forced investment." And while it has undoubtedly drawn some investment into the U.S. and into Mexico, to gain market access in North America, it is a game that can be played by other regions, too, which may result in "investment wars." NAFTA abolishes several trade-distorting performance requirements—such as export or import quotas, trade balancing, product mandating, and technology transfer—that were imposed mainly by Mexico as trade barriers for foreign investment. This provision should particularly benefit both U.S. and Canadian MNCs that plan to invest in Mexico's manufacturing and high-technology industries.

Rules of Origin

NAFTA grants preferential treatments to goods that are wholly obtained or produced in North America. The "rules of origin" are used to determine which goods are eligible for preferential treatment within the free trade agreement region and which are not. By and large, only those goods that are produced in the three signatory countries and made up entirely of NAFTA-originated components can meet this requirement. The main intention of designing this provision is to increase the competitive advantage of firms with their production base in the North American free trade area.

Since it is hard to decide the rule of origin for some high-technology products, NAFTA grants preferential treatments to goods that are wholly obtained or produced in North America. The "rules of origin" are used to determine which goods are eligible for preferential treatment within the free trade agreement region and which are not. By and large, only those goods that are produced in the three signatory countries and made up entirely of NAFTA-originated components can meet this requirement. The main intention of designing this provision is to increase the competitive advantage of firms with their production base costs.

As for goods containing imported components, they must go through substantial transformation or alteration to result in a tariff classification change and hence enjoy preferential treatment. In some cases, goods must have a specified percentage of North American content to benefit under the preferential treatment. For instance, passenger autos, light trucks, and engines must contain 62.5 percent NAFTA content to fulfill special origin requirements for NAFTA benefits. There is also a separate annex establishing special requirements for textile and apparel goods that will be discussed in the sectoral study section later in this paper. Most North Americans support the idea that rules of origin should be stringent, as they promote building manufacturing operations in North America and thus help create jobs and other subsidiary industries in communities.

Nondiscriminatory Treatment

This agreement guarantees nondiscriminatory treatment among the three NAFTA signatories by requiring each party to extend national treatment or most favored nation treatment, whichever is better, to NAFTA investors. In other words, all parties must treat each other's goods, services, and investors as they do their domestically produced one. Once goods, services, or investment from one signatory country enter the other two, they can no longer be discriminated against on the basis of origin.

Elimination of Tariff and Nontariff Barriers

NAFTA establishes the progressive elimination of all tariffs on goods qualified as North American in a fifteen-year transition period. There are three phase-out schedules for manufactured goods in general, agricultural goods, textiles and apparel, respectively. This step-wise reduction of tariffs on 20,000 goods will ultimately affect 377 million consumers and an annual production value of over $7 billion (Boscheck 1996: IX).

As for nontariff barriers, NAFTA will virtually eliminate most of import and export restrictions, such as quotas and import licenses except for auto, agriculture, textile and energy industries, which have been applied at the borders. Moreover, the three countries agreed to phase out the existing custom use fees by June of 1999. Also, NAFTA allows business investors to bring professional samples and repaired or altered goods across borders on a duty-free basis. In accord with this provision, Mexico has provided immediate duty-free access for many of American and Canadian investors' key export interests, including agricultural and fish products, machinery, and most telecommunications equipment.

Rules Governing Unfair Trade Practices

The remedial laws for unfair foreign trade practices are specially designed to offset the two most extremely sensitive issues for the U.S. and Canada—dumping activities and foreign government subsidies. Dumping occurs when foreign producers sell their goods in a host country at a less than fair-value price level. As for subsidies, foreign investors can operate at a lower cost with government subsidies than they would otherwise. Like other foreign trade disputes, unfair trade practice conflicts can be resolved by certain due process procedures set by the NAFTA signatories. There are still some unresolved concerns, however, regarding Mexico's different legal system and its inexperienced trade experts who serve in the dispute resolution panels.

Dispute Resolution Mechanism

The incorporation of a comprehensive dispute resolution mechanism makes NAFTA unique among free trade agreements. Instead of referring disputes among signatories to host countries' domestic courts or administrative tribunals, NAFTA's dispute settlement procedures ensure signatories' rights to go to international arbitration for any violation of the agreement's protections. In case of a dispute between a foreign investor and the host country, the participants can seek resolution through consultation and negotiation, which is the beginning procedure of the whole dispute resolution process. Should consultation fail to settle the dispute within thirty to forty-five days after initiation, the concerned parties may request a meeting of the Trade Commission, which relies on technical advisors and experts. If the dispute still cannot be resolved by the Trade Commission within thirty days, an arbitration panel with balanced panelists from both sides of the concerned parties will be established to resolve the dispute.

Not only do NAFTA's dispute resolution procedures provide fast settlement (the whole process takes only eight months from consultation to final panel report), they also contain effective enforcement rules. The winning party can demand compensation from the losing party. If no acceptable compensation is rendered, the winning party can retaliate in any sector covered by NAFTA. What is more, NAFTA has separate procedures for reviewing antidumping and countervailing duty matters. Binational review panels serve as an alternative to judicial review of antidumping and countervailing determinations.

SECTORAL STUDY

By and large, NAFTA has created a new environment for North American MNCs to invest. Its trade liberalization and protectionist provisions affect different economic sectors differently. In this section, the theories that have been discussed will be applied to explain adjustments in investment strategies of North American MNCs in the automotive, textile and apparel, and energy sectors as a result of NAFTA.

The Automotive Sector

Automotive products are the largest components of trade between Canada, the U.S., and Mexico. This sector constitutes a total of $60 billion in the three-way trade. Therefore, distinct and powerful constituencies, which include the U.S. Big Three automakers (General Motors, Ford, and Chrysler), auto parts firms in all three countries, as well as American and Canadian auto workers, with conflicting interests, were all involved in the NAFTA automotive negotiations. On the one had, foreign-based auto MNCs in North America like Nissan, Volkswagen, Toyota, Honda, and Hyundai were very concerned with the outcomes of NAFTA negotiations.

The Mexican automotive sector was very restrictive to foreign investors. Before NAFTA, Mexico required each auto assembler to balance its trade in terms of one dollar in exports for every dollar of imports to Mexico. Therefore, American and Canadian auto MNCs' major objective was to open Mexico's fast-growing but highly protected automotive market. On the other hand, they want to ensure that their Japanese and European competitors would not dominate the North American auto market. In seeking continuous access to the U.S. market, Canada wanted to prohibit overly restrictive rules of origin that might handicap Canadian assembly operations. As for the Mexicans, they saw NAFTA as an opportunity to modernize their automotive industry and achieve a fuller integration into the North American market despite the fact that a difficult transition period may occur as a result of NAFTA.

The results of the negotiation make significant accomplishments of pointing toward an integrated North American market. NAFTA provides us an immediate reduction of Mexican duties on vehicle imports and a timetable for their eventual elimination. It annuls Mexican quotas on new auto imports and removes tariffs on certain automotive parts. Besides, the rule of origin for automotive vehicles and parts was raised from 50 percent in the U.S.-Canada FTA to 62.5 percent in the eighth year of NAFTA. Although some North American auto workers find this content rule not stringent enough as many high-value parts and components can be incorporated in North American assembled vehicles that will quality for NAFTA benefits, North American MNCs opposed further regulation for the fear of hindering their production efficiency (Cantin and Lowenfeld 1993: 375-390).

Apart from shaping favorable investment environment through NAFTA, the North American MNCs also react to the altered North American investment environment as a result of NAFTA terms. It is quite obvious that relocating automotive and auto parts manufacturing operations from the U.S. and Canada to Mexico becomes the most logical response for North American MNCs. By so doing, they can capture the regional specific advantages by using Mexico's cheap labor and liberated market. For auto companies, closing inefficient plants, easing rule-of-origin requirements, taking advantage of the lowest production and labor costs become North American MNCs' competitive strategies to internalize their regional specific advantages as a result of NAFTA. For instance, Chrysler planned to build 70,000 Dodge pickup trucks right after the implementation of NAFTA in 1994 (***Auto Week, July 25,*** 1994). General Motors has moved its Detroit operation plant to Mexico City (Levinson 1995: 59). Briggs & Stratton's automotive lock division cut 286 jobs in Glenade, Wisconsin. Meanwhile, over 300 people in its Mexican plant at Juarez were hired (***Milwaukee Sentinel,*** May 18, 1995). Thomas & Betts, an automotive and computer electronics company, moved some of its production to Mexico after NAFTA had been in effect and laid off one hundred workers in the U.S. (***Spartanburg Herald Journal,*** April 19, 1994). Other strategic moves by North American MNCs include strategic alliances and acquisition. For example, Kirkland, a Washington-based Kenworth Truck Company, formed a joint venture with Vilpac, a heavy-duty-truck maker in Mexico, which in turn buys components from Kenworth (McClenahen 1996: 21-23).

Without a doubt, participating in the negotiation of NAFTA was one of the strategic moves of North American MNCs. As they recognized that their firm-specific advantages have been fading vis-a-vis their Japanese, Korean, and European counterparts, they sought protectionist measures against foreign competitors in order to increase their competitiveness in the North American market. Nevertheless, gaining regional advantages and protectionist measures cannot secure their position in the North American auto market. Earlier experiences show that relocating their manufacturing plants to Mexico cannot significantly reduce the automakers' production costs because Mexico has insufficient infrastructural facilities. This problem is aggravated as the Mexican government cuts back its plans to improve Mexico's inefficient road system. Moreover, labor cost becomes a decreasing component of automotive manufacturing costs. It seems that the North American MNCs need to seek other competitive advantages by focusing more on R&D and quality improvements to internalize their firm-specific advantages.

The Textile and Apparel Sector

NAFTA has special rights governing the textile and apparel industry. Under these rules, textiles and clothing must be produced from yarn produced in a NAFTA country. Cotton products are subject to a "fiber forward rule." Clothing and fabrics that cannot meet the requirements, however, may benefit from a reduced tariff rate under tariff rate quotas (TRQs). With NAFTA, Canadian and Mexican tariffs on apparel will be eliminated by the year 2003, while tariffs on textiles will be phased out by 2001.

Strict rules of origin under NAFTA exemplify the demand for greater protectionist measures of the North American MNCs to save the declining industry. Like their auto sector counterparts, a lot of the American textiles and apparel MNCs have brought their labor intensive sewing operations to Mexico and are sourcing fabrics from the U.S. and Canada. This is because under NAFTA apparel sewn in Mexico from fabric formed and cut in the U.S. and Canada enters the two countries free of duty. Although imports from Mexico to the U.S. role 17 percent, about 85 percent of Mexican apparel contains U.S. fiber. This strategy has proved a success to many American MNCs, as their sales to Mexico increased 39 percent in the first year of NAFTA's existence (***Textile World 1995).*** Actually, this move is also compatible to their recent desire to seek low-cost labor as labor wages in Taiwan, South Korea, and Hong Kong have risen considerably. In 1994, textile and apparel imports into the U.S. from the Far East fell from 58.7 percent to 55.7 percent, while investment and intrafirm activities within the NAFTA region increased substantially. For instance, Fruit of the Loom reported that its hosiery exports to Mexico in 1994 rose six times when compared with 1993 (***Textile World*** 1995).

Those textile suppliers who have been relying on inexpensive input from the Far East, however, find both ingredients difficult to obtain. The vice-president of the Continental Apparel Manufacturing Co., an American apparel company that laid off 85 apparel workers in 1994, claims that NAFTA has adverse effects on its operations (***Daily News*** -Naples, Florida, September 14, 1994). In fact, to survive in the global market, these MNCs should not only use Mexico's cheap labor as a substitute for East Asian laborers, but also should either fight for favorable free trade provisions or strike to take advantage of the NAFTA provisions. Both changing their product lines thoroughly to meet Mexican customers' demands and creating unique American-style products are possible ways to capture more regional-specific advantage generated from the NAFTA provisions. As the President and Chief Executive Officer of Metro Textiles, David Caplan, realized, the survival of American textile manufacturers "is going to depend on creativity, fast service, great merchandise, mergers and being acquired" (Stuart 1996: 25-34).

The Energy Sector

NAFTA provides substantial new opportunities for private energy companies by limiting Mexico's use of restrictive trade practices in the energy sector. Under NAFTA, North American MNCs can acquire and operate electric generation facilities in Mexico. Private facilities can use the electricity generated at the site or sell the excess to Mexico's government-owned electricity monopoly. Although NAFTA still reserves to the Mexican government goods, activities, and investments in the oil, gas, refining, basic petrochemicals, nuclear, and electricity sectors, it opens many activities in the energy sectors to greater domestic and regional private investment. It allows U.S. and Canadian oil and gas field service companies to negotiate more lucrative contracts for the exploration, development, and production of oil and natural gas reserves (Hoffman and Cano 1995: 5). In addition, NAFTA contains foreign participation in the restricted sector up to 49 percent.

In general, the NAFTA negotiation offers a good opportunity to combine Mexico's abundant oil reserves with U.S. and Canadian financial capital and technological expertise (Hufbauer and Schott 1993: 33). NAFTA successfully provides market access to Mexico's coal industry. Mexico has permitted U.S. and Canadian MNCs to own 100 percent of new coal mines and facilities in its country. Moreover, the elimination of Mexican investment restrictions on secondary petrochemicals, coupled with the immediate elimination of trade restrictions on most petrochemicals offers important investment opportunities for Canadian-based MNCs. These results demonstrate that the American and Canadian attempts to preserve their internalized firm-specific advantages will press for further liberalization to obtain regional-specific advantages.

CONCLUSION

The proactive and flexible nature of MNCs makes them major actors in transnational trade. They are most sensitive to trade liberalization and protectionism. The sectoral study and the theories presented in this paper have illustrated how North American MNCs shaped their investment environment by pressuring their governments to come up with a multinational trade agreement—NAFTA—as their institutional tool and then reacted according to its outcomes. MNCs that have failed to internalize their firm-specific advantages tend to lobby for more protectionist measures in order to create regional-specific advantages. Those MNCs that have succeeded in internalizing their productive and marketing advantages, on the other hand, tend to ask for more liberalized measures.

Another noteworthy result of NAFTA is that when U.S. and Canadian MNCs first enter the Mexican market, they invest in labor intensive manufacturing and resources extraction industries due to Mexico's country-specific advantages of cheap labor and abundant supply of natural resources. For instance, the first year of NAFTA implementation demonstrated that American MNCs have shifted their operation investment to Mexico at a record pace. These shift-of-operation strategies contribute to the growth of U.S. investments in Mexico from an average of $2 billion in 1993 to $4 billion in 1994 (*The Washington Virginian,* March 10, 1994). According to a National Association of Purchasing Management survey in 1994 (Koechlin 1995: 25-27). 17.1 percent of large U.S. companies planned to move operations to Mexico because of NAFTA. When some basic infrastructure has been developed, more complex manufacturing industries will also be attracted to the region. Recently, further infrastructural development invited MNCs of more sophisticated services such as financial services, computer and telecommunications industries, and business services to Mexico. Some scholars call this sequential growth of FDI "thick market externalities" (Oman 1993: 79-105).

The United States is the largest recipient and source of foreign investment in the world. Its large, dynamic market and long-standing commitment to an open and non-discriminatory investment regime in most areas of economic activity have clearly contributed to its large volume of FDI stocks and flows. The strong surge of FDI inflows from the early 1980s led to a reversal of its traditional position as net exporter of equity capital to one of net recipient. This situation lasted until the early 1990s when FDI outflows again overtook FDI inflows.

The policy of the United States rests on the view that its interests are best served by a liberal global investment regime. Accordingly, the United States has become more engaged in recent years in bilateral and regional initiatives that have implications for foreign investors. The North American Free Trade Agreement, the Asia-Pacific Economic Cooperation forum and the Japan-United States Framework for a New Economic Partnership signal a more diversified approach to U.S. external investment relations. As suggested by Rugman and Gestrin, the findings show that those MNCs that cannot take benefit of their firm-specific advantage will stress for more regional specific advantage.

Once NAFTA was in effect, they reacted promptly by relocating their labor-intensive industries to Mexico and changed their product lines for the Mexican market.

North American MNCs, however, should not see NAFTA as the only tool to improve their competitiveness, since non-NAFTA-based MNCs will soon learn to adjust to the NAFTA provisions and apply strategic moves. For example, Nissan Trading Co. Ltd. announced it will form a joint venture with Motor Wheel Corp. to manufacture brake components and flywheels in Mexico. Toyota also plans to build a manufacturing plant in the U.S. as a result of NAFTA's rules of origin. Moreover, North American MNCs should not rely too much on Mexico as a niche for marketing and industrial operation, as the country's financial, legal, and infrastructural systems are still very confusing. Hence, North American MNCs still need to continuously develop new technology and improve product quality in order to increase their competitiveness vis-a-vis their foreign rivals.

For the last 50 years Canadian trade activity has been dominated by the U.S., and the government has utilized GATT mechanisms and individual bilateral agreements as a means to minimize barriers to that trade. However, with the increased use of trading blocs and the continual emergence of new markets around the world, Canada had begun to shift its focus away from the U.S. Building on established trade agreements and actively seeking new links, Canada has changed its passive role in world trade and is aggressively capturing new opportunities in both Latin America and Asia.

The very enactment of NAFTA accelerates economic integration and opens up the member states to increased international scrutiny of their social standards and political practices. NAFTA will affect the overall social and political context in which public policy decisions will be made. This study has shown the multiplying and deepening linkages among national markets created by foreign direct investment and the growth of trade that it brings. Further it demonstrates that as markets integrate across borders, the ability of national policies to influence the structure of the market or the behavior of MNCs is greatly reduced. In essence, the main thrust of NAFTA is to reduce and redirect the role of government, while enhancing the role of the market.

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