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North American Economic Integration: A Primer on its History, Theory and Practice

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North American Economic Integration

A Primer on Its History, Theory, and Practice

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PREFACE

Many books and academic articles have been published on North American economic integration in the last decade. In fact, this vast outpouring of literature has produced what one author referred to, only partly in jest, as one of the most dramatically expanding industries in North America, the "Free Trade Debate Industry" (Kresl 1991). Nevertheless, until the publication of this book there was, to our knowledge, no single volume providing a balanced and accessible introduction to this complex and controversial subject.

The project that led to the writing and subsequent publication of this book brought together economists from three North American universities: San Diego State University, El Colegio de la Frontera Norte, and the University of Calgary. This endeavor, and the book itself, grew out of a larger project, entitled "North American Integration," funded by the United States Information Agency's University Affiliations Program. Subsequently, other organizations contributed the modest amounts necessary for the authors to convene and bring the book to fruition.

While there is considerable diversity among the authors in terms of background, training, and beliefs regarding the virtues of international economic integration, all share the view that North American economic integration has been under way for several decades. That is, North American economic integration did not start with the implementation of the North American Free Trade Agreement (NAFTA) in January 1994, nor would it have stopped had the agreement not been signed. Therefore, we regard the NAFTA, not as a milestone dramatically altering a historical process, but rather as a tool that may serve to better manage the ongoing process of North American integration in an efficient and equitable manner.

The authors' overall objective has been to produce a book that will help the reader understand the agreement itself, the context in which it was forged, and the various perspectives on its impacts. We hope that our readers feel this objective has been fulfilled.

We have subtitled the book a "primer" for understanding the history, theory, and practice of North American integration, suggesting that it is meant to be an introduction to the topic. The organization, level, and style of the book make it accessible to readers, from any discipline, who have a basic understanding of the principles of economics. And it will provide them with the tools necessary to undertake more advanced readings on the subject. Thus it can be read by the interested lay person or be utilized in a wide variety of undergraduate and graduate courses in business, economics, international relations, and the emerging field of North American studies.

We recommend it as a core text, to be supplemented with additional readings if desired, for special courses such as "North American Economic Relations" and "The Political Economy of North America" now being taught at San Diego State University. Alternatively, it can be used as a supplementary text in business, international relations, and economics courses, such as the "International Economics" course at the University of Calgary.

This book focuses on the integration experience of the United States, Canada, and Mexico and is available in both English and Spanish. Each chapter is written as a separate module, so that it may be updated and revised as necessary. As more countries are invited to join the NAFTA, or as NAFTA evolves into something quite different, the book will be expanded to include chapters on the new NAFTA countries and/or the shape of the new agreements, to be authored by specialists from the new member countries and/or on the subsequent negotiations.

A major strength of this book lies in the fact that it was developed by a multinational team of economists and advisers from other, related disciplines. This team approach, we believe, has produced a balanced perspective from each country on the NAFTA process and the controversies it engendered, both within and between countries.

The book complements another volume, entitled *North American Federalism*, which focuses on the *political* dimension of North American integration and is authored by political scientists from the same three universities that are represented in this volume.

We wish to express our thanks to the organizations that provided financial support for this effort, including the United States Information Agency; the Center for International Business Education and Research, and the Center for Latin American Studies, both at San Diego State University; and the Canadian Studies Grant Program of the Canadian government. We are also grateful to Francisco Botrán, a graduate student in Latin American Studies and International Business at San Diego State University, who worked for several months gathering data for the project coordinators, preparing graphics, and assisting with other administrative tasks. Finally, we wish to acknowledge the input of two individuals who read drafts of the chapters, attended a three-day workshop, and provided valuable comments on the book's direction: Tony Cherin, Professor of Finance, and Paul Ganster, Director of the Institute for Regional Studies of the Californias at San Diego State University.

Norris Clement & Gustavo del Castillo V. (project managers)
July 1996

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CHAPTER 1

North American Economic Integration in the Global Context

Norris C. Clement and Gustavo del Castillo V.

NAFTA'S Rocky Road

Implementation of the North American Free Trade Agreement (NAFTA) began on January 1, 1994. Scarcely eleven months later, on December 9 of the same year, thirty-four heads of state met for three days at the Economic Summit of the Americas in Miami to begin the creation of a Free Trade Area of the Americas (FTAA), to be implemented by the year 2005. At that same summit, Canada, the United States, and Mexico announced that negotiations with Chile would soon begin to provide for that country's accession to the NAFTA. This was to be the first step toward a hemispheric free trade agreement. Thus for a brief time it appeared that the "gospel of free trade" had finally been accepted throughout the entire Western Hemisphere.

A few days later, however, on December 20, Mexico's newly elected government announced that, in response to a growing trade deficit (i.e., imports > exports), dwindling international currency reserves, and a pressing need to refinance part of its short-term foreign debt, the government of Ernesto Zedillo would allow the peso to depreciate relative to the U.S. dollar, the currency of its principal trading partner. Almost immediately, Mexican and foreign investors panicked, selling stocks and exchanging pesos for dollars.[1]

Over the next few months the Mexican stock market, which had experienced a strong boom in recent years, lost a good portion of its gains, the peso fell to approximately half its previous value, inflation skyrocketed, and economic output and employment took

[1] During the latter half of 1994 the Mexican government had financed the growing gap between exports and imports with inflows of investment capital, much of it attracted by the rapidly rising stock market. As the situation deteriorated, investors lost confidence in the economy and simply cashed out of the stock market and Mexican pesos.

their deepest plunge in fifty years. Once again the country found itself in a deep recession, the deepest since 1981, when a previous "liquidity crisis" had forced the Mexican government to declare a moratorium on debt service payments which, in turn, triggered a generalized debt crisis throughout the entire Third World.

Again in 1994 events in Mexico spread to other countries of Latin America, especially Argentina and Brazil, as the so-called "tequila effect" stimulated investors to reassess the risk involved in Latin America's "emerging markets" and reduce their short term investments in those countries. Even the U.S. and Canadian dollars and some European currencies weakened in this environment, especially after it was announced that a support package of some U.S.$50 billion had been assembled, involving the U.S. Federal Reserve (Currency Stabilization Fund), the Canadian Central Bank (Bank of Canada), the International Monetary Fund, the Bank of International Settlements, and a small number of advanced industrial countries (see chapters 2 and 3 for details on these institutions).

The irony of the situation is that throughout the late 1980s and early 1990s Mexico was held up as one of the bright stars of the International Monetary Fund and other proponents of market-oriented structural reforms. In response to its infamous 1981 debt crisis, Mexico had implemented an ambitious market-oriented plan to restructure its heretofore protected, state-oriented economy.[2] This plan included liberalizing international trade and investment (Mexico joined the General Agreement on Tariffs and Trade, or GATT, in 1986); privatizing government enterprises; cutting government expenditures and subsidies in order to balance the budget; and decentralizing governmental functions.

Despite the record high rates of inflation, deteriorating terms of trade, and falling real wages that characterized much of the 1980s, by 1993 Mexico was able to reduce inflation to the single-digit range, achieve modest economic growth, and attain balance-of-payments stability in the context of a relatively steady peso. Additionally, private capital was returning, mainly financing the country's rising imports but also providing badly needed investment in plant and equipment. All of this was accomplished while servicing

[2] In very general terms Mexico had pursued a policy of import-substitution industrialization (ISI) which required protection of its manufacturing sector through tariffs and quotas and government action in terms of subsidies and, in some cases, government ownership and operation in key industrial sectors (e.g., oil and gas). See chapters 3 and 7 for more on this.

and restructuring the external debt, which rose from about U.S.$86 billion in 1982 to $119 billion in 1993.

Meanwhile, in the United States (in 1994) a conservative Republican majority took control of both houses of Congress for the first time in several decades. While the Republican congressional leadership generally has supported free trade initiatives such as the Uruguay Round of negotiations (1986–94) of the GATT[3] and the NAFTA itself, many conservative members of Congress strongly opposed the NAFTA when it was debated and finally approved in November 1993. Now they and many liberal Democrats, who fear massive job displacements from U.S. multinationals exporting jobs to low-wage Mexico, strongly oppose expanding that agreement and the World Trade Organization, a new, more powerful institution which has supplanted the GATT.

Of course, the Mexican peso crisis provided NAFTA opponents in the United States a splendid example of how closer relations with "unstable Latin American countries" can weaken, rather than strengthen, the U.S. economy. But this view neglects other aspects of the NAFTA story. During the NAFTA debates the United States enjoyed a trade surplus (i.e., exports > imports) with Mexico, which helped compensate for its large trade deficit with Japan and other Asian countries. From this perspective closer trade relations with Mexico looked very attractive; but that perception changed quickly following Mexico's crisis—when the U.S. surplus turned into a deficit—and suddenly the NAFTA appeared to many U.S. observers as simply a bad deal.

Canadians too have had their problems with the NAFTA. Confronted with high unemployment, several years of economic stagnation, and exploding federal budget deficits, they are still adjusting to and debating the impacts of the Canada–U.S. Free Trade Agreement (CUSFTA) implemented in 1989. In recent years the Canadian economy has experienced significant restructuring as both U.S. and Canadian firms adjust to an increasingly borderless economy and the challenges and opportunities it presents. Additionally, the specter of Quebec's secession and a lingering constitutional crisis has taken its toll on Canadian unity and enthusiasm for freer trade.

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[3] The Uruguay Round refers to a series of negotiations between 1986 and 1994 that substantially expanded the "rules of the game" for international trade under the GATT. Additionally, a new institution (the World Trade Organization, or WTO) was created that provides expanded powers to crack down on unfair trade practices. For more details, see the discussion of the GATT and the WTO in chapter 2.

Nevertheless, as a small country, Canada is more dependent on international trade than is the United States and generally open to the concept of adding more members—trading partners—to the NAFTA. Not only is a multilateral agreement likely to increase Canadian exports, but more NAFTA members would dilute the bargaining power of the United States—the largest and most powerful of the three countries—in negotiating the agreement and settling trade disputes.

Clearly the first two years of NAFTA's implementation have been difficult for the three countries, and much of the blame has been directly or indirectly placed on the agreement itself. While the NAFTA does not seem to be in danger of being dismantled at this time, a "widening" of the agreement to include more members or a "deepening" to further integrate the three countries certainly appear less likely than in January 1994.

The NAFTA Debates

The road to NAFTA was paved with harsh debates. Critics from the right and the left in all three countries argued, usually for different reasons, that freer trade would reduce national sovereignty and economic autonomy and give large multinational corporations (MNCs) more freedom to exploit the human and natural resources of member countries without regard for the needs of the populace or the environment. Proponents, however, maintained that freer trade would bring increased competition and efficiency, higher living standards, and a more competitive North American economy, better able to compete in global markets. Understanding these different perspectives and the events that led up to the implementation of NAFTA is essential to understanding what it is and where it might go in the future.

From the perspective of most market-oriented economists, it is quite natural that the three countries of North America negotiated, signed, and ratified a treaty to formally integrate their economies. The only question they might ask is, What took them so long? After all, from a purely economic point of view, the fact that Canada, Mexico, and the United States are close neighbors, with relatively complementary economies,[4] implies that

[4] Economic complementarity usually refers to the countries producing different types of goods and/or using different production techniques. For example, Mexico tends to specialize in basic manufacturing utilizing labor-intensive manufacturing techniques, while the United States tends to specialize in advanced manufactured products and services using capital- and knowledge-intensive production techniques.

they are natural trading partners. Thus, the three countries, already highly integrated economically,[5] would benefit from removing barriers to international trade and investment by forcing a more rational geographical redistribution of economic activity throughout the three countries, allowing for a better realization of potential economies of scale and more efficient allocation of resources.

Of course, economists acknowledge that there will be both winners and losers as international trade and investment expands. But, they argue, the gains from trade (i.e., lower production costs and lower prices to consumers) outweigh the losses that workers and firms in certain sectors of the economy are likely to sustain.

One question that bothered some economists is how to deal with the enormous disparities in economic development between Canada and the United States, on the one hand, and Mexico, on the other. In the case of the European Union, which recently (1992) brought together twelve countries into a "single market" after almost four decades of conscious integration efforts, the disparities between the most advanced countries (Germany and France) and the least developed (Spain and Portugal) were not as great as those between the countries of North America. However, in the European case a "social fund" was established to transfer resources from rich to poor countries in order to reduce the disparities between them and the instabilities that could result from those disparities. Yet, so sure were mainstream North American economists that a NAFTA based mainly on

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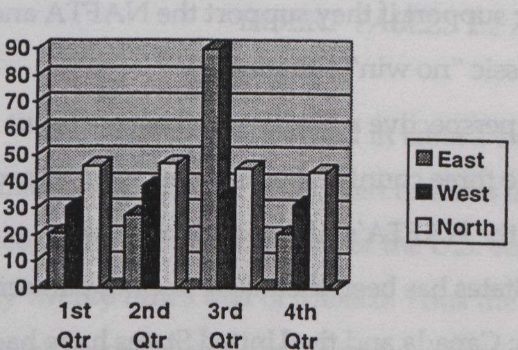

[5] The degree of integration is usually calculated as the total value of intraregional trade (exports among members) as a percentage of total exports of all the member countries. In the late 1980s, before implementation of either of the two free trade agreements, this was approximately 43 percent for North America, compared to around 59 percent for the twelve-country European Economic Community which had been involved in economic integration agreements since the late 1950s.

market forces would result in significant employment and income gains that such a fund was not seriously considered during the negotiations.[6]

Geographers, like economists, see the three countries of North America as "natural trading partners." Close proximity means lower transportation costs, and they would expect there to be a high degree of integration in the absence of significant natural or artificial barriers such as rugged mountain ranges or closed border gates. Additionally, they would look at the main trading patterns in the Canada–U.S. border region, where some 80 percent of all Canadians live within one hundred miles of the border, and see that trade mainly flows north-south, not east-west. This same pattern can be found in the U.S.–Mexico border region.

Historians, however, are likely to have a different perspective on NAFTA than mainstream economists or geographers. Given the United States' enormous size and hegemonic behavior as well as the history of conflict and lack of trust that has characterized North American relations over the last two centuries, historians might very well be astonished that such a treaty even reached the negotiating table.

Political scientists also have reason to be uneasy about a NAFTA. They tend to view free trade agreements as problematic issues for political candidates irrespective of their ideological positions. That is, free trade is usually seen by workers in developed countries as a threat to their economic security, especially during periods of stagnating wages and massive restructuring ("downsizing") like the early 1990s. However, large multinational firms, especially those in high-tech, export-oriented industries, tend to support freer trade and, through lobbyists, wield great power over political candidates. Therefore, politicians are likely to lose voter support if they support the NAFTA and campaign financing if they oppose it—a classic "no win" situation.

Thus, from a mainstream economic perspective a NAFTA makes sense, but from many others it does not. As noted above, the three countries' economies were already economically integrated before 1994, when the NAFTA's fifteen-year process of implementation began. In fact, the United States has been the major trading partner of both Canada and Mexico for many decades: Canada and the United States have had some

[6] The main argument against a social fund was that North America was building a "free trade area," not an "economic union." See chapter 2 for details on what distinguishes these two forms of integration.

sort of free trade arrangement since the mid-1960s, while the United States and Mexico have attempted to manage their trade relationship since the mid-1980s (see table 1.1).

Nevertheless, it is important to note that what is now emerging as a "trilateral" relationship is being created from two "bilateral" relationships that exists between the United States and Canada and between the United States and Mexico, respectively. The reality is that the bilateral relationship between Canada and Mexico is not now nor ever will be as important quantitatively or qualitatively as the other two. This is mainly due to the fact that the U.S. economy dwarfs those of Canada and Mexico and therefore serves as the "hub" in a "hub-and-spoke" relationship based as much on economic realities as on geography.

INSERT TABLE 1.1 ABOUT HERE

This relationship is clearly illustrated in tables 1.2 and 1.3, which provide an overview of North American trade relationships for the years 1989 (the initial year of the CUSFTA) and 1993 (the most recent data available). For example, table 1.3 shows that in 1989 U.S. exports to Mexico and Canada were approximately $78 billion and $25 billion, respectively, while exports between Canada and Mexico totaled less than $1 billion combined. It is roughly the same story if you look at imports among the three countries; the Canada-Mexico relationship simply isn't as strong as the U.S.–Canada or U.S.–Mexico link, but a comparison of the two tables demonstrates that the Canada-Mexico relationship is growing rapidly.

INSERT TABLES 1.2 AND 1.3 ABOUT HERE

The other data presented in table 1.4 reveal why this is so. In 1994 the U.S. population was approximately ten times as large as Canada's and three times that of Mexico, while the absolute size of the U.S. economy was also ten times that of Canada but nearly twenty times that of Mexico. Thus the United States is both the largest producer/exporter and the largest market/importer in the North American region.

INSERT TABLE 1.4 ABOUT HERE

Table 1.4 also provides other information on the three countries—most notably, each country's ranking on the United Nation's Human Development Index (HDI), developed in the late 1980s by the United Nations Development Programme (UNDP) and introduced in its 1990 annual report. It has since been refined and now combines three basic components of human development: longevity (life expectancy), knowledge (adult literacy and mean years of schooling), and standard of living (real GDP per capita adjusted for local cost of living, purchasing power parity). The UNDP holds that, with its latest refinements, the HDI provides a better measure of a country's socioeconomic progress than does simple GNP[7] per capita. Furthermore, the HDI can be used to evaluate progress over time and to guide policy making, and it provides a wider basis for comparing the experiences of different countries. In this context, note that the United States ranks ninth, while Canada ranks first and Mexico fifty-second, reflecting their enormous disparities not only in income but also in health and education.

Given these asymmetries in the trilateral relationship, the long history of conflict between the United States and its neighbors, and the lack of popular support for the NAFTA in the three countries, we might inquire as to exactly what did bring these three economies together in the early 1990s to draw up this agreement. Many factors, both internal and external, contributed. First, the election of a conservative, free trade proponent (Ronald Reagan) as U.S. president in 1980 and the election of his ideological equivalent in Canada (Brian Mulroney in 1984) certainly was important in bringing the United States and Canada together to negotiate the CUSFTA in the late 1980s. Then when Mexico elected Carlos Salinas de Gortari in 1988, another free trader (educated in the United States), the stage was set, at least politically, for such an agreement.

From an economic perspective there are several factors worth mentioning here. First, the case can be made that the relatively weak competitive positions of all three countries vis-à-vis key European and Asian economies forced the economies of North America to come together to defend their increasingly vulnerable domestic and export markets against foreign suppliers. Another factor was that North America was, in fact, becoming more integrated economically, and there seemed to be a growing consensus in

[7] GNP (Gross National Product) is very similar to GDP (Gross Domestic Product). GDP refers to all outputs produced within the geographic boundaries of a country, by both citizens and foreigners. GNP excludes output produced by foreigners living or working in the country.

the three countries that the integration process should be better managed in order to provide clearer "rules of the game" with respect to both international trade and investment flows. Still another factor was the desire—or, rather, the need—of both Mexico and Canada to gain guaranteed access to the large and prosperous U.S. market at a time when international trade conflicts, especially between the United States and Japan, were heating up.

To these must be added a number of external forces that played important roles. Why did these three countries, which by the mid–1980s had embraced a multilateral approach to trade negotiations through the GATT, decide to take a trilateral/regional approach to lowering trade barriers? After all, the GATT had been relatively successful: in a series of negotiating rounds over the last three decades; the GATT had reduced overt protectionism (e.g., tariffs and quotas) on manufactured products and introduced a system of rules and arbitration procedures which, although complex and cumbersome, had reduced trade conflicts in much of the world from their 1948 levels. Thus, why was this "global" approach pushed aside by a regional one in 1990?

Several factors influenced this decision. First, from the perspective of the United States and Canada, in the early 1990s the Uruguay Round of GATT negotiations did not appear particularly promising.[8] Second, other transnational regions (e.g., Europe and Asia) were putting together trading blocs that could potentially reduce North America's access to those markets.

Of final note, it was President Salinas of Mexico who initiated negotiations with the United States in 1990 after completing an extensive trip through Europe, during which he concluded that rebuilding Eastern Europe following the collapse of the Soviet bloc would likely absorb much of the financial capital that he had hoped to attract to Mexico. Thus he turned to the United States for both increased trade and investment. Canada, already in a free trade agreement with the United States, then decided to join the (trilateral) negotiations, primarily to protect its own interests by working with Mexico to

[8] The agenda of the Uruguay Round (1986–94) focused on reducing tariff and nontariff barriers on a wider spectrum of products (including agricultural products and services) while increasing protection for "intellectual property" (i.e., patents and royalties). At the time that NAFTA negotiations opened in 1990, progress in these areas was particularly slow.

counterbalance the enormous power of the United States and to avoid being excluded from a favorable trading relationship with Mexico.

The NAFTA negotiations lasted approximately three years (1990–93). During much of this time a serious global recession increased unemployment and undercut most people's incomes. Large and small firms throughout the world began a process of "restructuring," usually implementing new management practices such as "just in time" inventory systems and "total quality management," and eliminating jobs ("downsizing") at all levels. Suddenly, the long-standing concerns of workers, foremen, and managers, who saw their jobs evaporating, roiled the waters of the NAFTA debates in all three countries. In general there were four sources of criticism:

- Labor and community groups, mainly in Canada and the United States, decried the loss of jobs in the manufacturing sector, the deteriorating living standards that they predicted would result from freer trade and from MNCs moving jobs to lower cost locations, and the resulting disruptions to communities that would follow. However, most labor groups in Mexico, long loyal to the official government party, saw job and perhaps wage gains resulting from the NAFTA and, therefore, for the most part sided with the government's pro-NAFTA position.
- Environmentalists in all countries, citing the poor environmental enforcement record in Mexico, feared a massive exodus of firms out of Canada and the United States to escape those countries' stricter enforcement policies, aggravating both regional and global pollution as well as driving the job displacements noted above. Additionally, a growing group of environmentalists, who oppose expanding international trade generally, sided with the anti-NAFTA forces. They maintained that increasing "global interdependence" could have enormous negative effects on both the environment (e.g., through oil spills) and "institutions of community" within national borders.
- Human rights groups in the three countries pointed to the absence of truly democratic processes and the large number of human rights violations in Mexico. They argued that increasing trade links would implicitly condone such behavior. It is widely recognized that, while Mexico had dramatically reformed its economy, political reform had consciously been relegated to the back burner.

- In both Mexico and Canada, NAFTA opponents were concerned with the potential loss of cultural identity, sovereignty, and political autonomy that could result from a closer, more open relationship with their much larger and more powerful trading partner.

The opposition to the NAFTA produced concrete results: three complementary agreements were generated, one dealing with environmental concerns, another with labor practices, and a third with protecting the harmful effects of import surges (i.e., sudden increases in the volume of U.S. imports).

Understanding the NAFTA

"Economic integration occurs when two or more countries join together to form a larger space. Countries enter integration arrangements in the expectation of economic gain."[9] Economic integration can occur in a variety of forms—from a simple free trade area to a much more complex economic union (see chapter 2)—but the essence of economic integration is linking national economies.

From the outset it should be clear that the NAFTA is not simply a free trade agreement among the three nations. If it were, it would consist of considerably fewer than the approximately two thousand pages that were needed to adequately define the new North American economic relationship. The NAFTA extends to include rules on foreign investment and the treatment of intellectual property, but, significantly, it excludes labor flows.[10]

In order to understand the NAFTA, its implications, and its future development, we have provided—in the next seven chapters—a brief but comprehensive overview of what you need to know, including:

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[9] Franklin R. Root, *International Trade and Investment*, 7th ed. (Cincinnati: South-Western Publishing, 1994).

[10] There are provisions for the temporary entry of certain white-collar workers in certain occupations, but in general terms the agreement does not provide for the free movement of workers between member countries, as does the European Union.

- the economic theory of international trade and economic integration underlying the NAFTA and any subsequent agreements that may emerge in the future (chapter 2),
- the circumstances and the (global) environment that brought the three countries together to negotiate the NAFTA and its complementary agreements in the early 1990s (chapter 3),
- the major points regarding the economic development of each country in the context of the changing global economy and the institutions responsible for managing it (chapters 4–6),
- what NAFTA does and does not do (chapter 7), and
- alternative paths for the future development of the NAFTA and the likely impacts of NAFTA on business, the environment, and other aspects of North American life (chapter 8).

Table 1.1

CHRONOLOGY OF IMPORTANT EVENTS

HISTORY

1854 - 66	U.S. - Canada Reciprocity Treaty
1866	Treaty abrogated by U.S.
1869 - 1923	Canada attempts to reinstate Treaty 7 times
1882	U.S. - Mexico Reciprocity Treaty

- *1965 - U.S. - Canada Auto Pact*
- *1979 - Mexico rejects GATT Membership*
- *1979 - U.S. assesses "special relationship" with Mexico (PRM51)*
- *1982 - Mexico looses "Injury Test"*
- *1982 - U.S. - Mexico Agreement on Subsidies & Countervailing Duties*
- *1986 - Mexico joins GATT*
- *1987 - Framework Agreement on Bilateral Trade (U.S. & Mexico)*
- *1989 - Implementation of U.S. - Canada FTA begins*
- *1990 - President Salinas proposes a U.S.- Mexico Trade Agreement*
- *1991 - NAFTA negotiations begin*
- *1992 - Single Market completed in Europe*
- *1994 - Implementation of NAFTA begins*

Tal. ~~2~~ 1.2

NORTH AMERICAN TRADE RELATIONSHIPS

INTRA-REGIONAL EXPORTS-IMPORTS (1989)

(In million of US dollars)

	U.S. Imports **% of total imports**	Canadian Imports **% of total imports**	Mexican Imports **% of total imports**	TOTAL EXPORTS TO THE WORLD	**% OF EXPORTS TO NAFTA**
U.S. Exports % of total exports		**70.93%** 78,266 21.13%	**72.92%** 24,969 6.74%	370,417	**27.87%**
Canadian Exports % of total exports	**18.51%** 85,305 69.31%		**1.53%** 525 0.43%	123,084	**69.73%**
Mexican Exports % of total exports	**3.51%** 16,163 31.68%	**0.25%** 272 0.53%		51,019	**32.21%**
TOTAL IMPORTS FROM THE WORLD	460,887	110,345	34,240	544,520 605,472	
% OF IMPORTS FROM NAFTA	**22.02%**	**71.17%**	**74.46%**	—	

(Source: Direction of Trade Statistics Yearbook, IMF)

* Due to different measurements used (FOB prices versus CIF prices) Exports from one country to another do not always correspont from Imports from the [illegible] cou[illegible]

Tab. 1.3

NORTH AMERICA TRADE RELATIONSHIPS

INTRA-REGIONAL EXPORTS-IMPORTS (1993)

(In million of US dollars)

	U.S. Imports **% of total imports**	Canadian Imports **% of total imports**	Mexican Imports **% of total imports**	TOTAL EXPORT TO THE WORLD	% OF EXPORTS TO NAFTA
U.S. Exports % of total exports		73.91% 100,177 20.85%	69.55% 41,636 8.67%	480,443	29.52%
Canadian Exports % of total exports	19.65% 114,448 78.78%		1.00% 599 0.41%	145,280	79.19%
Mexican Exports % of total exports	6.36% 37,041 72.60%	1.97% 2,665 5.22%		51,019	77.83%
TOTAL IMPORTS FROM THE WORLD	582,353	135,532	59,861	676,742	
% OF IMPORTS FROM NAFTA	26.01%	75.88%	70.56%		

(Source: Direction of Trade Statistics Yearbook, IMF)

Table I. 4.

COMPARATIVE STATISTICS: NAFTA PARTICIPANTS

Country	Population (1993 Million)	GDP (1993 U.S. $ Million)	GDP Per Capita (1993 U.S. $ 'ooo)	Exports (1993 U.S. $ Million)	Imports (1993 U.S. $ Million)	U.S. XP as Share of Imports (%)	U.S. Exports To (1993 U.S. $ Million)	U.S. Imports From (1993 U.S. $ Million)	External Debt (1993 U.S. $ Million	Inflation 1980-90 (%)	Inflation 1993 or latest (%)	Life Expectancy (Years)	HDI rank
CANADA	27.8	617,700	22,219	13,900	125,300	80	100,444	111,261	435,000	4.4	1.9	78.1	1
MEXICO	90.4	740,000	8,186	50,500	65,500	63	41,581	39,917	125,000	70.3	8	72.9	52
U.S.A.	258.1	6,379,000	24,715	449,000	582,000	0	NA	NA	NA 0	3.7	3	75.9	9
TOTAL	376.3	7,736,700	20,560	613,400	772,800	74	142,025	151,178	560,000	10.1	3.4	75.3	

delete

CHAPTER 2

International Integration : Theory and Practice

W.A. Kerr

This chapter has two main objectives: (1) to put the concept of international integration within the context of economic theory; and (2) to describe and provide insights into the international institutions countries have put in place to regulate the process of international integration. Understanding the theoretical basis for economic integration is important because, to a considerable extent, government initiatives regarding trade and other aspects of integration are influenced by theoretical arguments. As with any change in government policy, changes to how nations interact with each other will involve trading off a set of benefits against costs. Theory can provide insights into those benefits and costs. This chapter discusses the major theories of international trade and the insights they provide for policy makers.

International commercial relationships with other countries will impinge on a nation's sovereignty. To provide a commercial environment where firms are willing to invest in trade-related activities requires rules for trade and other aspects of international commercial activity that trading nations accept. As these rules limit nations' sovereignty, a large number of international organizations have been established to facilitate the difficult trade-offs between the need for a secure business environment by those engaged in international commerce and the sovereignty concerns of nations. These international organizations have evolved over time. They are described and the extent of their role in the process of international integration outlined. The combination of theoretical arguments and institutional arrangements presented in this chapter should provide the background required to understand the complex issues dealt with in the chapters that follow. Without a basic grounding in trade theory and the organizations of international commercial relations, it will not be possible to fully appreciate the impact NAFTA will have on North American integration or the opportunities it creates for individual firms.

International Trade Theory

International integration is an idea that encompasses a very wide range of institutional arrangements among nations—open borders, coordination of economic strategies, common political institutions, and shared responsibility for the well-being of individuals, to name only a few. International integration is also a matter of degree, with many possibilities between the polar cases of a nation-state that does not engage in international trade (practices autarky) and has no relations with other countries (is isolationist), to the complete abrogation of national sovereignty to another level of political authority. While almost all modern nation-states represent, to some degree, an evolutionary process whereby smaller political groups have surrendered sovereignty, no examples of completely isolated countries exist. All nations trade and enter into discourse with other states, however minimally. Most nations are heavily involved economically and politically with other nations and, hence, exhibit a considerable degree of international integration. While international integration encompasses a wide range of institutional arrangements, the fundamental motivation for interaction with other nations is the perceived benefits from engaging in trade. Hence an understanding of why benefits from trade are expected to arise is essential to any discussion of international integration.

Why Study International Trade Theories?

Even among economists (who are well known for abstract theorizing), the theory of international trade is considered more as a purely intellectual exercise than a policy-making tool. The importance of international trade theory, however, lies in its ability to provide fundamental insights into the economic forces underlying nations' trade. The world of international commerce is exceedingly complex, and only by stripping away the nonessentials can the basic principles of trade be uncovered. Hence, while the assumptions often imposed in trade theory—e.g., only two goods, two countries, two factors of production—often appear extremely unrealistic, it is important to concentrate on the insights provided by the results generated by trade theories.

The insights deriving from international trade theory are important because, in spite of the restrictive assumptions of the models, they have weathered the test of critical intellectual scrutiny over a very long period and, hence, have come to be generally accepted by political decision makers. As a result, these propositions represent the underlying basis for trade policy, particularly in the major developed economies. Thus, unless one has a basic understanding of trade theory, it is not possible to comprehend the dynamics of nations' international commercial relations.

The Determinants of International Competitiveness

Since the earliest investigations of economic activity, it has been recognized that firms in different countries initiate transactions with firms in other countries because it will bring them some advantage. This is one of the cornerstones of *The Wealth of Nations*, written by the Scottish economist Adam Smith in 1776. The reasons for exchanges between firms in different countries are no different than those that underlie exchanges between firms in the same country. To understand this fundamental point is extremely important. This is because concerns are often expressed regarding transactions taking place internationally that would not illicit any comment if undertaken by two firms in the same country. This suggests that the source of concerns regarding international transactions must be based on a perception that what may be good for an individual firm may not necessarily be good for the nation. It is also important to realize that nations themselves do not trade, only firms.[1] Why then, are international trade issues often so politically charged and trade debates so heated?

The reason lies in the concept of competitiveness. The bundle of goods and services traded and their volumes are determined by the relative competitiveness of the firms in a nation. The types of goods a nation exports or imports are important indicators of that nation's degree of economic development. While the perception of

[1] Of course, in some countries the government or its agents may actually undertake all or part of a nation's international commerce. If this is the case, different types of advantages may be perceived as arising from trade than those associated with the strict commercial interest of private firms. Transactions must, however, still be organized, and a nation's trade is only the sum of these transactions.

what constitutes a developed country has changed over time—for example, from a producer of iron and steel in the early part of the twentieth century to a producer of automobiles and planes in the middle part of the century to a producer of computer software and microchip designs in the latter decades—a failure to competitively produce the goods and services that conform to the current definition of a developed country gives rise to political concerns. Further, when international competitiveness appears to be declining, political action is often called for to restore it.

The factors that determine a nation's international competitiveness are exceedingly complex. In some cases, competitiveness is related to factors over which nations have little control—the availability of natural resources, geographical location, and climate. For the most part, however, competitiveness relates to factors over which governments can exercise some control—the skills of the labor force, higher education, the legal and commercial environment, infrastructure such as roads and ports, entrepreneurial incentives, taxes, research and development activity, the market power exercised by foreign firms, and the activities of foreign governments. Trade theories help identify the sources of competitiveness and what causes them to change.

Alternative Theories of International Trade

Trade theory has undergone a long evolution in its quest to explain competitiveness, but as yet no comprehensive theory has been developed. The insights gained along the way, however, are considerable. *Classical* theories of international trade—most closely associated with the work of Adam Smith in the eighteenth century and David Ricardo in the nineteenth (Smith 1961; Ricardo 1951)—were primarily concerned with showing that trade was beneficial to the nations that engaged in it. The two simple proofs of classical trade theory, *absolute advantage* and *comparative advantage*, still provide much of the popular intellectual underpinnings for belief in trade liberalization.

If two nations voluntarily trade, then both must gain if each country specializes in producing the good for which it has an *absolute advantage*. Advantage is defined by efficiency in resource use. The good that the country produced would then be exchanged in trade for the commodity in which it had an absolute disadvantage. This intuitive result can best be proved through a simple numeric example. In table 2.1 we have two countries (Canadiana and Americana) and two goods (oranges and pencils). By expending one unit of labor, Canadiana can produce one orange. Alternatively, Canadiana could use one unit of labor to produce four pencils. For an equal commitment of labor, Americana can produce five oranges or three pencils. Clearly Canadiana has an absolute advantage in producing pencils, and Americana has an absolute advantage in producing oranges. Assume that people in Canadiana will exchange one pencil for one orange. Americana could shift one unit of labor from producing pencils to producing oranges (it is beginning to specialize in orange production). If Americana can trade five of its oranges for five pencils produced by Canadiana, it will gain two pencils (i.e., by moving one unit of labor from its own production of pencils, three pencils less are produced but five pencils are gained from trading). The five units of oranges Canadiana receives from trading would have required it to expend five units of labor time if they were produced domestically. If Canadiana had used this labor time producing pencils, it could have produced twenty pencils. By specializing and trading, Canadiana can make a net gain of fifteen pencils (twenty minus the five pencils it must trade). Of course, people in Canadiana have given up nothing because the five oranges they are no longer producing have been acquired by trading.

TABLE 2.1

Absolute Advantage

(output per unit of labor)

	Oranges	Pencils
Canadiana	1	4
Americana	5	3

Our example has shown that by specializing in the production of the good in which it has an absolute advantage and then engaging in international exchanges, a country can make gains. The next important question that comes to mind is, "Should a country trade if it is more efficient in the production of all goods?"

The law of *comparative advantage* states that a country with an absolute advantage in the production of both goods (in a two-good world) should specialize in producing and exporting the good in which its absolute advantage is the greatest—importing the other good. This is numerically illustrated in table 2.2. In this example, Mexicana has an absolute disadvantage in the production of both steel and silver, meaning that Americana is more efficient at producing both goods. Americana is seven times more efficient in producing steel and twice as efficient in producing silver. As its major advantage is in producing steel, Americana's comparative advantage is in the production of steel. Compared to Americana, Mexicana is least inefficient in producing silver, (3:6) versus (1:7), and can be said to have a comparative advantage in silver production.

TABLE 2.2

Comparative Advantage

(output per unit of labor)

	Steel	Silver
Mexicana	1	3
Americana	7	6

To illustrate the gains from trade, assume Americana can exchange 7 kg of steel for 7 kg of silver. If Americana chooses to shift 1 unit of labor out of the production of silver and into the production of steel, it could produce an extra 7 kg of steel. This extra steel could be traded for 7 kg of silver. As only 6 kg less silver was produced, Americana would gain 1 unit of silver compared to its no-trade position. Mexicana would also gain because the 7 kg of steel it received for its silver would have taken 7 units of labor time to produce. Mexicana could now use that labor effort to produce 21 kg of silver, trading 7 kg of this extra silver production for an extra 7 kg of steel. Hence it would have the same quantity of steel and an extra 14 kg of silver by specializing and trading. Mexicana gains more (14 kg of silver) than Americana (1 kg of silver), but they both have gained by specializing and entering into trade with one another. This is the fundamental (and somewhat counterintuitive) lesson of the theory of comparative advantage. The potential for exploiting gains from trade arising from comparative advantage remains the most popular justification for trade liberalization to this day.

While classical theories of trade focused on the benefits to be gained from trade, they did not answer the question, "What determines comparative advantage?" Classical economists suggested that the quality of natural resources or differences in climate led to differences in the efficiency of labor. While this provided a reasonable explanation when trade consisted largely of agricultural and resource-based commodities, it did not seem relevant in the case of industrial goods.

In the 1930s, a new *neo-classical* theory of trade was developed to explain how comparative advantage could arise (Ohlin 1933). Neo-classical theory assumed, in addition to the two countries and two goods of the classical economists, two factors of production—usually stylized as capital and labor. Further, the two output goods were assumed to have different factor intensities—one using more capital than labor, the other more labor than capital—but the production technology used was assumed to be the same in both countries. If the countries have different resource endowments—one country has relatively more capital than the other—neo-classical theory predicts that the capital-rich country will specialize in the production of capital-intensive goods and then export them. The labor-intensive country would specialize in and export labor-intensive goods. For example, Mexico, with its abundant labor, would be expected to export labor-intensive goods to the United States and Canada, while labor-short Canada and the United States would export capital-intensive goods to Mexico. A further neo-classical conclusion was that in capital-abundant countries, labor productivity (and hence income) would be high because labor had more capital to work with. This conclusion of neo-classical trade theory led to a host of government policies designed to increase capital accumulation as a way to improve a country's standard of living. Another important conclusion of neo-classical trade theory was that if countries were opened up to international trade, labor in the capital-intensive country would shift out of the production of labor-intensive goods and into the production of capital-intensive goods—for example, out of producing textiles and into the production of cars.

While it offered powerful arguments to explain comparative advantage, neo-classical trade theory does not provide an all-encompassing explanation of comparative advantage. It has been argued (Keesing 1966) that nations whose populations include a large proportion of highly skilled labor and professionals will specialize in the export of skill-intensive goods. Countries with large quantities of unskilled labor will export goods requiring little skill, producing little reward for labor. As skills can be altered through education—often called investment in human capital—governments have initiated programs to improve the skills of their workforces.

Efficiency can be affected by the size of industrial enterprises. To a point, large industrial enterprises tend to be more efficient than smaller enterprises—they embody *economies of scale*. If a country can gain the lead in attaining economies of scale, they will have a lower unit cost than foreign competitors and export those goods. Government intervention in the economy has often been focused on aiding industries to achieve economies of scale, "picking the winners" and supporting them.

Innovativeness has also been suggested as a means of generating a comparative advantage. Countries that develop new products are able to gain a technological advantage (and possibly economies of scale) over other countries. Profits are gained by exporting before the competition catches up (Posner 1961). Vernon (1966) postulated that traded industrial goods go through a *product life cycle* whereby production and exporting ability gradually move from innovating countries to countries with abundant low-skilled labor. This would seem to fit the pattern observed for many electronics goods developed in the United States and other developed countries whose production gradually moves offshore. In part, the *maquiladora* sector along Mexico's border with the United States is a manifestation of this phenomenon. The mature "stages of production" have moved to Mexico while the development of new products and manufacture of components remain situated in the United States.

These theories suggested that comparative advantage could be generated by being more innovative than competitors. Programs designed to encourage or directly fund *research and development* (R & D) have been put in place by most governments in developed countries.

Neo-classical theory, as well as the theories that followed it, predicted that countries would trade goods produced in different industries—e.g., wheat for steel. But during the 1960s it became obvious that trade was growing fastest between advanced industrial countries and that this trade was in goods from the same industries, albeit in differentiated products—e.g., Budweiser for Heineken (Balassa 1975).

Consumer tastes are, at least in part, determined by income. As people become wealthier, they desire better quality goods and greater variety. These are often only available from abroad, but at a premium. As incomes rise, consumers may well be willing to pay these premiums (Barker 1977). The opening up of trade and the commensurate larger market will allow firms to specialize in the production of varieties.

Clearly there is no single trade theory that can explain all aspects of trade. Success as a trading nation is likely to depend on a large number of factors.

Why Are Some Countries More Successful in International Commerce?

Some countries' industries continue to be successful even when factors such as labor costs, available resources, and so on, worked against them. Porter (1990) identified four major determinants of international competitiveness:

- Factor endowments, whether basic (natural resources, labor, etc.) or advanced (labor skills, technical knowledge, infrastructure). Basic factors can give a country a competitive edge in the production of certain goods; it is the availability of the advanced variety that maintains and enhances it.
- The size and composition of the domestic market relative to foreign demand, specifically the demands placed on local firms by domestic consumers relating to the quality and upgrading of their products. If the home market is demanding, firms are often better prepared to sell in international markets.
- The existence of internationally competitive support industries: banking, transportation, communications, information.
- Domestic industrial rivalry which forces firms to adopt innovative organizational structures and managerial strategies. Firms in sleepy, protected industries are unlikely to be international competitors.

These four aspects are mutually reinforcing. A nation's competitiveness in a particular area can be achieved and enhanced if favorable demand conditions coexist with plentiful factor endowments, successful and competitive support industries, and a group of producers whose rivalry encouraged them to make full use of the other conditions and to continually upgrade and improve their products. Governments' attitudes toward education, R & D, and the provision of advanced communication and infrastructure could affect factor conditions. Their industrial and competitiveness policies, along with taxes and interest rates, can influence firms' strategies, structures, and security, as well as those of support industries.

What Conclusions Can Be Drawn from Trade Theories?

While no comprehensive trade theory has yet been developed, trade theories are useful in explaining trade patterns in certain groups of goods. Those that require unsophisticated labor inputs, a heavy degree of natural resources, or a favorable climate will be traded according to absolute or comparative advantage. Thus trade in goods coming from the extractive industries (i.e., petroleum, minerals, timber) or basic agricultural commodities such as wheat and corn can be explained adequately by classical trade theory. Goods whose production requires standardized technologies and no specific factor inputs will be produced in countries that offer the best combination of factor prices: textiles or unsophisticated electronics will trade according to simple neo-classical trade theory. More sophisticated goods will be produced in innovative countries with highly skilled labor forces. As these goods require efficient supporting industries, they will be produced in advanced countries and exported both to other advanced countries and to developing countries.

Theoretical explanations of trade patterns feed directly into policy debates concerning what governments can do to improve a country's competitiveness. The main classical conclusion—that countries gain from trade—has stood both the test of time and considerable intellectual scrutiny. Totally open economies, however, have not often been observed.

Protectionist Arguments and Managed Trade

While trade theories suggest there are gains to be made from an open international trading regime, protectionist sentiments are deeply rooted and have considerable political appeal.

The Benefits of an Open Trade Regime

It is common to think of success in trade as arising from increases in exports. Exports are "good" while "imports" are somehow "bad." This is a fallacy. A general increase in international exchanges—both imports and exports—is desirable. The gains from trade arise from moving resources out of relatively inefficient industries and into efficient industries, with part of the extra production from efficient industries exchanged for the inefficiently produced goods that have been given up. Over the long run, lowering trade barriers will allow countries to reap benefits from trade.

Protectionism and Political Economy

One of the longest-ranging debates in economics and politics centers around the degree to which a nation's economy should be protected from the rigors of international competition. This is in spite of the theoretical evidence suggesting that countries gain from trade. Further, few of those who are identified with protectionist sentiments would advocate an autarkic trade policy (i.e., that Canada should produce its own bananas rather than importing them). The case for protection is, however, often made for existing industries that find themselves noncompetitive internationally.

The reasons for this are simple. All of the gains that are expected to arise from trade in the models discussed above are based on the premise that resources can move easily (and costlessly) from declining, less competitive to expanding, more competitive industries. Neo-classical trade models are "timeless" and all adjustments are long run.

Of course, resources do not move easily. Labor employed in textiles one day does not quickly and costlessly switch to making computers the next day. When foreign competition leads to the downsizing or closure of domestic firms, layoffs occur. People become unemployed. Skills applicable to one industry may not be useful in the expanding sector. Even if those let go from declining industries can find work in other sectors, it may require a move to a new location halfway across the country. Moving one's household is not costless. Further, if the declining industry is a locally or regionally important industry, its downturn will mean that the value of the assets—such as housing—of those now unemployed will fall, making it even more difficult to get established somewhere new. Workers may find themselves faced with a costly retraining period.

The owners of existing businesses will also find the value of their productive assets threatened by foreign competition. Support industries, and in some cases whole communities, may be threatened by an industry's decline. Hence, foreign competition creates a coalition of *vested interests* in the status quo. These vested interests are often difficult for politicians to ignore. Trade theorists argue that as there are considerable gains from trade available, those who are winners in the process should compensate the losers. Unfortunately, in practice, direct compensation is almost impossible to organize and, hence, does not occur.

Governments have three basic policy approaches to the problems created by declining competitiveness. First, they can ignore the problem. Unemployed workers must rely on the social welfare system and bear most of the costs of adjustment themselves. Second, the government can provide retraining, moving assistance, and other adjustment packages for displaced workers. Both of these courses of action may require considerable government expenditures. The third option is to attempt to prevent the industry's decline by erecting trade barriers against foreign competitors. Costs are imposed on consumers of the protected goods, but budgetary expenditures are not required unless the protection is temporary and combined with a government restructuring package.

It is often difficult for politicians to ignore the concerns of vested interests. To the extent that declining industries are geographically concentrated, locally elected members of legislative bodies may have to promise expensive adjustment packages or protection to ensure re-election. However, delivering on protectionist packages promised to local constituents may be difficult for individual politicians because they represent only one voice in a larger process of government with national concerns as its priority. For example, in the United States, with its system of divisions of powers, the administration (with its national focus) tends to be *free-trade* oriented while Congress (with locally elected members) is more *protectionist*. To improve their effectiveness, members of Congress or Parliament must form strategic voting alliances (log rolling) with members who represent other industries in separate geographic locations seeking protection. These "I'll vote to protect your industry if you'll vote to protect mine" tactics can lead to protectionism being a major political force.

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Of course, there may be compelling reasons for not wanting certain industries, or types of industries, to disappear from a nation's economy. Domestic production of strategic military goods—parts for jet aircraft, specialized lubricants, communications electronics, etc. Even in these cases, however, one must be careful not to confuse true strategic needs with the arguments of vested interests. Often it may be far less expensive to store vital military supplies or civilian necessities than to protect the existence of domestic industries on an ongoing basis. In most cases, domestic production, including food production, can be brought on line relatively quickly in times of crisis, well before carefully managed stockpiles are depleted. When this is not the case and the domestic industry needs to be kept in production, it is usually less costly to provide a direct subsidy than to put up trade barriers with their resulting multisector distortions.

Another common protectionist argument is the *infant industry* theory. The premise of this theory, and its variants, is that a country could have a comparative advantage in the production of a good if the initial difficulties associated with establishing a new industry could be overcome. The task of establishing a new industry can be much more difficult if the industry is already well established in other countries. As foreign firms already have all the "teething" problems sorted out, their lower-cost exports make it almost impossible for the infant domestic industry to become established. Hence the domestic industry requires temporary protection. The evidence would suggest, however, that infant industries fail to grow up and that protection is seldom temporary. There are a number of reasons for this. One is that infant industry firms must rely on the domestic market initially. If there are considerable economies of scale in the industry, the domestic market may not be large enough to justify an efficient scale of operation. As a result, smaller plants with higher unit costs are built. Removal of trade barriers would leave these firms vulnerable to foreign firms already able to gain the cost advantages associated with economies of scale. In Canada, with its small domestic market, industries established under infant industry policies were victims of this dilemma. Once established behind trade barriers, it is often easier for firms to successfully argue for continued protection than to make the cost adjustments necessary to become internationally competitive.

One variant of the infant industry theory is the *senile industry* argument. The argument is that an industry that has lost its comparative advantage may be able to regain it if it receives temporary protection so that it can re-equip its factories and retrain its workforce. These costs could be recouped if it acquired a greater share of the home market. Whether one can distinguish between a loss of competitiveness due to poor management or a genuine change in a country's comparative advantage is, however, questionable.

A more sophisticated version of the infant industry theory was the basis of many developing countries' industrialization policies from the 1940s through the 1970s. It was argued that to break out of their dependence on low-growth, low-value industries such as agriculture and resource extraction, countries needed to industrialize. As developed countries already had the lead in manufactured goods, it would not be possible for competing industries to become established in the home market of developing countries without protection. This strategy became known formally as *import-substitution industrialization* (ISI)—substituting domestically produced manufactured products for imports—and was particularly popular in Latin America, including Mexico. Many inefficient industries were established as a result. These industries were unable to compete internationally and, once the growth potential of the domestic market was exhausted, these industries acted as a brake on further economic development (Flanders 1964).

One of the most often expressed arguments, but the least sophisticated, is the *cheap foreign labor* argument. According to this argument, workers in developing countries are paid much lower wages than is the case in developed countries. Hence the developed country will be swamped by less-expensive foreign imports, domestic businesses will be bankrupt, and workers will be unemployed. While this can be true for any individual firm or even industry, it cannot be true for the whole economy. Imports have to be paid for. Over the long run, the only way imports can be financed is through export sales. This means that other industries in developed countries must expand. Of course, this is simply the normal manifestation of resource reallocation to take advantage of shifting comparative advantage and the benefits that specialization provides to the nation as a whole. These theoretical advantages, however, provide little comfort for those who face unemployment as a result of foreign competition. They will lobby hard to protect their livelihoods. As a result, when dealing with declining comparative advantage, most governments follow policies that are combinations of assistance for adjustment, social welfare benefits, and protectionist policies.

The Trade Reality: Managed Trade

The trade policy of any country represents a political compromise between the two forces outlined above—the perceived benefits of an open trade regime and protection conceded to those with a vested interest in the status quo. No country has a completely open trade regime, nor does any country practice total autarky. All countries operate trade regimes that fall in the middle ground of *managed trade*. Under a wide variety of rationales, certain industries receive protection from trade measures while others operate in a virtually free trade environment. Many of the existing trade restrictions are the result of retaliation for the actions of other countries who found it politically expedient to impose protectionist measures. Protection damages the interests of the countries from which they source their imports. For example, if German products using high-quality Swedish steel as a major input were excluded from the Japanese market, Sweden as well as Germany might retaliate against the Japanese. These countries often retaliate with protectionist measures of their own. The degree of protectionism and openness that characterizes a nation's economy is seldom static, with swings between more protection and more openness common. This is because politicians seldom envision that the protection they are extending is permanent and because the arguments for trade liberalization are so compelling. As a result, the long-term trend is toward liberalization while the short run can be punctuated with (often dramatic) increases in protection.

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When economies are booming, the forces of liberalization tend to gain the upper hand. In part, this is because in a growing economy it is far easier for those in industries whose relative efficiency is declining to find employment in alternative sectors. Industries experiencing rapid growth cannot be as choosy about their labor force and are more willing to make the investment in workers' retraining. Booms also mean that governments have more tax revenues available which can be applied to adjustment policies. On the other hand, during economic slumps, protectionists tend to be on the ascendancy. Those who become unemployed will have difficulty finding employment in alternative industries. Governments faced with declining tax revenues and rising social welfare costs are more prone to opt for the *cheap* option of raising trade barriers. Many of the trade barriers that have existed between developed countries in the second half of the twentieth century arose out of the Great Depression of the 1930s, when desperate governments initiated a host of protectionist measures in vain attempts to isolate domestic jobs from the worldwide economic decline. The result was a retaliatory *beggar-thy-neighbor* spiral that both deepened and lengthened the Great Depression. One can view the entire period from the end of World War II until the start of the Uruguay Round of trade negotiations in 1986 as a long, torturous process focused on removing the trade barriers enacted largely on manufactured goods in the 1930s. While in the Uruguay Round the focus of trade negotiations shifted to new issues such as trade in services, international protection for intellectual property, and rules for foreign investment, there was still considerable effort put into reducing trade barriers first erected almost half a century before.

Managed trade implies rules for international commerce. If imports are going to be limited or prohibited, there must be rules that firms engaged in international commerce can follow. Governments like to have very flexible systems so that they can react to protectionist pressures easily. Businesses engaged in international commerce, which often requires large investments, desire protection from capricious—and unanticipated—acts by governments. An American firm that has made a large investment in exploiting export potential wants to be sure that the Canadian government cannot act to curtail imports once that investment is made. It is not much consolation to the U.S. investors that the U.S. government could retaliate against Canadian exports of some unrelated product; their investment is still lost. Of course, Canadian exporters to the United States are seeking the same assurances. To protect the interests of their exporters, governments are forced to enter into discussions with other governments regarding rules for trade: under what circumstances countries can raise tariffs or impose import quotas, how they will be calculated, how often they can be changed. Firms often engage in international commercial relationships in a number of countries. For them, a common set of rules provides an advantage: they do not have to learn, monitor, and possibly alter their production practices to comply with, regulations of many countries. As a result, multinational rules for the conduct of trade are sought.

A host of bilateral, regional, and international agreements have been negotiated to facilitate managed trade. These agreements represent a compromise between governments' desires to retain freedom of action and businesses' desires for security in their international dealings.

Economic Integration

While the benefits from trade provide the incentive for nations to engage in discussions regarding international commerce, to fully capture the benefits from specialization and commercial interactions, states may consider cooperation on a number of economic fronts. This wider process of international economic cooperation is known as *economic integration*. All formal international agreements limit the actions of the individual nations taking part in the agreement. Each nation must weigh the expected benefits of closer economic ties against the loss of its sovereignty when deciding what degree of international integration to pursue.

Questions of Sovereignty

The nation-state is still the primary actor on the world economic stage. There is no supranational government that can compel countries to engage in activities that they do not wish to engage in. All countries are, for example, free to leave the United Nations. When nation-states join international organizations, and thereby agree to operate by the rules which have been negotiated, they do so voluntarily. Nation-states guard their sovereignty closely. They are ultimately entrusted with their citizens' security as well as their economic and social well-being. Even when certain elements of sovereignty are temporarily ceded to multilateral organizations, the nation-state still represents and promotes domestic national interests. Although states always have the right to withdraw from their international commitments, if they choose to do so, the benefits from cooperation will also be withdrawn. Hence nation-states must consider carefully what constraints they are willing to accept on their freedom of action when they begin to proceed down the road to economic integration.

Degrees of Economic Integration

While broad multilateral organizations exist to foster international trade and cooperation, progress is often slow, given that the sovereignty concerns of well over one hundred nations must be addressed simultaneously. In some cases, progress is virtually impossible given the range of political ideologies, vested interests, and cultures involved. As a result, smaller groupings of nations may attempt to negotiate more wide ranging agreements concerning economic integration. These are often easier to negotiate given a stronger common incentive, based in many cases on geographic factors or a similar perspective. These *economic blocs* are allowed within the rules of the major multilateral trade organizations.

An economic bloc can be defined as a grouping of countries that mutually grant trade concessions to each other. Trade blocs can be loosely classified into four categories: (1) *free trade areas*; (2) *customs unions*; (3) *common markets*; and (4) *full economic unions*.

In a *free trade area*, trade restrictions between member states are eliminated for most or all of the products traded. Each country is allowed to keep its tariffs and other trade restrictions that are applied to countries that are not members. This means that member countries apply different trade barriers to nonmembers. As a result, a free trade area must put mechanisms in place to prevent importation of commodities into low-tariff countries that are subsequently transshipped duty free to high-tariff countries. For example, in the Canada–U.S. Trade Agreement there are provisions that require a certain proportion of the value of an automobile shipped from Canada to the United States to be added in Canada. These *rules of origin* prevent cars made in Japan from being exported to Canada and then sent to the United States, avoiding U.S. automobile duties.

In a *customs union*, the members trade freely among themselves; but unlike in a free trade area, a common external tariff regime is agreed upon. This means that in multilateral trade talks, the member countries must negotiate as a single unit and, hence, there needs to be a coordinating institution.

In a *common market*, in addition to a common external tariff and free trade in goods among members, there is also free movement of capital and labor. Taxes must be coordinated to prevent industries locating in low-tax countries; and health and safety standards, which impose costs on businesses, must be made roughly equivalent so that firms in different member states face a *level playing field* in their commercial environment. Educational and professional qualifications are recognized as equivalent across member countries. Given that differences in interpretation in these areas of the agreement are likely to arise, a central coordinating body will be required to negotiate common standards and arbitrate any disputes.

A *full economic union* moves a step beyond a common market and requires the total harmonization of macroeconomic fiscal and monetary policy. Government spending and taxation decisions are made in common, and the operations of the member countries' central banks must be coordinated. A single currency may be adopted but is not necessary; fixed exchange rates among currencies will suffice. Government contracts must be open to bids from firms in any member country.

Clearly these are somewhat arbitrary divisions, and existing arrangements for economic integration often straddle these divisions. The importance of these divisions may also decrease over time as trade barriers worldwide are removed or reduced through progress made in the multilateral trade organizations. In some cases, trade arrangements among sovereign states may have fewer trade restrictions than those observed between the political subdivisions of nations. For example, professional qualifications are equally recognized throughout the European Union. Hence lawyers or schoolteachers certified in any country can work in any other country—a condition that does not apply across the individual states in the United States or the provinces of Canada. Hence economic integration may move beyond that which exists in political federations. The fundamental difference, however, is that states in the United States, for example, cannot secede from the union. In the European Union, each state retains the sovereign right to withdraw from the organization at any time.

The central coordinating bodies of trade blocs can become quite formal and take on many characteristics of a *supranational* government. In the European Union there is a parliament, an executive branch, and a European Court. These institutions represent a system that can accommodate the needs of both the major economies such as Germany, Britain, France, and Italy, and those of smaller nations such as Denmark, Belgium, and Finland. With a number of relatively equal large member countries, a centralized organization provides a reasonable structure.

In the NAFTA, particularly if it is extended to other countries, there will be one dominant economy—the United States. A central body in which the smaller states could *gang up* on the United States probably represents an unacceptable level of sovereignty reduction for the United States. As a result, the *hub-and-spoke* model for economic integration in the Western Hemisphere has been favored in the United States. Each member of the NAFTA makes an individual treaty with the United States (and each other) so that the United States becomes the hub of a large number of agreements with individual states. Whether this model will continue to be acceptable to other NAFTA members if the bloc expands remains to be seen.

Regional Economic Integration in Theory

Trade blocs, because they are a subgroup of states, will always have benefits as well as costs associated with their formation. There will be benefits gained from *trade creation* among the members of the bloc as well as losses associated with *trade diversion* as international commercial transactions with firms in countries outside the bloc are replaced by transactions with firms in countries within the bloc. If the benefits outweigh the costs, then countries should join the regional trade bloc. The factors that determine the relative size of the benefits and costs are: (1) the degree of overlap (production of similar products) in the economies contemplating the formation of an economic bloc; (2) the magnitude of the cost differences among common industries; and (3) the level of import tariffs between potential member countries prior to the formation of the bloc.

The greater the overlap between the economies, the greater the likelihood that the bloc will be trade-creating in terms of both inter-industry trade and intra-industry trade. This is clearly the case with the United States and Canada. If there are large cost differences between industries in two countries, then the potential for trade creation is large. The Mexican clothing industry has a considerable cost advantage over that in the United States, while the U.S. corn industry has a cost advantage relative to the Mexican industry.

When high tariffs are removed as a result of the formation of an economic bloc, growth in trade will ensue. While much of Canada–U.S. trade was tariff-free prior to the NAFTA, those sectors that were protected generally had high levels of protection. In particular, Canadian manufacturing received considerable protection. There were high Mexican tariffs on many Canadian and U.S. goods as a result of Mexico's previous import-substitution development strategy.

While the sovereignty of individual countries will be somewhat reduced, it is also true that collective economic power is increased. As a result, small or medium-sized states may find it beneficial to join or form economic blocs. The combined power of the bloc may enable the member countries to achieve objectives, say, in trade negotiations that would have been impossible had they attempted to achieve them individually.

Trade blocs also have a dynamic element. If trade blocs are successful, other nations will want to join. If more nations are accepted, other states in the region will fear they will suffer as they are excluded from the bloc's markets. Worried they will be left out of the bloc and isolated, they have a considerable incentive to join the bloc.

Regional Trade Associations

The process of regional economic integration has probably progressed furthest in Europe. For a long period there were three competing regional economic associations there: the European Union (EU),[2] the European Free Trade Area (EFTA), and the Council for Mutual Economic Assistance (CMEA). The CMEA was the trade grouping comprising most of the communist states in Eastern Europe dominated by the old Soviet Union. With the fall of communism, CMEA ceased to exist.

In Western Europe there has been a long process whereby the more successful EU attracted members from EFTA. As a result, EFTA is no longer an important trade association. The EU has expanded steadily from its original six members—France, Germany, Italy, Holland, Belgium, and Luxembourg—to include the United Kingdom, Ireland, Denmark, Greece, Spain, Portugal, Sweden, Finland, and Austria. In Western Europe, now only Norway and Switzerland remain outside the EU. Countries in Eastern Europe, particularly the Czech Republic, Slovakia, Hungary, and Poland, are eager to join.

[2] Formerly the European Community (EC) and, in yet another previous incarnation, the European Economic Community (EEC).

The EU has been very successful in moving along the road toward full economic integration, with the removal of trade barriers, the virtually free movement of capital and labor, and the harmonization of many regulations. In its trade relations, the EU acts as a single nation and has become a powerful voice in global economic affairs.

While regional economic associations exist in Africa and Asia, little real progress toward economic integration has as yet taken place. Countries in these areas still follow independent economic policies. In the Western Hemisphere, there seems to be more positive movement toward economic integration. In addition to the NAFTA, in South America there are MERCOSUR—which includes Argentina, Brazil, Paraguay, and Uruguay—and the Andean Common Market (ANCOM)—with Bolivia, Columbia, Ecuador, Peru, and Venezuela. A Central American Common Market (CACM) has also been established, along with the Caribbean Community and Common Market (CARICOM). These various regional trade associations may provide the embryo of a trade bloc for the Western Hemisphere.

The Multilateral Institutions of the International Economy

The NAFTA and other regional trade associations operate within the rules agreed to at the multilateral forums that provide the institutional structure for international commercial relations and economic coordination. These institutions arose out of the strong belief in trade liberalization that emerged at the end of World War II, especially in the advanced industrial countries of Europe and North America.

Bretton Woods

There were two major factors that policy makers in many developed nations felt were responsible for the disruptions to international commerce that occurred in the 1930s. These were an absence of any international controls over the erection of trade barriers by countries, and the strategic use of currency devaluations. Negotiations after World War II led to the establishment of the *General Agreement on Tariffs and Trade* (GATT) in 1948 to provide a set of mutually-agreed-upon rules for the former. Prior to this, in 1944, an agreement was reached among the finance ministers of forty-five nations to establish new international monetary institutions to address the latter problem. The United States and the United Kingdom took the lead in devising the *Bretton Woods* system, which had as its core institution the *International Monetary Fund* (IMF).

The International Monetary Fund

The Bretton Woods system was a fixed (pegged) exchange rate regime. While devaluations were still possible, they could not be used as part of strategic macroeconomic policy. Devaluations, when used strategically, can artificially increase exports and discourage imports. The IMF managed a pool of gold and currencies which could be allocated to countries faced with devaluation. The Bretton Woods system of pegged exchange rates could not be sustained, and in 1973 the exchange rates of the major industrial nations began floating. The IMF still has, however, an important role of coordinating broad exchange rate policies.

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The International Bank for Reconstruction and Development

As part of the new world economic order established after World War II, there was a recognition that international prosperity could be threatened by differences in levels of economic development. Countries suffering from high levels of unemployment, low levels of investment, and impoverishment tended to be politically unstable, and governments perceiving themselves in desperate situations often adopted disruptive economic policies.

To aid in overcoming these problems, the *International Bank for Reconstruction and Development* (IBRD)—or, as it is more commonly known, the *World Bank*—was established. Initially the World Bank's chief concern was with the reconstruction of Europe in the wake of the devastation of World War II.

Once Europe recovered, the World Bank transferred its focus to the problems of developing countries. Recently it has been heavily involved in aiding the transition from command economies to market economies in Eastern Europe and the former Soviet Union.

The World Bank finances a wide variety of projects in developing countries and the former command economies. Its financing is mainly in the form of loans and, hence, does not represent transfers of aid funds. The World Bank applies commercial criteria to its loans and is often criticized for this limitation in its development activities. Nevertheless, World Bank is still the major multilateral policy instrument for fostering international development.

The World Trade Organization

An attempt was made to negotiate a comprehensive *International Trade Organization* (ITO) as part of the new international order after World War II. The ITO, along with the IMF and the World Bank, was expected to be a major pillar of the international economic system. Agreement could not be reached except on the limited subset of trade matters that had been negotiated in the General Agreement on Tariffs and Trade (GATT). The ITO was never ratified by the U.S. Congress. As a result, the GATT, by default, became the principal multilateral organization regulating trade. The GATT's original mandate, however, was limited to trade in goods. While the GATT had considerable success in removing barriers to trade in goods, nations became interested in regulating other aspects of international commerce—in particular, trade in services and the international protection of intellectual property. As the GATT's structure was not designed for this wider role, in 1993 an agreement was reached to establish a *World Trade Organization* (WTO). Members of GATT automatically became members of the WTO.

The WTO is guided by a regularly scheduled conference of ministers from all WTO members. The day-to-day administration of the WTO is the responsibility of the General Council. The General Council settles trade disputes between members and reviews, on a regular basis, their trade policies. The WTO oversees three organizations: the GATT and two new organizations negotiated at the same time as the WTO—the *General Agreement on Trade in Services* (GATS) and the *Agreement on Trade-Related Aspects of Intellectual Property Rights* (TRIPS).

The GATT, within the overall structure of the WTO, remains the primary international organization establishing the rules for trade in goods. High tariffs had been erected in the beggar-thy-neighbor period of the 1930s, and these were still in place at the end of World War II. Reducing these tariffs was the primary role envisioned for the GATT. Hence tariff reduction combined with *tariffication* are the major liberalizing mechanisms of the GATT. Tariffication is a process whereby alternative trade-restricting practices such as import quotas are converted to tariffs giving an equivalent degree of protection. When trade restrictions are in the form of tariffs, they can be directly compared, which facilitates the negotiation process. A major GATT principle is that once a tariff is lowered by a country it becomes *bound*—cannot be raised—at the new level.

Nondiscrimination is another major GATT principle. This means that tariff concessions given to any GATT member must be extended to all GATT members. This prevents countries from being able to single out, for increased trade barriers, a particular trading partner whose comparative advantage is improving.

Transparency is a third GATT principle. This means that there can be no secret trade arrangements between countries. This helps strengthen the nondiscrimination principle. Any trade action taken by a country must be brought before the WTO, where other nations have the right to express any concerns they may have.

The fourth principle of the GATT is *accepted retaliation*. To protect their sovereignty, it has been agreed that individual countries can ignore the GATT's trade rules in ways that could injure other countries. There is a recognition that politicians may have to acquiesce to domestic protectionist pressures in certain circumstances; hence these actions must be accommodated in the GATT. It is also agreed, however, that injured countries have the right to retaliate up to an amount of equivalent value without fear of second-round retaliation. Hence, beggar-thy-neighbor retaliations are prevented.

Regional trade agreements are also allowed in the GATT. Regional trade agreements must abide by GATT principles but are free to exceed the degree of trade liberalization that has been accomplished at the GATT. Hence the NAFTA and European Union, for example, have gone beyond the GATT protocols on a wide range of trade issues.

Members of the new General Agreement on Trade in Services (GATS) have made a commitment to improve the transparency of regulations concerning services. Countries have agreed to open the services market to varying degrees. Future negotiations will take place regarding reductions to restrictions in the cross-border movement of individuals providing services, the harmonization of professional standards, and the control of trade-distorting subsidies in service industries.

The central theme of the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) is that countries agree to enforce the property rights of other countries' firms and citizens. This commitment extends to patents, trademarks, films, sound recordings, computer software, integrated computer circuits, trade secrets, and test data.

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The United Nations Conference on Trade and Development

The GATT was often seen as a "rich nations' club" by developing countries, many of whom were still colonies when it was originally negotiated. It was felt that the GATT was not responsive to the needs and concerns of developing countries. In response to this frustration, the United Nations Conference on Trade and Development (UNCTAD) was established in the early 1960s. It deals exclusively with issues concerning trade relations between developing and developed countries. Its scope is very wide, dealing with many aspects of trade that are outside the GATT mandate. The mandate of UNCTAD is to attempt to enhance nations' development prospects by improving their trade opportunities. While UNCTAD's mandate is broad, it has not been endowed with any real power and, hence, remains primarily a forum for the presentation of ideas and concerns as well as the exchange of information on trade problems. It attempts to reform trade through the use of persuasive arguments based on the ideas of obligation and responsibility.

The major policy-making forum of UNCTAD is conferences convened every four years, commonly referred to by their chronological order, such as UNCTAD VI. The major concerns of UNCTAD have been attempts to raise and/or stabilize the prices of developing countries' primary exports, to improve market access in developed countries for developing countries' manufacturers, to enhance technology transfer, and to facilitate the solution of developing countries' debt problems.

Hemispheric Multilateral Organizations

In addition to truly international organizations, there are also multilateral organizations which span the Western Hemisphere. These organizations attempt to capitalize on recognized commonalities of interests within the region. This has not always been easy as various nations have tended to perceive that there was more to be gained from focusing their attention on other political and economic ties. Further, many of the states in Latin America as well as Canada were wary of U.S. hegemony in any hemisphere-based organization. Canada, in particular, was focused on ties with Europe and its *North American Treaty Organization* (NATO) obligations for most of the period after World War II. Argentina, Brazil, and some other South American countries felt closer ties with Europe than with their northern neighbors. After the Castro revolution, Cuba was increasingly drawn into closer relations with the Soviet Union and other Eastern European countries. In recent years, the attention of the United States and Canada has shifted toward the Asian-Pacific Rim in response to the trade opportunities presented by the rapid rates of economic growth in that region. Still, hemisphere-wide organizations have had an important role to play.

The major multilateral organization in the region is the *Organization of American States* (OAS), founded in Bogota, Columbia, in 1948. Its mission is to foster peace, security, mutual understanding, and cooperation among the nations of the Western Hemisphere. The OAS has never lived up to its potential largely because it could not rise above *Cold War* politics. The organization's credibility with many Latin American states was damaged due to the perception that it was an instrument of the United States in the East-West conflict (Muñoz 1994). The ending of the Cold War has revitalized the OAS to some extent, and it may have an increasingly important role in the control of drug trafficking and protection of the hemisphere's environment.

The *Inter-American Development Bank* (IDB) was founded in 1959 and is the hemisphere's rough equivalent of the World Bank. The IDB provides financing for economic and social development projects as well as technical assistance. Projects may be cooperative efforts among nations or they may be confined to an individual country. The most important U.N. organization in the hemisphere is the *Economic Commission for*

Latin America and the Caribbean (ECLAC). Founded in 1948, it promotes coordination of economic development in the Latin American region in conjunction with other U.N. organizations.

Thus there are a number of multilateral and hemispheric organizations that operate in conjunction with subhemispheric trade organizations such as the NAFTA.

Can an Economic Bloc Take Shape in the Western Hemisphere?

The success of the NAFTA in bringing together three large and diverse economies has put in motion two forces. The first force is momentum. If the NAFTA appears to be "a winner," then other nations will want to join to capture the economic benefits that are available. Second, there is the fear of being left out. Nations who don't join may see their trading opportunities drying up as other states join the NAFTA and reorient their economic focus. Each nation must weigh the benefits from joining against the reduction in sovereignty that will inevitably ensue. Other states in the hemisphere are watching the NAFTA closely.

The likelihood of a successful expansion of the NAFTA is higher now than it would have been in the past. With the obvious failure of *import substitution* as a means of providing sustained economic growth, most nations in Latin America have embraced an open trading policy as part of their development strategies. The real question is whether the founding members of the NAFTA, particularly the United States, wish for a further expansion. More countries will mean more complex coordination and more consultation. This will inevitably mean pressure to create new institutions. These regional institutions will begin to limit the freedom of action of national governments—to reduce economic sovereignty. Whether an acceptable compromise can be found remains the major question mark in the future expansion of the NAFTA.

Summary

Currently, trade liberalization is in ascendance. Protectionism is largely discounted as a policy associated with the *national good*. This does not mean that vested interests cannot mobilize considerable political support in aid of their individual industry, but the protection granted is now largely identified with the particular vested interest it serves.

There is a general consensus among the developed countries that the long process of trade liberalization that followed World War II was a major contributor to the long period of sustained growth through the 1950s, 1960s, and 1970s. If sustained growth is to return, then many of the remaining trade barriers must be removed. This means removing barriers in areas of commercial relations not traditionally dealt with in international trade—services, investment, protection of intellectual property, and macroeconomic coordination. These new aspects of liberalization suggest that a greater degree of economic integration among nations may be required than in the past. While progress is being made in multilateral negotiations, it is slow. Nations seeking to garner the gains available from economic integration have been increasingly seeking regional economic associations with smaller, more tractable groups of countries.

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SIDEBAR BOX A

Protectionism and the Political Process

There has been a general long-term trend toward trade liberalization, at least in developed countries, since World War II. Protectionists have, however, been able to secure sector-specific increases in trade barriers and have been particularly effective at delaying the process of liberalization. As there has been little broad-based political support for protection over the period, they have been able to accomplish the ends of vested interests they represent through effective manipulation of the political process. In part, this stems from the stakes involved: the potential losers from a deteriorating competitive position will have a lot to lose and may be geographically concentrated, while the benefits of liberalization tend to be widely spread among the population. Hence potential losers have a larger incentive to take action to protect their vested interests.

The central focus of political action by protectionists is the formation of groups to lobby governments for the imposition or retention of trade barriers. For a number of reasons, the protectionist lobby is often very effective. First, as suggested above, the pressure to organize is greater because they are a well-defined group. If they are geographically concentrated they are likely to face lower costs of organization. Those who gain may not be as willing and/or may face higher costs to organize to prevent trade restrictions from being put in place. This gives protectionists an advantage in the political process.

Second, the potential losers may be better represented in the congress, parliament, or legislature than the gainers. This is even more pronounced if the losers enjoy a favorable geographic distribution. For example, if the losers command a majority of 51 percent in two out of three constituencies, then only 34 percent of the total vote is needed to secure a majority in the legislature. The same 51 percent majority in thirteen of twenty-five legislative districts means that a majority of seats is gained through only 27 percent of the total vote. Further, as they have more to lose, potential losers are more likely to vote.

Third, the political power of potential losers can be increased if different lobby groups support one another. A majority in the legislature can be secured if the politicians supporting protection vote strategically. This log rolling works as follows: say there are three seats in the legislature and two industries threatened by proposed trade liberalization legislation. Each threatened group is geographically concentrated and able to elect a politician who advocates their position. Politician A is strongly in favor of import barriers to protect the industry located in his constituency—Bill 1—but weakly in favor of reducing the level of protection afforded to the industry located in the constituency of politician B—Bill 2. Politician B takes the opposite position. Without cooperating, both politicians may be in a minority position and their bills will be voted down; liberalization will result. By combining to support each other, they will be able to form a majority and pass both their propositions.

The result of the ability to act strategically is that there is a political market for protection. Demand for protection will come from groups that can identify a threat to their livelihood from trade liberalization. These groups tend to be domestic firms facing foreign competition in the home market, trade unions representing workers employed in those domestic firms, and firms that supply threatened domestic firms with components.

This positive demand for protection will be diminished by opposition from groups that will lose out from protection—firms that rely on an open trading system for access to markets, their component suppliers, and workers. Companies involved in the distribution of imports, such as Japanese automobile dealerships in the United States, will work against protection. Finally, consumer groups who fear higher prices will work against protection.

The supply side of the market for protection is made up of politicians and bureaucrats. Politicians wanting to get reelected may be willing to support protectionist legislation if the protectionist group can deliver more votes than can the free traders.

Although nominally neutral, bureaucrats have an important role in providing a supply of protection. Bureaucrats are often motivated by the "prestige, power, and influence" they enjoy relative to the economic group they serve—e.g., the positions of the civil servants in the Department of Energy vis-à-vis oil companies. The main constraint that bureaucrats face is the power of elected politicians. Because politicians must rely on the civil service for advice, bureaucrats' discretionary power in the supply of protection can be great.

SIDEBAR BOX B

The Instruments of Protection

How is protection against imports provided? In reality, the structure of protectionist measures is only constrained by the inventiveness of the bureaucrats who think them up. Here we will only discuss the most common instruments used by governments to protect domestic industries. This discussion will be confined to what are generally termed "border measures," which are designed to disrupt the flow of goods. Other "nonborder" measures that can be used to improve a domestic industry's competitiveness include subsidies, tax holidays, and preferred access to government contracts or public facilities such as transport. These are not discussed.

Border measures are commonly divided into tariffs and nontariff barriers to trade.

Tariffs

Tariffs are a tax on goods collected by the importing country when they cross its border. For example, assume that a tariff is set by the government at $10.00 per pair of shoes. Assume the price of a pair of shoes when it arrives in customs is $30.00. The government collects its tax before the shoes enter the domestic market. This effectively increases the price of a pair of shoes to $40.00 per pair ($30.00 plus the $10.00 tariff). Hence, instead of having to compete against $30.00 shoes, domestic firms only have to compete against $40.00 shoes. Domestic shoe producers' competitiveness is increased.

Tariffs are generally of two types: (1) flat rate—a set monetary rate per unit imported (as in our shoe example); and (2) *ad valorem*, which is calculated as a fixed percentage of the value of the goods imported. Hence the more valuable the import, the higher the monetary amount of the tariff.

According to internationally agreed rules, tariffs must be fixed and announced in advance. They can only be altered by governments on preannounced schedules. This provides exporters with a degree of certainty when they are making production and investment decisions.

Tariffs are the preferred protection measure of multinational organizations. Tariffs are preferred because they are the least distortionary protectionist instrument; if the same tariff rates are applied to the goods of all countries wishing to export a product to a country, then trade will gravitate to the lowest-cost producer. Tariffs are also easily compared, which makes negotiations to reduce them simpler than for other measures.

Nontariff Barriers

Import Quotas. Import quotas are quantitative restrictions on the number or volume of a commodity that can be imported over a specified time period—e.g., 50,000 automobiles per year. By limiting the total quantity that can be imported, the total supply (domestic and foreign) available in the domestic market over the period is reduced. As total supply is reduced, domestic price rises, which is to the advantage of domestic firms.

Quotas often require complex administrative structures to monitor imports and allocate the total quota among foreign countries wishing to supply the protected market. The latter is required because by restricting quantity, excess demand is created for the right to import. Quotas are apportioned among competing exporters by a variety of methods. Difficulties are encountered when a new potential exporting country with no quota asks for access to the market or when an existing exporting country has considerably improved its competitive position relative to other exporters and desires a larger share of the quota.

According to international agreements, import quotas are to be converted into tariffs giving equivalent protection. The rate at which this conversion is supposed to take place is, however, only vaguely set out.

Health, Sanitary, and Phytosanitary Regulations. These regulations cover a wide range of rules governing the physical condition of products entering a country. All countries have regulations designed to ensure that products coming from abroad are not hazardous to the environment or the health of humans, animals, or plants (phyto is the Greek term for plants).

In many cases these regulations are legitimate. However, if cleverly designed, they can also act as barriers to trade. As these regulations are developed by each country independently, differences in procedures can impose considerable costs on exporters. A country may specify scientific tests that are different from those used in the exporting country. Testing facilities may not be recognized, or the qualifications of those conducting the tests questioned.

The only effective means to remove this source of trade barriers is to establish internationally accepted standards and harmonize regulations over time. This has, as yet, proved to be a slow and tortuous process. Nations are particularly reluctant to give up sovereignty when the health and safety of their populations are involved.

Consumer Protection Legislation. Countries tend to establish consumer protection legislation independently. Exporters can incur large costs when faced with multiple regulations. These regulations can be used strategically to inhibit trade. For example, the spacing of headlights on cars can be part of consumer protection legislation. Metal stamping presses for car bodies are one of the largest cost items in the production of automobiles. If an exporter's domestic market requires headlights to be three feet apart, an importer requiring a three-foot six-inch spacing for headlights simply excludes the exporter's vehicles from its market. Performance standards for electrical equipment or the resolution of television sets provide other examples. International harmonization of standards is the only effective means of reducing these nontariff barriers.

Variable Levies. Similar to tariffs, variable levies are taxes collected by customs when products are imported. Unlike tariffs, they are not fixed. As the difference between the domestic price and the foreign supply price of a product increases, so does the variable levy. Hence the domestic market of the importer is totally isolated from changes in international prices. Variable levies have been used very effectively by the European Union to exclude imports of agricultural commodities that have volatile prices. Variable levies make planning by exporters extremely difficult.

Rules of Origin. Some countries impose rules of origin requirements on products sold in the domestic market. For example, 60 percent of the value of a car sold in the domestic market might have to have originated within the country. This means that no imported cars can be sold. It would, however, allow a foreign firm to set up an assembly plant and import some of the parts for the same car for assembly. By using local labor and some local parts, the 60 percent rule can be met. This has been a strategy followed by a number of developing countries as part of their industrialization strategy.

SIDEBAR BOX C

The Question of Exchange Rates

While the world of international finance and exchange rates is exceedingly complex, acceptance of one idea is the key to understanding the factors that affect exchange rates—a nation's money is no different than any other commodity; its exchange price (rate) is determined by supply and demand. If international transactions are to take place, the currencies of countries must be exchanged. Coffee cannot be purchased with Canadian dollars in Brazil, nor can Mexican pesos be used to buy steel in Sweden. These exchanges take place in international money markets located in cities like London, Zurich, New York, and Tokyo, which act as clearinghouses for those wishing to acquire foreign currencies.

There are three sources of supply for a nation's currency in international money markets: (1) domestic firms that wish to buy imports—they supply domestic currency to exchange for the currency of the country from which they wish to buy; (2) investors with funds in the country who wish to invest abroad—they supply domestic currency to exchange for the currency of the country where they wish to make their investment; (3) the government—it supplies domestic currency to acquire a foreign country's currency as part of its foreign reserves.

There are three sources of demand for a nation's currency in international money markets: (1) foreign firms that wish to import products produced in the country—they buy the country's currency (by exchanging their domestic currency) in order to facilitate their purchases; (2) investors with funds in foreign countries who wish to invest in the country—they buy the country's currency in order to be able to undertake their investments; (3) the domestic government that wishes to buy back its domestic currency in the international market—it can only do this by using its foreign exchange reserves.

As with any other commodity, an increase in the supply of a currency in the international market will decrease its price. That is, it takes more Canadian dollars to acquire a specified quantity of Mexican pesos; hence the exchange value of the Canadian dollar has gone down. If there is an increase in demand for a country's currency, the price will rise; it will take fewer Canadian dollars to buy the same quantity of Mexican pesos.

One option countries have is to simply allow the international money market for its currency to operate according to the forces of supply and demand. This is known as a floating or flexible exchange rate policy. Floating exchange rates are, however, unpopular with most domestic firms and investors. Floating exchange rates make it difficult for importers and exporters. As most international transactions are complex, involving payments over varying time periods, changes in exchange rates alter the profitability of an international transaction. For example, let us assume a Mexican businessman contracts to buy goods worth 1,000 Canadian dollars when the peso exchanges at 3 new pesos to the Canadian dollar; the expected cost of the imports is 3,000 new pesos. If, when the time comes to pay for the goods, the exchange rate of the new peso to the Canadian dollar has changed to 5 new pesos per Canadian dollar, the price of the imports has increased to 5,000 pesos.

Investors do not like flexible exchange rates because their return on investment can be adversely affected by changes in the exchange rate. Assume a Canadian firm invested a million Canadian dollars in Mexican government bonds when the rate of exchange was 3 new pesos to the dollar. It acquires bonds worth 3 million pesos. If the exchange rate changes to 5 pesos to the dollar after the bonds are purchased, when the Canadian firm wishes to sell its bonds and bring its investment home, 3 million pesos will only buy 600,000 Canadian dollars. The Canadian firm has lost 400,000 Canadian dollars on the investment. Allowing exchange rates to float can inhibit both trade in commodities and foreign investment because of the risks it creates.

An alternative is for governments to put in place a fixed exchange rate policy where it guarantees the rate at which its currency can be exchanged for foreign currencies. Hence the exchange rate risk is removed for investors and those wishing to engage in foreign trade. The government has two ways to ensure that the exchange rate remains at the established level. First, it can use its foreign exchange reserves to buy back domestic currency when there is excess supply at the fixed exchange rate. It can also sell domestic currency in the international money market (acquiring additional foreign reserves when there is excess demand at the official exchange rate). Second, the government can raise interest rates so that investments in their bonds and other securities look more attractive. This will increase the demand for its currency when it is in excess supply, thereby keeping the exchange rate at its announced level. Lowering interest rates has the opposite effect.

While firms and investors like fixed exchange rates, governments may be less enthusiastic. Keeping the rate fixed by selling foreign reserves will only work so long as there are reserves to sell. If there is consistent excess supply, reserves will eventually run out, forcing a devaluation—a formal, government-announced change in the rate. Devaluations tend to shake the confidence of both investors and domestic firms. Using the interest rate to keep the exchange rate at its fixed level may also work against other macroeconomic objectives. Raising interest rates may choke off domestic investment, slowing the economy. High interest rates on government debt will make the management of budget deficits more difficult.

Because there are a number of supply and demand factors affecting the exchange rate, it may be possible to run, for example, trade deficits over a long period. An unfavorable balance of trade means that imports exceed exports at the fixed exchange rate. If trade in goods were the only factor affecting the supply and demand for a currency, then supply would exceed demand and the exchange rate would have to change. However, if there was sufficient foreign investment (an increase in demand) at the fixed exchange rate to offset the excess imports, there would be no need for a change in exchange rates. Similarly, as long as the government is willing to sell foreign reserves to increase demand for its currency sufficient to offset the surplus generated by the unfavorable balance of trade, there is no need for a devaluation.

All of these ideas can be used to explain the Mexican devaluation crisis of December 1994. The Mexican government had been following a variant of a fixed exchange rate regime for a number of years; for our purpose it is sufficient to think of it as fixed at approximately 3 new pesos to the U.S. dollar. With the peso fixed, Mexico was exhibiting strong economic growth; inflation was low and exports were growing very strongly (22 percent annually). As a result, Mexico was receiving a great deal of foreign investment, increasing demand for the peso. This strong demand for the peso allowed an unfavorable balance of trade to be maintained (U.S.-$23 billion in 1993 and U.S.-$29 billion in 1994). In the United States, interest rates began to rise, making investments in the United States look more attractive. The Mexican government did not wish to follow the United States in raising its interest rates, fearful that economic growth would be inhibited. As foreign investment demand for pesos declined, the government stepped in, buying pesos with foreign reserves. The growing unfavorable balance of trade in goods, however, meant that Mexico's foreign reserves were depleted from U.S.$24.5 billion at the end of 1993 to U.S.$17 billion in October 1994 and to U.S.$6.5 billion in mid-December 1994. To prevent the total depletion of its reserves, Mexico attempted a small devaluation on December 20, 1994. This precipitated a crisis. Investors, fearful of further devaluations, began to move their money out of Mexico in huge amounts. This put a very large supply of pesos on the international market. With no reserves and an investor panic meaning that they would not respond to increased interest rates, two days later the Mexican government had to let the peso float. The peso immediately fell to approximately 5 new pesos per U.S. dollar and it continued to fall.

SIDEBAR BOX D

Intellectual Property Rights and Trade

Strictly speaking, the issue of protecting the property rights of foreign individuals or companies and the rules of international trade are topics that are only tangentially related at best. They are, however, both part of the broader issue of rules for international commercial relations. It is true in some cases that counterfeit or pirated goods—where no payment has been made for the use of intellectual property—become imported competitors in the markets where the intellectual property was developed. In these cases, however, domestic intellectual property laws are sufficient to exclude imports of counterfeit goods. The question then arises as to why intellectual property rights were included in the recent Uruguay Round of trade talks and why the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) was included under the umbrella of the new World Trade Organization (WTO).

The international protection of intellectual property rights has become a major concern of developed countries over the last few decades. Most of the new intellectual property in the world is produced in developed countries. There are a large number of reasons for this: higher levels of education; large amounts of government resources put into research infrastructure, including universities; populations with sufficient incomes to create large markets for new products; and the strong enforcement of property rights. Much of the new intellectual property developed requires large amounts of risky investment. Without the ability to capture the rents that accrue from the sale of products embodying new intellectual property, the investments will not be made. In the case of films, recording artists, etc., large investments in production and marketing have to be made. Firms invest a great deal in their reputations, often visually represented by their trademark.

While the protection of intellectual property rights is strong in developed countries, in many developing countries such protection is weak, partially due to the limited abilities of developing countries' governments and partially by design. Some developing countries have argued that, because most of the development of intellectual property takes place in rich countries, they will never be able to close the development gap. Other countries have argued that in the case of pharmaceuticals and agricultural technology, for example, their citizens are too poor to pay high prices for essential drugs or farm inputs. For other governments, the effort to enforce the property rights of foreigners did not seem justified given other activities they could undertake which would lead to higher domestic benefits. The net result was that the returns for those who develop new technology were reduced relative to their true potential. Poor protection of intellectual property in developing countries has, however, been a fact of life for a very long time. The question is, Why has it become a major issue in the last quarter of the twentieth century?

There are two reasons for the current prominence of intellectual property issues. The first relates to the revolution in electronic technology which ushered in the computer era. In previous eras, the intellectual property component of goods was small relative to the total price when manufacturing processes were complex. This meant that counterfeiting provided few rewards given the small intellectual property value. Manufacturing processes were often too complex to be undertaken in poorly developed economies. One result of the revolution in electronic technology, however, is that manufacturing these new products is relatively simple and can take place almost anywhere in the world. Low-cost labor provides competitive advantage. At the same time, the cost of developing new computer chips, computer programs, etc., represents a very high proportion of the value of output. Once developed, computer chips or programs can be copied easily, meaning that the rewards for counterfeiting are very large when protection of intellectual property is lax. As a result, large-scale pirating began to take place in developing countries.

The second problem that brought the issue of international property rights protection to the fore was the general slowdown in economic growth in most developed countries. Investment in new technology is fundamental to economic growth. The corporations involved in research and development argued that their investment efforts were reduced as a result of the inability to capture the full benefits from the development of new technology. Only by extending intellectual property rights internationally could this problem be corrected.

The governments of developed countries, however, had no means by which they could influence developing countries. No effective international rules for intellectual property rights enforcement was in place, and no mechanism to exert economic pressure on nations refusing to enact and/or enforce intellectual property rights existed. To gain leverage over developing countries, developed countries decided to make intellectual property rights protection part of the Uruguay Round of GATT negotiations. By tying intellectual property rights to the threat of trade retaliation, the developed countries gained a lever which could be used to influence the behavior of developing countries. Having the GATT and TRIPS linked directly in the WTO will allow the withdrawal of trade concessions to be used as a weapon against those nations who do not live up to their TRIPS commitments regarding the enforcement of foreigners' intellectual property rights.

CHAPTER 3
Evolution of the Global Economy, Post–World War II

Norris C. Clement

In the last chapter we briefly examined theories of international trade and economic integration, as well as the various multilateral institutions that have managed the global economy throughout the post World War II period. In this chapter we explore the evolution of the main features of the global economy in that period, especially as it relates to North American integration. The main objective here is to show the relationship between important international events and the development of international multilateral institutions and economic theory in the entire post–World War II period, on the one hand, and the emergence of the NAFTA in the 1990s, on the other. We believe that an understanding of this link is necessary in order to understand: (1) the forces that have shaped current economic integration efforts in North America,[1] and (2) the nature of the current controversies that divide proponents and opponents of the integration process. In this sense we are saying that history is important because it has conditioned our thinking regarding what can or should be done now and in the future.

Some of the ideas discussed in this chapter already have been touched on in the preceding chapters. However, they reappear here in a different context, as part of the evolution of the global economy and the intellectual thought that attempts to explain that evolution. In order to facilitate this discussion we invite the reader to follow the timeline illustrated in table 3.1, as we believe it will help to organize and synthesize the concepts more effectively.[2]

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[1] We also give special attention to events and trends in Latin America, the most likely region to become associated with the NAFTA in the near future.

[2] The *World Development Report 1991: The Challenge of Development* presents an interesting view of the global economy and economic development over the last century.

Figure III-1 THE GLOBAL ECONOMY (time line)

	1930	1940s	1950s	1960s	1970s	1980s	1990s•
Main Events	Great Depression (1929-41)	WWII (1941-45)	Korean War (1951-53)	Vietnam War (1963-75)	OPEC (Petrodollars)	Global Recession (1981-82)	End of Cold War (1990)
	Int'l Economy Collapses	U.S. major econ/mil. power "Cold War" begins	Expansion of U.S. MNCs	OECD	Stagflation	Third World Debt Crisis (1982) - Plan Baker (85) - Plan Brady (89)	Steps towards Trade Liberalization - Enterprise of the Americas (1990s) - European Union emerges (1992) - End of Uruguay Round (GATT) - NAFTA implemented (1994) - Econ. Summit of the Americas (1994)
	Gold Standard abandoned	Reconstruction after WWII - Marshall Plan - Bretton Woods	Europe/Japan rebuilt	Alliance for Progress	Emergence of NICs	"Lost Decade" for Latin America	
	Bank for Int'l Settlements (BIS)	United Nations - IMF - GATT - IBRD	Emergence of Third World Solidarity		Decline of U.S. competitiveness	Econ. Restructuring in Latin America (neo-liberalism) - stabilization policies - structural reforms	Economic restructuring continues in Latin America
			IDB				Quincentary of the Americas (1492-1992)
		ECLA		UNCTAD	North/South Dialogue (NIEO)	Soviet reforms - perestroika - glasnost	Global conference on Econ. Growth & Environment (1992)
						Reforms in other socialist countries	Global Conference on Population (1994)
Evolution of Global Economy	Center: manufactured goods CHANGING INT'L DIVISION OF LABOR ——»——» Periphery: primary products			——»——— Global Production Sharing	———»———	———»——— High Tech Goods & Services Primary Products & Manufactured Goods	———»———»———
Economic Theories	Keynesian Theory Emerges	- countercyclical monetary/fiscal policies -welfare state -warfare state regulation of business		- emergence of development economics - expansion of state and mixed economy - "fine tuning" of countercyclical policies		Orthodox, Neo-Conservative and Heterodox Stabilization Policies in Latin America	
						Growing critiques of Keynesian economics and Structuralism	
	(Demise of Neo classical macro-economics)	Emergence in L.A. of Structuralism - ISI (Protectionism) - Planning - Economic Integration		Emergence of Dependency Theories in the Third World		Emergence of: - Supply-side economics - International Monetarism - Export Oriented Industrialization (EOI) - Neo-structuralism	
	Primary Export Model						

The Legacy of the Past

Economic historians of the twenty-first century will probably look back on the 1980s as a crucial (watershed) decade in the history of modern economics and in the history of economic thought. In fact, not since the 1930s, the decade of the Great Depression, have there been such wrenching and far-reaching changes in economic life and the way we view it.

Prior to the 1930s, economists viewed the "free market" as an efficient and just mechanism for guiding capitalist economies in their quest for growth and development. Consequently, governments were usually viewed as "necessary evils," and most businessmen believed that "the best government is that which governs least," as Adam Smith had said—except, perhaps, when their own interests coincided with those of the government.

In this view, which we now call the "conservative" or "classic liberal" view, national governments are regarded simply as passive caretakers of an active market system, which allegedly adjusts automatically to changing conditions through the actions of the "invisible hand" of market forces. Of course, in practice governments historically have played important roles in most market economies (e.g., in the provision of economic infrastructure like highways, port facilities, and other "public goods"). Nevertheless, the proper role of government in conservative economic theory has been very limited.

All of that dramatically changed, however, with the Great Depression of the 1930s, which brought falling living standards, rising unemployment, and increased political instability in most countries of the world. Largely as a response to that crisis, and due mainly to the concepts pioneered by the most influential economist of modern times—the Englishman, John Maynard Keynes (1852–1949)—national governments gradually assumed a more active role in the management of their economies. This new, expanded role for governments that began during the 1930s came about simply because there was no other entity in the economy that could or would, according to Keynes, provide the analysis, resources, and actions necessary to revive the severely depressed economies of both the advanced, industrialized and the poor, raw material–producing economies of the capitalist world.

Thus in the short period of a decade, from the mid-1930s to the mid-1940s, governments became major actors in guiding the economic development of most capitalist, market-oriented countries. The role of government expanded from simply providing national defense, police and fire protection, a legal structure, and a few basic services, to regulating business, providing a wide variety of goods and services, assuming responsibility for stabilizing the "boom and bust" fluctuations of the business cycle, and in some countries implementing planning systems for promoting national economic growth and development. The expansion of the governmental role in the economy, according to this new "modern liberal" (Keynesian) view, would reduce the risks and uncertainties inherent in a continually changing market economy, and provide for a more efficient and equitable use of scarce resources so as to maximize long-term growth and development.

The 1940s

World War II (1939–1945) conveniently provided a demonstration of Keynes's contention that large amounts of government spending could lift an economy out of depression and into prosperity. In the United States, for example, just before the war, in 1940, labor unemployment was still approximately 15 percent, down somewhat from the 25 percent level at the height of the Depression in 1933. However, by 1944, after three years of large government expenditures and budget deficits to finance the war effort, unemployment stood at a mere 1.2 percent. During the same three-year period, total production (GNP) almost doubled, demonstrating that a country could, by increasing budget deficits, at least for a limited time, spend itself into prosperity, thereby providing a powerful argument for increasing the participation of the federal government in economic affairs.

In addition, it is important to note that the increased demand for all types of goods and services during World War II stimulated some Latin American countries' export markets, which in turn stimulated the growth of their domestic industrialization processes. The war also limited exports from the United States and Europe and thereby provided domestic manufacturing firms in Latin America with an opportunity to expand and develop without having to compete with the lower priced imports that frequently had thwarted industrialization attempts in the past.

Immediately after World War II the war-torn countries of Asia and Europe began the process of rebuilding their economies. They were assisted by the United States through the now famous Marshall Plan, designed to provide loans and grants to the advanced western economies to strengthen them economically and militarily against the alleged threat of Soviet expansion and domination.

The reconstruction process was carried out rather quickly, and within a decade or so the economies of Japan and Europe emerged with new factories and equipment which frequently were more efficient than those of their principal competitor and benefactor, the United States.

By the 1950s, buoyed by the successful reconstruction of Europe and Japan, economists throughout the capitalist world turned their attention to the poor, "underdeveloped" economies of Africa, Asia, and Latin America. What these countries needed, they concluded, was foreign investment via multinational (transnational) corporations (MNCs or TNCs, corporations operating in more than one country) and technical assistance from the advanced industrial countries, accompanied by a vast transformation of the economic and cultural values and institutions of these "backward" countries. In short, the traditional economies of the "underdeveloped" world should be restructured, replacing traditional ways with market-oriented, capitalist institutions.

About this same time representatives from many underdeveloped countries in Africa, Asia, and Latin America began to meet in a variety of contexts to discuss their common economic and political problems and interests as ex-colonial, relatively backward, raw material–producing countries. After much deliberation they concluded that their own interests and their relative position in the global economy were generally different from those of the industrial, developed countries. Out of these meetings came the term "Third World" to describe these emerging nations whose history and economic and social structures were significantly different from those of the advanced, industrial, capitalist countries—the First World—and from the industrialized countries of the socialist bloc—the Second World.

The economist who provided the first and best analysis of the economic condition of the Third World generally and Latin America specifically was Argentine Raúl Prebisch (1901–1986). Prebisch, who began his career as an economist in Argentina's banking sector, became interested in the uniqueness of economic conditions in the "underdeveloped" economies of Latin America. His works were widely published during the 1940s, and in 1948 he became the first secretary general of the United Nations

Economic Commission for Latin America (ECLA). Later he held the same position with the United Nations Commission on Trade and Development (UNCTAD), founded in 1963.

As noted in chapter 2, his main argument, now usually referred to as the Prebisch-ECLA thesis, was that the traditional "international division of labor"—based on trade between developed, industrial "center" countries and underdeveloped, raw material–producing "periphery" countries—tends to result in an "unequal exchange" that, according to Prebisch, historically favored the center countries at the expense of the periphery countries (refer to The Global Economy time line). Extensive studies carried out by Prebisch and others showed that not only do commodity prices suffer wide fluctuations, but over time Latin America had to sell (export) more and more primary products (e.g., coffee or copper) in order to buy (import) the same quantity of manufactured products from its more industrialized trading partners in the center. In economic terms this represents a "deterioration" of the periphery's terms of trade—prices of exports (mainly primary products) in comparison with prices of imports (mainly manufactured products)—with the center.[3]

The implication here is that the international trading system has, since colonial times, contributed to the "underdevelopment" of Latin America and other periphery regions while subsidizing the "development" of its major trading partners, the industrialized center countries.

In order to correct this systemic deficiency, Prebisch and others suggested that periphery countries abandon the market-oriented development strategy based on traditional primary product exports—the "Primary Export Model" (PEM)— and adopt independent development strategies based on fomenting a domestic manufacturing base. Such strategies came to be known as import-substitution industrialization (ISI)—industrialization by domestically producing consumer goods that previously had been imported from First World economies. Such inward-directed strategies, Prebisch argued, would require both increased government support and protection of domestic industry in order to keep cheaper foreign goods from displacing domestically produced goods. Such protection, it was believed, would give emerging domestic industries some time to achieve

[3] While this point has been debated interminably throughout the last four decades, Prebisch's position still seems to have validity: "whether we look at the last 40, 120 or 150 years, a deterioration of primary product prices in relation to prices of manufactures is beyond doubt" (Avramovic 1994: 109).

the same level of efficiency as industries in the First World. Meanwhile, it would be necessary to carry out certain "structural" changes both within Latin America (e.g., agrarian reforms and regional economic integration) and internationally (e.g., commodity cartels to prop up commodity prices as well as economic and technical aid) in order to enable periphery economies to compete in the global economy.

Prebisch's views eventually provided the basis for what is often called the "ECLA school of economic thought," which had an enormous effect on economists in Latin America throughout the post–World War II era. His theories, although hotly contested by many economists, especially those in the center countries, also contributed to the development of the "structuralism" and "dependency" theories [4] that subsequently enjoyed considerable popularity in Latin America and other periphery areas. Both of these theories, in varying degrees, supported the protection of national industries, at least in their "infant" stages.[5]

Thus the new theories of Keynes and Prebisch led to policies that over the next few decades would transform capitalist economies from market economies to "mixed economies." This meant that the market forces of supply and demand increasingly were modified and/or complemented by governmental actions. Subsequently governments became committed to pursuing such objectives as full employment, price stability, and high rates of growth and economic development. Achievement of these objectives, it was assumed, would translate into increased job opportunities and rising living standards for all sectors of the population through appropriate management of the budgetary (fiscal) and credit (monetary) policies of the national government while maintaining the essential aspects of a market economy (i.e. market allocation of most goods and services through the price mechanism).

The new policies took on a variety of forms, depending on the particular circumstances of each country. In most Third World countries, in order to utilize scarce resources more effectively, governments became planners, regulators, and in many cases

[4] For an excellent survey of traditional structuralist views in comparison with the contemporary "neostructuralist view," see Sunkel 1993. For an overview of dependency views, see Chilcote and Edelstein 1986.

[5] The idea of temporary protection for "infant industries" is related to, but not identical to, the ideas of Ricardo presented in chapter 2.

producers of those goods and services considered essential to the process of rapid industrialization and modernization.

Meanwhile, in World War I, when resources were more plentiful and living standards higher, there was more emphasis on countercyclical, stabilization policies—monetary and fiscal actions designed to smooth out the wide swings of the business cycle. However, many countries also implemented various types of industrial policies—coordinated actions between private firms and government agencies to increase international competitiveness. Moreover, political pressures applied by liberal politicians and grassroots movements of workers and the poor forced the creation and expansion of a modern welfare state—large expenditures on social security, unemployment insurance, basic medical care, and so on—that provided a safety net for those people unable to work and/or support themselves. The welfare state was supposed to humanize the capitalist system by reducing the risks and uncertainties inherent in an unrestrained market system and to provide macroeconomic stability to the system itself.

During the same period, the emergence of the Cold War between the East and the West, mainly between the United States and the Soviet Union, stimulated the emergence of a "warfare state"—with high levels of government expenditures made in order to assure a constant state of military preparedness, even during peacetime. The warfare state was supported by a large and politically effective "military-industrial complex"—military officers and weapons manufacturers—in the United States, the Soviet Union, and many other countries of the capitalist and socialist blocs. Unfortunately, large military expenditures meant less spending on economic and social development and spawned an international arms race that has endured to the present.

At the international level, the major center countries, led by the United States and England, began to construct a new version of the international trade and monetary system which had virtually disintegrated during the Great Depression and World War II. Thus during the period 1944–48 a group of multilateral, international economic institutions was created that was designed to provide new "rules of the game" for international trade and financial transactions in order to facilitate the expansion of the global trading system.

As noted in chapter 2, these new institutions included the International Monetary Fund (IMF), the International Bank for Reconstruction and Development (IBRD, now called the World Bank), and the General Agreement on Tariffs and Trade (GATT).[6] These institutions, along with the Bank for International Settlements (BIS, "the central bank for central banks," founded in 1930), are still in existence; however, over time their operations have expanded and changed considerably in order to keep up with the needs of the continually evolving global economy.[7]

Because of the dominant position of the United States immediately after the war, the U.S. dollar became the foundation of the new international monetary system, usually referred to as the Bretton Woods system, which lasted from 1944 to 1971. However, since 1971 the U.S. dollar, and the U.S. economy in general, have lost much of their dominance in the global economy, and the international monetary system has changed considerably. Nevertheless, the United States is still a major actor in the global economic system, and the U.S. dollar is still a key international reserve currency along with the German mark and the Japanese yen.

The 1950s and 1960s

During the 1950s and 1960s the economies of many First and Third World countries enjoyed relatively high rates of economic growth, and international trade expanded even faster. For some countries the new policies associated with the mixed economy, together with the rapidly expanding international trade system, meant rising prosperity and employment opportunities accompanied by increased industrialization.[8]

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[6] All of these agencies are attached to the United Nations (UN), established at the end of World War II to promote international peace and security.

[7] In many ways the evolution of the international trade system has been quite successful. Between 1950 and 1990 the volume of world exports increased ninefold, while the volume of world output increased fivefold. The GATT, which now has become part of the World Trade Organization has some 150 member countries and encompasses some four-fifths of world trade, has played a major role in lowering the average tariffs on manufactured goods among the major capitalist countries from about 50 percent in the 1930s to about 5 percent in the late 1980s. Nevertheless, as we shall see, the international trading system still has many problems.

[8] During this time two more important international economic institutions came into existence. The Inter-American Development Bank (IDB), with its headquarters in Washington, D.C., and the Organisation for Economic Co-operation and Development (OECD), located in Paris. The former was created to provide capital for infrastructure projects in Latin America; the latter was created in 1960 to achieve a greater degree of economic consultation and harmonization between the advanced, market countries of Europe, North America, and Asia.

Still, throughout the period many Third World countries continued to stagnate and became even more underdeveloped as their rapidly growing populations made it more difficult than ever to translate modest economic growth rates into rising living standards for all. In recent years this group of very low income countries—mainly in Africa and Asia—has come to be known unofficially as the Fourth World.

Meanwhile, during the 1950s and 1960s, another much smaller group of Third World countries, utilizing varying degrees of state-directed (government-directed) development strategies, was relatively successful in terms of achieving higher levels of industrialization. The strategy usually followed in Latin America, including Mexico, was that of import-substitution industrialization, mentioned above in connection with Raúl Prebisch.

During this period (1950s and 1960s), ISI policies produced many benefits by generating new jobs, higher incomes, and higher levels of industrialization. But there were costs as well. ISI strategies focused mainly on the development of the domestic manufacturing industries while neglecting agricultural and export sectors. Moreover, the fruits of progress largely benefited the middle and upper classes and did not reach the poor who, in many cases, saw their plight worsen.

Thus, while the inward-directed development policies of ISI did bring industrialization to many Latin American countries, they fell short of the objective of achieving reducing their "dependency" with respect to center countries. Multinational corporations came to dominate the most dynamic sectors of the economy; and while imports of consumer goods generally decreased, imports of capital and intermediate goods (goods used in the production of other goods) increased.[9]

By the late 1960s some Latin American countries began to study the outward-directed policies implemented by Asian countries like Taiwan, Singapore, and South Korea, which were following more outward-directed policies of integrating with the international economy by exporting nontraditional products, including labor-intensive manufactured goods. The strategy of export-oriented industrialization—deliberate opening up of the domestic economy to international trade as a means of increasing

[9] For an excellent overview of the impacts of ISI policies in Latin America, see the special issue of *World Development* (1997), "Latin America in the Post Import Substitution Era."

production for export and accelerating domestic industrialization—seemed to produce a more balanced development process and a more equal distribution of income than in Latin America.

During this period, the economies of many of the newly industrializing countries (NICs) were transformed by the phenomenon of "global production sharing."[10] This geographical dispersion of manufacturing activities occurred primarily because of two factors: (1) the availability of new, more efficient communications and transportation technology, which dramatically cut travel and communications time and costs, and (2) the existence of large and growing wage differentials between the rich and poor countries of the world. These factors have allowed MNCs to organize their manufacturing activities to take advantage of significant cost and/or tax differences. Thus labor-intensive phases of production tend to automated or relocated to virtually any part of the world where adequate infrastructure exists, while capital- and knowledge-intensive phases of research and development (R & D), manufacture of components, final testing, and distribution usually remain in the high-wage core countries where skilled personnel and instrumentation are readily available. The developing countries that participate in this arrangement usually create special "export-processing zones" (EPZs)—designated areas providing special tariff treatment and infrastructure to firms performing labor-intensive assembly operations. They do so in the expectation of generating new jobs, foreign exchange, and technology transfer as part of their export-led development strategy.[11]

Thus the phenomenon of global production sharing, along with the emergence of the NICs, has led to a gradual but continual modification of the international division of labor that traditionally condemned the periphery to being producers/exporters of primary products while the center produced/exported manufactured goods. Today we increasingly find center-based MNCs searching the Third World for stable, low-wage areas where the labor-intensive phases of production can more efficiently (and more

[10] This phenomenon refers mainly to the labor-intensive assembly operations that have been shifted out of First World countries to Third or Fourth World countries where those operations can be carried out with low-skilled, low-paid labor. Most of the assembled components or final products are then reexported to be sold in First World markets.

[11] Mexico has become the most important Latin American country with respect to this type of activity, mainly because of its close proximity to the United States. However, the effectiveness of the *maquiladora*, as the EPZ is called there, as a tool of regional and national development has been quite limited. For an overview of this global industry, see Grunwald and Flamm 1985.

profitably) be carried out. Likewise, more and more basic manufacturing is being carried out in countries like Brazil, Mexico, Taiwan, and Korea, while Japan, the United States, and Europe increasingly tend to specialize in high-quality, high-tech manufacturing and service special "niche" markets throughout the world economy. Nevertheless, for most very poor developing countries, the traditional international division of labor continues, and as primary product prices fall, so do incomes.

While there are certain disadvantages inherent in "outward-directed" strategies, they have in the past proved to be more successful than inward-directed, ISI strategies. There is, however, some question as to whether or not such strategies can be duplicated by each and every developing country, given the high degree of saturation of First World markets and increased competition that characterizes the global environment of the 1990s.

.. Finally, it should be noted here that it was during the 1960s that the United States, chided by the 1959 socialist revolution in Cuba, carried out its largely ineffective aid effort in Latin America, the Alliance for Progress. After ten years of pouring billions of dollars into development projects, many economists and statesmen alike concluded that a "Marshall Plan for Latin America" could not build developed countries as rapidly nor as successfully as the original Marshall Plan had rebuilt the war-torn countries of Asia and Europe after World War II.

The Unique Role of the United States

During this period the U.S. economy expanded at relatively high rates. Aided by increased expenditures on armaments during the Korean War (1950-53), economic growth was interrupted by only two minor recessions in the 1950s and one in the early 1960s. Thereafter the economy expanded continually, fueled by large military expenditures during the Vietnam War (1963–75) and by social expenditures on the domestic "War on Poverty" (1963–68).

The main problem of the U.S. economy during the last half of the 1960s was a relatively high rate of inflation , and this problem continued to plague both the U.S. and global economies that characterized the next decade. Nevertheless, given the fact that the U.S. economy was, and still is, the largest national economy in the world, its growth fueled the rapid economic expansion throughout this period, and it became widely known as the "engine of growth" for the entire global economy. Thus, when the U.S. economy expanded its demand for imports, the exports of its major trading partners grew as well. Of course, this also meant that when the U.S. economy contracted, its imports also contracted, negatively affecting the exports of its trading partners. Unfortunately, it also meant that inflation in the United States was transferred to the global economy through trade and financial links.

Throughout this period the United States was regarded as the undisputed economic and military leader of the global system. The special position of the U.S. dollar as the "key international currency" gave U.S.-based MNCs an unusual advantage which stimulated their sometimes not-so-welcome expansion throughout the capitalist world. Thus, after World War II, MNCs from many First World countries, but mainly the United States, replaced national corporations as the major actors in the global economy, accounting for roughly one-third of the total world production of goods and services.

Prior to War II, MNCs investing in developing countries invested mainly in the primary sector—extractive industries such as mining, fishing, forestry, and agriculture—but after World War II they moved into the secondary sector—manufacturing and construction—as well as the tertiary sector—commerce, finance, and other services—operating in a variety of organizational forms.

The impacts of MNCs on both sending (First World) and host (Third World) countries has been widely debated. On the one hand, it is alleged that they generate jobs and foreign exchange in host countries and provide access to new technology, capital, markets, and skills. On the other hand, they can and frequently do exert an inordinate amount of political pressure on host governments, remove profits arbitrarily, and frequently act as independent and destabilizing agents without regard for the economic or social needs of the host country. The major cost for the sending (center) countries, where most MNCs are based, is that jobs are frequently lost as operations are moved offshore, while the major benefit is the income that accrues to the sending country from the profits and other fees earned abroad by the MNC.

The growth of U.S. MNCs, together with the emergence of the U.S. military as the Western world's police force and protector of U.S. interests around the globe, gave the United States an inordinate degree of economic and political power and engendered a great deal of both criticism and emulation.

Meanwhile, by the mid-1950s the economies of Asia and Europe that had been decimated during World War II were substantially rebuilt and quickly began to challenge U.S. economic hegemony. Increasingly, Japanese and European products displaced U.S.–made goods throughout the global economy, especially in the United States itself. And during the 1960s the once large U.S. trade surplus dwindled, to become a trade deficit in the early 1970s, signaling the demise of the United States' "golden era" as the world's undisputed economic leader.[12]

While much of this decline was inevitable, some of it has probably been due to poor management and the fact that so many resources were directed from economic to military uses during the Cold War. Now in the post Cold War era relatively fewer resources are utilized in such "non-productive" sectors. Nevertheless, many economists and statesmen worldwide doubt the ability of the United States to adequately manage its own economic affairs and to provide competent leadership in the rapidly changing global environment.

The 1970s

Beginning in the 1960s several Third World countries—most notably Mexico, Brazil, Taiwan, Hong Kong, Singapore, and South Korea—began to manufacture and export products such as steel, automobiles, textiles, and consumer electronic products that previously had been produced only in First World or Second World countries. Not only did these Newly Industrializing Countries (NICs) achieve high levels of economic growth during this period, but they made serious inroads into markets that previously had been the exclusive domain of the advanced industrial economies of the First World. The emergence of these NICs, of course, further aggravated the problem of the growing U.S. trade deficit.

The 1970s brought another very significant change in the Third World: the emergence of the Organization of Petroleum Exporting Countries (OPEC) as an effective cartel for securing monopoly profits for member countries. Dramatic increases in oil

[12] In 1945, when the United States was the undisputed leader of the world economy, its share of world production was over 50 percent. However, by 1980 this figure had dropped to about 32 percent. Currently, the United States produces approximately 20 to 25 percent of Gross World Product.

prices—first in 1973 and again in 1979—temporarily, at least, made most oil-exporting countries rich. However, the oil price hikes created serious disruptions in the international economy, especially for oil-importing countries, many of which contracted more external debt to keep their economies growing. The oil price increases also aggravated existing inflationary pressures and shocked the global economy into two worldwide economic downturns, one in 1974–75 and another in 1981–82. The latter turned out to be the most severe since the Great Depression.

This combination of economic stagnation—low or negative rates of economic growth—combined with relatively high inflation—rising prices—led to a new term to describe the situation: *stagflation*. Prior to the 1970s, First World economies had experienced either stagnation or inflation, but not both simultaneously. Stagflation, therefore, presented a serious challenge to the Keynesian macroeconomic stabilization theory which had guided economic policy makers throughout the global economy since the 1930s. Ultimately the problems surrounding stagflation stimulated economists to reassess Keynesian theory and led to significant criticisms and modifications of the original theory.

Throughout this decade the economic situation of most oil-importing Third and Fourth World countries became increasingly difficult. Not only did their energy costs skyrocket due to the OPEC price increases, but First World demand for their exports of primary products such as food, fibers, forestry products, and minerals fell. This resulted in lower prices, lower volume of exports, and substantially decreased foreign exchange earnings. Thus their ability to finance the imports necessary for economic development was severely thwarted.[13]

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[13] There is evidence that the demand for primary products will rise at a slower rate in the future than in the past and that periphery countries will therefore have to depend on other types of exports to finance their economic development needs. Thus, due primarily to technological developments in the use of new materials, manufacturing processes no longer use the same quantities of natural resources per unit of output as they did ten, twenty, or thirty years ago. And the same thing is happening with respect to labor; new production processes now utilize more computers and more automated processes than they did ten years ago, thereby reducing the demand for labor.

If this trend continues, it will have enormous effects on the future development of periphery countries. Historically, most Latin American countries relied on the export of primary products to generate the foreign exchange. This foreign exchange financed the imports they needed for industrialization which, it was assumed, would generate enough jobs to absorb new entrants into the labor force. Now, because of the new technology, this will probably work even less well than in the past.

The 1970s also were marked by the rise and demise of the so-called North-South Dialogue. As noted above, during the 1950s and 1960s a number of United Nations organizations were established (e.g., ECLA and UNCTAD) to systematically examine the special problems of the periphery countries, particularly with respect to their economic relations with the center. Then in the 1960s and 1970s, at the insistence of periphery country governments, a number of important conferences were held, under the auspices of the United Nations, between the main center and periphery nations. At issue were the many structural deficiencies of the global economic system discussed above with respect to the Prebisch-ECLA thesis.

In this extended "dialogue" between the North (center) and the South (periphery), the South argued, as had Prebisch, that the global economy systematically favors the North. Subsequently the South formulated and then presented its demands for a *new international economic order* (NIEO). These demands were essentially that the center countries make special concessions to periphery countries, such as lower tariffs on periphery exports of manufactured goods and higher levels of economic and technical assistance that allegedly would accelerate industrialization in the periphery.[14]

The 1980s

While the countries of the North were reluctant to negotiate with the South as a bloc, many discussions did take place, nevertheless, during the 1970s. Then, in the early 1980s, falling oil prices and the Third World debt crisis significantly changed the negotiating environment in favor of the North. Suddenly many countries of the South found themselves responding to the IMF's conditions (see below) for restructuring their debt instead of pushing for the reforms of a global system they considered to be unfair and detrimental to their future development.

Throughout the 1970s many Third World countries had sought to stimulate their stagnating economies and pay for their rising oil bills by borrowing increasingly large amounts of recycled petrodollars—dollars deposited by OPEC countries in U.S.,

[14] Out of these deliberations came a few special programs like the Generalized System of Preferences (GSP) which eliminates duties on a range of products imported into the advanced industrial economies, including the United States and Canada. But, in general, the developed countries were occupied with their own problems, and the demands of the Third World as a bloc were not taken seriously.

European, and Japanese banks—from commercial banks in the First World. The banks were, of course, delighted to loan the dollars that OPEC countries had deposited with them and on which the banks were obligated to pay interest. But with the 1981-82 recession, triggered mainly by anti-inflationary monetary policies in the United States, most Third World countries found their export markets disappearing and the payments on their external debt rising, due mainly to higher interest rates on their loans. Additionally, oil prices reached a peak in 1981 and then began to fall sharply, so that even many oil-exporting countries, including Mexico, found themselves with serious debt service problems.

Subsequently the ability of Third World debtor countries to service their debts—make scheduled interest and principal payments—fell dramatically, and many countries throughout the Third World found themselves on the verge of international bankruptcy. Thus in 1982 the "debt crisis" was formally declared.[15]

Bankruptcy, however, would have meant default on the debts owed, and a likely consequence could have been a crumbling of the international monetary system, with big troubles for all countries of the global economy. So, not wanting to risk such drastic consequences, First World governments (mainly the United States), large commercial banks (mainly in the United States, Japan, and Europe), and the International Monetary Fund began a long series of negotiations with debtor countries to temporarily resolve the debt payments problems and prop up the commercial banks whose "exposure" in Latin America was dangerously high. This was done by restructuring Third World external debt—lengthening the payback period, reducing fees and sometimes the interest rates charged, and extending more loans—so that they could pay the debt service due (interest plus principal).

Meanwhile most First World economies, following the leadership of Britain and the United States, began to carry out extensive market-oriented reforms, ranging from tax cuts and deregulation of key industry sectors to financial liberalization and privatization

[15] In 1981 Costa Rica declared a moratorium on debt payments, but it was not until the larger countries of the region found themselves in similar positions (Mexico in August and Brazil in November of 1982) that the crisis was formally recognized. Despite formal recognition, however, there has been no clear definition of the debt problem nor a definitive strategy for resolving it. Early definitions referred to it as a "liquidity crisis" (a temporary scarcity of foreign exchange), but later definitions focused on "insolvency" (the inability to amortize the debt).

of state-owned industries, based on the main principles of supply-side economics—cutting both taxes and the role of government in the economy in order to stimulate economic growth. This switch back to *laissez-faire* economic policies was embraced by the IMF and the World Bank, which used the Third World debt crisis as an opportunity to impose market-oriented reforms on many developing economies which had relied for decades on "statist" economic policies.

IMF assistance in "bailing out" distressed, debt-ridden countries was therefore conditional on those countries' acceptance of the IMF's "austerity policies." At first, these policies routinely required governments to cut government expenditures and devalue their exchange rate. Such policies, argued the IMF, would cut inflation, increase exports, and decrease imports, thereby increasing earnings of foreign exchange and, in turn, improve countries' ability to service their (external) debts and attract new investment, needed to stimulate long term economic growth..

The main problem with this approach was that such programs, which reduce inflation by restraining economic growth, frequently provoke recessions. Additionally, devaluations can increase inflation by making imports more expensive. Thus such programs—in the short run, at least—usually led to lower living standards, increased unemployment, continued inflation and, in turn, political instability as the poor and middle classes protest their deteriorating circumstances.

Meanwhile, with the emergence of the debt crisis in 1982, First World commercial bank loans to periphery countries virtually disappeared while official development assistance from First World governments also fell. So, while loans from multilateral lending agencies like the IMF, World Bank (IBRD), and the Inter-American Development Bank (IDB) increased somewhat—although they were not sufficient to make up the decrease in other categories—they became the only available source of long-term funding, increasing the leverage of the those agencies.

After a few years the IMF and the creditor countries recognized not only was political instability increasing throughout the Third world but also that First World exports there were falling resulting in fewer jobs and lower incomes. Therefore, after some deliberation, the United States came up with a new plan in 1985: the Baker Plan, named after former U.S. Treasury Secretary James Baker III. New loans and assistance and restructuring of the debt were to be provided by the commercial banks and the U.S.

government, together with the IMF and the World Bank. Again, such assistance was conditional on implementing a set of policies which would allow "the magic of the marketplace" to work more effectively without the burdens of excessive government control.

Specifically this meant that debtor countries would have to carry out short term "stabilization policies" and market-oriented, "structural reforms"—long-term changes in economic policy including reducing government subsidies and bureaucratic regulations, overhauling the tax system, and selling state enterprises to private entities as well as opening up their economies to increased foreign trade and investment by abolishing import quotas and permits, and lowering tariffs and barriers to foreign investment.

Thus it was argued that, over the long term, such reforms would stimulate economic growth and the size of their debt in relation to the size of their economies would become smaller, and debtor nations would be able eventually to pay off their debts, which by the mid-1980s totaled about $1 trillion for the entire Third World and $400 billion for Latin America, one-fourth of which was owed by Mexico alone.

While most debtor countries endeavored to comply with the conditions set out above, they also criticized the major theme of the Baker Plan: that new, restructured loan packages, together with internal reforms in the debtor countries, would allow their economies to grow at the same time they serviced their debts. In fact, the debtor countries repeatedly asserted that paying off their external debts was inconsistent with achieving long-run economic growth and development.

Periphery countries also complained that while center countries, especially the United States, urged them to restructure their economies along free market lines in order to increase internal efficiency of resource use and exports, barriers to trade in center countries, which had been reduced in the 1950s and 1960s, were once again increasing. Many economists also expressed concern about the potential negative effects on global trade of the formation of regional trading blocs like the Canada–U.S. Free Trade Agreement in 1989 and the commitment of the Europeans to form a "single market" by 1992.

By 1989 it was clear that the new loans promised under the Baker Plan would not be forthcoming; commercial banks were still reluctant to "throw good money after bad." So a new plan was put forth, the Brady Plan, named after another U.S. treasury secretary, Nicholas Brady. This plan provided that the IMF and the World Bank would back debt reduction agreements (with funding and repayment guarantees), again, assuming that debtor countries implement the market-oriented reforms. Several countries—the first was Mexico—subsequently obtained some debt relief (i.e., lower debt service payments), but total external debt still increased. In Mexico, for example, total external debt rose from approximately U.S.$94 billion in 1989 to $119 billion in 1993.

Thus, from one perspective, for most Latin American countries the decade of the 1980s was a "lost decade." Living standards for most Latin Americans fell significantly. Meanwhile, political instability rose in many of the newly democratized nations of Central and South America[16] as governments attempted simultaneously to service their external debts, restructure their national economies, and adjust to rapidly changing international conditions.[17] Nonetheless, from another perspective the 1980s was a decade of dramatic change in the thinking of economists and policy makers—a "silent revolution" of market-oriented reforms that has continued into the 1990s (Inter-American Development Bank 1992).

Meanwhile, in North America and Europe a different kind of "crisis" emerged. The competitive challenge emanating from Japan and the Asian NICs and the negative effects of globalization itself (i.e., the export of manufacturing jobs via multinational corporations' investment in low-wage countries and the emergence of domestic manufacturing capabilities in the NICs) were increasingly recognized as real threats to continued economic growth and rising living standards.[18]

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[16] In the post–World War II period many Latin American countries experienced military dictatorships (e.g., Paraguay, Brazil, Peru, Uruguay, Chile, and Argentina) and civil wars that became associated with military regimes (such as Bolivia, Cuba, Nicaragua, El Salvador, and Guatemala). Since the beginning of the 1990s most of these have returned, at least nominally, to democratic systems.

[17] Latin America's debt crisis was never really resolved. While the overall health of First World commercial banks and the international monetary system has improved and debt service burdens have been reduced since 1982, the size of the external debt has increased and, theoretically, must still be repaid, someday.

[18] The concept of the "product life cycle" is helpful in understanding this situation. Essentially this theory maintains that certain countries (those with advanced R & D capabilities) tend to specialize in the development of new products, while others specialize in the production of old (mature) products. Thus each product moves through a life cycle from new to old while the geographical location of production also changes. In practice this has meant that new products are usually developed and initially produced in the center countries; as they mature they move offshore to be produced in the low-wage areas of the periphery.

The response in the United States was twofold. First, President Reagan (1980–88) introduced a series of measures which came to be known as "Reaganomics"—"supply-side" tax cuts and deregulation of business, on the one hand, and large increases in military spending, on the other—in order to increase competitiveness, jobs, and economic growth.[19] Second, the United States renewed efforts to lower protectionist measures throughout the world by expanding GATT's coverage to agricultural and service areas—the new areas of competitive advantage for the United States—and by negotiating a free trade agreement with Canada, its main trading partner. In Europe the response focused on renewed efforts to create an economic union, coupled with infrastructure modernization.

Before proceeding to the 1990s we must note the enormous changes in the political-economic landscape of Eastern Europe in the final years of the 1980s. Premier Gorbachev's policies of *perestroika* (economic restructuring) and *glasnost* (democratization) brought profound changes in the economic structure of the Soviet Union and the other communist bloc countries. Meanwhile, the infamous "wall" between East and West Germany was dismantled, and a process of transition from state-planned to market-oriented economies was initiated in most Soviet bloc countries. This process, similar to the policies of restructuring in Latin America generally and Mexico specifically, also incurred high social costs incurred mainly by the poor and middle classes.

The 1990s

At the global level the most significant event of the early 1990s was the end of the Cold War initiated in the mid 1940s. The cost to both the East and the West in terms of the resources used to maintain their respective "warfare states" had been enormous. With the disintegration of the Soviet Union and the demise of the Warsaw Pact (for military cooperation) and the socialist trading bloc (COMECON, Council for Mutual Economic Assistance) and the end of the Cold War came new possibilities for constructing a new world order that could free those resources for peaceful uses. Nonetheless, the optimism that marked the first few months following these dramatic events soon evaporated when

[19] It is difficult to assess objectively the success of these policies; conservatives claim that the increased military spending was responsible for ending the Cold War, while liberals claim that Reaganomics was responsible for quadrupling the U.S. national debt in one decade while neglecting U.S. international competitiveness. Nevertheless, during this period the United States became a net debtor country.

it was realized that democratizing and rebuilding the former communist countries' economies along market lines would be costly, painful, and frequently violent. Additionally, the transition to capitalism in Eastern Europe—and to some extent in China and India, which are now undergoing market-oriented reforms—implies that over the next few decades another two billion people will be incorporated into the global market system as consumers and low-cost producers.

The 1990s also brought a new fascination with regional trading groups and international trade liberalization. In Latin America the "Enterprise of the Americas" proposal to create a hemispheric free trade zone, announced by U.S. President George Bush in June 1990, focused attention on regional (trade) integration. The overall process of market-oriented reform that began in the 1980s with macroeconomic stabilization and structural adjustment programs now began to focus on opening up national economies through regional trading groups in order to force domestic efficiency, reduce inflation and foster international competitiveness.

As noted previously, in North America negotiations began in 1990 to create the three-country NAFTA, building on the Canada–U.S. Free Trade Agreement. By 1993 the agreement was negotiated, and implementation began in January 1994.

In Latin America, the three main regional trading groups (the Central American Common Market, the Andean Common Market, and the Southern Cone Common Market) also made significant progress toward increased integration, and at the Summit of the Americas in Miami, Florida, in 1994 an agenda was established to create a hemispheric free trade area by 2005.

Meanwhile, in Europe considerable progress was made toward political and economic unification with the negotiation and ratification by fifteen countries of the Treaty on European Union. And in Asia an informal regional trade bloc has evolved in recent years, centering around Japan.

Finally, as noted in the previous chapter, progress toward global trade liberalization occurred when the Uruguay Round of GATT negotiations concluded in the early 1990s in late 1994, just before the Summit of the Americas meetings in Miami. As noted in chapter 2, the new agreement broadened coverage from manufactured goods to agricultural goods and services, protected trademarks and patents (i.e., "intellectual property"), and create a new World Trade Organization (WTO) with more power to enforce the new "rules of the game" for international trade.

Even though "free trade," a major theme of the 1990s in the Western Hemisphere, still stimulates heated controversies in each country, an enormous amount of activity is being expended in virtually every country (except the United States) to expand trade relations through new agreements.

Nevertheless, there are still formidable obstacles to expanding the NAFTA. Despite significant economic growth in recent years, most Latin American countries are still in the early stages of the reform process. They are regarded as relatively unstable and still have significant trade barriers. And yet, since the early 1990s many Latin American countries have received considerable attention from the international financial community as "emerging markets," and private capital has begun to flow back into the region as stock markets have boomed and MNCs have attempted to position themselves for taking advantage of the region's growing and increasingly open markets.

Nevertheless, the December 1994 peso crisis and the subsequent "tequila effect" in other countries, whereby investors temporarily withdrew their capital in anticipation of further devaluations, have increased resistance to new trade agreements in the United States.

Conclusions

During the time period covered in this chapter, from the 1930s to the mid-1990s, the global economy and our way of thinking about it have changed in several ways.

First, technological developments in communications, transportation, and information systems have made globalization of economic activity a reality. Consequently, manufacturing has become more dispersed geographically, and more countries have become more industrialized. Protectionism has diminished considerably, and most countries are more "open" now than at the beginning of the period. The global system is somewhat more "managed" than it was at the outset of the period, due to the actions of a handful of multilateral economic institutions, including the WTO and the IMF.

Second, the role of government in the economy has changed considerably, twice. Prior to the 1930s the best government was considered one that governed least. After the Great Depression, the theories of Keynes and Prebisch challenged that premise, and capitalist economies entered a period of active government participation in economic affairs. This changed once again with the Third World debt crisis and emergence of supply-side economics in the 1980s. Despite the many social and economic problems that now characterize virtually all countries of the world, there are strong ideological biases against using government to alleviate them and fewer resources available for this purpose even when the political will is present.

Another important change is the relative waning of U.S. hegemony in global affairs. The United States, which emerged from World War II as the dominant power in the global economic system, has experienced serious challenges—from both Japan and the newly constituted European Union—to its competitive position in global markets and to its leadership in international economic institutions. In the post–Cold War era it is not yet clear how the world order will function—economically, militarily, and politically.

Finally, the general deterioration of the environment has emerged as an issue to be reckoned with if global living standards are to be improved or even maintained. In this context, the "good news" is that the level of awareness and discussion of environmental issues is rising; the "bad news" is that rampant, large-scale environmental destruction still occurs every day. In this context local, national, and global systems must be fashioned to regulate the current wanton misuse of the earth's resources. (World Bank, 1992)

It is in this context that t(he NAFTA has emerged. The world is a very different one than existed in the immediate post–World War II period. Some of the countries that were struggling simply to survive then have emerged as economic powerhouses in the current context. Firms in Japan and in mature economies in Europe now develop and produce state-of-the art consumer and producer goods and in many cases out-produce U.S. firms, while firms in the NICs are now capable of producing a wide range of low-cost consumer goods and in some cases intermediate and producer goods.

Increasingly, the nationality of firms and their products has become irrelevant as North American firms enter into strategic alliances with Asian and European companies and international trade increasingly becomes "intra-firm," with components and final goods moving between different divisions of the multinational firm. Additionally, firms have become increasingly mobile as they relocate production plants from one place on the globe to another to in order to cut costs or better serve a new, emerging market. In many cases the casualties of such moves are displaced workers and their communities; in others it is the environment that suffers, underscoring the need to somehow regulate international corporate behavior.

As new technology increasingly makes globalization possible, economic borders become less relevant. Individual countries have responded by increasing their integration with others, thereby creating regional trade blocs. Ideally, from the perspective of mainstream economists, all countries should move toward a borderless world at the same time, but reality does not yet conform to that ideal world. So we are left with a melange of overlapping trade blocs struggling to find some sort of overriding order under the auspices of the GATT and the WTO.

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Part II — Introduction

In this section we look at the economic history of the three NAFTA countries, focusing on some of the key factors explaining their development (or lack of it) as well as their trade relations with the rest of the world. Each of the three countries has developed in its own way, struggling with its unique endowment of geographic, climatic, demographic, social, and political characteristics which, in turn, led to different development and international trade policies.

One factor that was common to all the countries was a colonial experience; however, that experience was certainly different for each. The United States began as a colony of Great Britain in the early 1500s and was the first to break its colonial ties, in the 1770s. Mexico, a colony of Spain, also since the early 1500s, broke its ties some forty years later, in the 1810s. Canada's Europeanization occurred much later, initiated in the early 1600s by French settlers. It was a British colony for a century, up until 1867, when the provinces formed a confederation.

While it certainly goes too far to say that Mexico's colonial experience was "bad" and those of the United States and Canada "good," it is certainly true that Spain's administration of Mexico, with its focus on gold and silver extraction, left Mexico with fewer possibilities for economic development than did Britain's looser administration of the United States and Canada. But many other factors contributed to the differences between the three countries' current level of development. Since this is not a text on economic development, it may suffice to say that theories of economic development have centered on a wide variety of factors, ranging from religion, culture, and entrepreneurship to capital investment, education, and institutional development.

In the next few pages we present a series of graphs to describe the current economic differences between the three countries and some of the factors underlying these differences. Most of the indicators used are fairly standard (e.g., GDP per capita) and may not need explanation; however, others (e.g., "openness") may be somewhat alien. We have provided a brief description for each indicator and then interpreted what the differences mean in this context.

The three chapters following this graphical introduction provide an overview of the development experience of the three NAFTA countries within the context of the global economy generally, and more specifically within the context of NAFTA. As we have already seen in earlier chapters, the NAFTA has from the very beginning been strongly debated in each country. And as the agreement is implemented over the next decade or so, we can expect both the intensity and the nature of the debates to change, depending on the performance of each country's economy, the rulings on trade disputes by the various trilateral institutions, and what is happening in other international institutions such as the World Trade Organization and other trade blocs (e.g., the European Union). Nevertheless, a basic understanding of each country's economics and related politics is necessary to understanding the dynamics of NAFTA over the long term.

Real GDP per Capita

Real GDP per capita is gross domestic product (GDP) divided by population. GDP is adjusted for inflation so it measures real changes in the quantity of goods and services produced. Social scientists use this statistic as a crude measure of living standards, even though most will freely admit that no single number can capture all the subtleties of a nation's quality of life. For example, real GDP per capita ignores a number of important issues such as the distribution of income, the condition of the environment, the degree of congestion, and issues of personal safety, to name just a few.

Nevertheless, it is convenient to have a single number that summarizes the average material wealth of a nation's citizens, and real GDP per capita comes closer than any other single number.

International comparisons of living standards also encounter the problem of radically different prices for similar goods. For example, if the U.S. dollar is chosen as the standard for comparing Canadian, Mexican, and U.S. incomes, then Canadian and Mexican GDP must be converted into dollars. Sudden shifts in the value of the peso or the Canadian dollar will dramatically alter the conversion. As a result, a given quantity of pesos may exchange for a lesser or greater amount of dollars, regardless of the state of Mexico's GDP.

In order to overcome this problem, economists have constructed an artificial exchange rate that converts one currency into another at a constant level of purchasing power. In essence, this technique converts currencies at a rate that keeps their purchasing power constant. For example, 10,000 pesos will convert into dollars at a rate that keeps their purchasing power constant, whether in Mexico in pesos or in the United States in dollars. These artificial exchange rates are called purchasing power parity exchange rates.

The comparison of real GDP per capita in the following chart is based on purchasing power parity conversions of Canadian dollars and Mexican pesos into U.S. dollars. It shows that the quantity of goods and services available to the statistically average Mexican citizen is about one-third of the quantity available to the statistically average U.S. citizen. For Canada, the level is about 90 percent of the U.S. quantity.

Comparisons over time, from 1950 to 1992, show that Mexico's real GDP per capita has grown from approximately one-fourth to one-third of the U.S. level. For Canada, the convergence has been from 75 percent to 95 percent over the same time span.

INSERT "REAL GDP PER CAPITA" GRAPH ABOUT HERE

Real GDP per Worker

Real GDP per worker is similar to real GDP per capita. The only difference is that real GDP is divided by the labor force, instead of by the population. The value of this statistic is that it shows the average amount of goods and services produced by each worker in the course of a year.

Notice that the U.S. and Canadian figures are very close to each other, as was the case with real GDP per capita. In Mexico's case, however, the difference is much less than it was with real GDP per capita. This reflects the fact that Mexico has a much greater share of its population that is not yet in the labor force. Another way to say the same thing is that Mexico has a greater proportion of dependents in its population. Everyone is counted in the population figure that is used in the denominator of GDP per capita, but only economically active persons are counted in the denominator of GDP per worker. For this reason, the United States' GDP per capita is about three times that of Mexico, but GDP per worker is only a little more than twice as great.

INSERT "REAL GDP PER WORKER" GRAPH ABOUT HERE

Real Capital per Worker

How productive are workers? In large part the answer depends on the quantity and quality of the tools they have to work with. In the language of economists, it depends on the amount of capital per worker.

The non-residential capital stock consists of factories, office buildings, and the machines and tools that go in them. The greater the stock of capital per worker, the more productive a worker will be. For example, consider the case of two workers who are identical in every respect: motivation, intelligence, and education. If we give one of them a $5 shovel and the other a $100,000 earth-moving machine, it is obvious who will have a bigger hole at the end of the day.

To some extent, nations can compensate for having less capital on the job by using the capital they have more wisely. This may partly explain why the United States has higher productivity and higher GDP per capita than Canada, which is shown in the graph to have more capital per worker.

The graph also shows how the 1980s were hard on Mexico as its rapidly growing labor force soaked up all the new capital so that the amount per worker stayed relatively constant (or even fell slightly). In the long run, as Mexico's income levels approach those of Canada and the United States, we will see a rise in the amount of capital each worker has at his/her disposal to approximately U.S. and Canadian levels.

INSERT "NON-RESIDENTIAL CAPITAL STOCK PER WORKER" GRAPH ABOUT HERE

Trading Partners: Canada, Mexico, and the United States

The Canada–U.S. trade relationship is the single largest bilateral trading relationship between any two countries in the world. Exports and imports together total well over U.S.$200 billion.

Both Canada and Mexico are dependent on their trade with the United States to a much greater extent than the United States depends on them. Canada sends about 80 percent of its exports to the United States, while Mexico sends about 68 percent. The United States is also by far the greatest source of both countries' imports. About 65 percent of Canada's imports and 78 percent of Mexico's imports come from the United States.

While U.S. trade is less concentrated on Canada and/or Mexico, both nations are important to overall U.S. trade. Canada is the single largest consumer of U.S. exports (22 percent) and the most important supplier of U.S. imports (19 percent).

In effect, these numbers indicate that the large U.S. market is a hub for North American trade which radiates both north and south, into Canada and Mexico. Although Canadian-Mexican trade is relatively undeveloped, trade with the United States is so large and so important that the NAFTA can be viewed as an extension of the naturally occurring trading pattern that had developed over the last several decades. Consequently, the NAFTA is not likely to divert very much trade from third parties but, rather, is more likely to extend trade relations in the same direction they would go with or without the agreement.

INSERT "CANADA: PRINCIPAL TRADING PARTNERS" GRAPH ABOUT HERE

INSERT "MEXICO: PRINCIPAL TRADING PARTNERS" GRAPH ABOUT HERE

INSERT "UNITED STATES: PRINCIPAL TRADING PARTNERS" GRAPH ABOUT HERE

Openness

Openness is defined by trade economists as exports plus imports divided by GDP: (exports + imports)/ GDP. Openness does not measure the trade policies or rules of trade; rather, it conveys a sense of how important trade is to a national economy. The larger the number, the greater its importance.

Canada is by far the most open economy of the three NAFTA countries. Mexico is a distant second, while the United States lags behind in third place. It is no coincidence that Canada, with the smallest population, is the most open, and the United States, with the largest population, is the most closed. Canada's smaller population means that it must depend more on international trade, both exports and imports. By focusing its production on a fewer number of items, it can capture the benefits that come to firms as they grow larger. If Canada tried to produce more goods for its own consumption, it would have to produce on a smaller scale and, in some industries, would lose those benefits.

At the other end of the spectrum is the United States with its huge internal market. U.S. firms can, in many cases, produce solely for the domestic market and still achieve a sufficiently large production scale to obtain the benefits of size. Consequently, in order to achieve scale efficiencies, U.S. firms are not required to search out additional markets in foreign lands for their goods.

Notice also that the 1970s was the only decade in which all three countries increased their openness. Most of the change in this measure that occurred between 1950 and 1990 happened in that decade. In the United States, the 1970s explain almost all the increase in the importance of trade since 1950. In Mexico, the increasing importance of trade in the 1970s and late 1980s makes up for its decreased importance in the 1950s and 1960s, during the years of import-substitution industrialization. And in Canada, the 1960s and 1970s show a substantial increase in the importance of trade, while the 1980s have seen a slight decrease.

INSERT "OPENNESS" GRAPH ABOUT HERE

Investment

The ratio of investment to GDP tells economists a great deal about a nation's economy. Since investment is one of the components of GDP (along with consumption expenditures, government expenditures of final goods and services, and net exports), the ratio must be between 0 (no investment) and 100 percent (GDP = investment only). For most countries in the world, the ratio ranges between 10 and 40 percent.

Investment is defined as expenditures on relatively long lasting goods and services that increase the ability of the economy to produce more goods and services. In other words, investment is the purchase of new factories and machines to go in them. Since houses and apartments are very long lasting, they are included as well, as are inventories of firms which are necessary to conduct business. To recap, the main items of investment are new plant, new equipment such as machines and computers for businesses, new residences, and any additions to business inventories.

The down side to investment is that the higher the level, the lower the level of consumption, government spending, and exports. In other words, the cost of investment is that we give up some consumption, government spending, or sales to foreigners. The up side, however, is that investment will ultimately enable our economy to produce more of all goods.

There are essentially two sources of funds for investment. There is domestic savings, which is created whenever households, businesses, or government bring in more income than they spend, and there is foreign savings, which can be borrowed from abroad but that must eventually be paid back.

One of the key pieces of Mexico's strategy with the NAFTA was to increase the amount of foreign savings that entered the country. The reason can be clearly seen in the graph of real investment as a share of GDP. Mexico invested around 16 percent of its GDP in the late 1980s and early 1990s. By comparison, Canada invested between 25 and 28 percent, and the United States invested between 20 and 23 percent. If Mexico's investment were compared to other developing countries such as the high-growth economies of East Asia, the comparison would be even less favorable. The newly industrializing economies of East Asia typically have investment levels equal to between 30 and 40 percent of their GDP.

Mexico's relatively lower investment rate is ultimately a result of lower levels of domestic savings. The consequence is that its rate of economic growth will not be as great unless it can supplement its investment with some other source of savings. Hence the strategy of trying to pull in the savings of foreigners through increasing capital flows into Mexico.

INSERT "REAL INVESTMENT SHARE OF GDP" GRAPH ABOUT HERE

Consumption

In many respects, the ratio of consumption to GDP is a mirror image of the investment to GDP ratio. Mexico has relatively lower investment levels (as a percentage of its GDP) and, consequently, has higher levels of consumption. This shows up clearly on the graph of the ratio of consumption to GDP, where the order of the countries from top to bottom is just the reverse of the investment to GDP graph.

It may seen logical to infer that Mexico's consumption to GDP ratio is greater because it is a developing country and savings must be harder. While reasonable, this assumption is incorrect in fact. Developing countries often save very significant amounts of their income in spite of the fact that doing so lowers their standard of living. Nevertheless, just as in high-income economies such as the United States and Canada, people in developing countries see savings as a means to improve their living standards *in the long run.*

The reasons for Mexico's relatively higher and Canada's relatively lower consumption levels are complex and not directly related to the fact that Canada is a rich country and Mexico is a developing country. Economists debate the importance of different determinants of consumption behavior, and no one can say for certain why one country consumes most of its income and another does not.

Consumption is always the single largest of the four main components that make up GDP. For this reason, economists who closely watch the cycle of boom and bust that characterizes every economy keep a close tab on the absolute dollar amount of consumption spending.

INSERT "REAL CONSUMPTION SHARE OF GDP" GRAPH ABOUT HERE

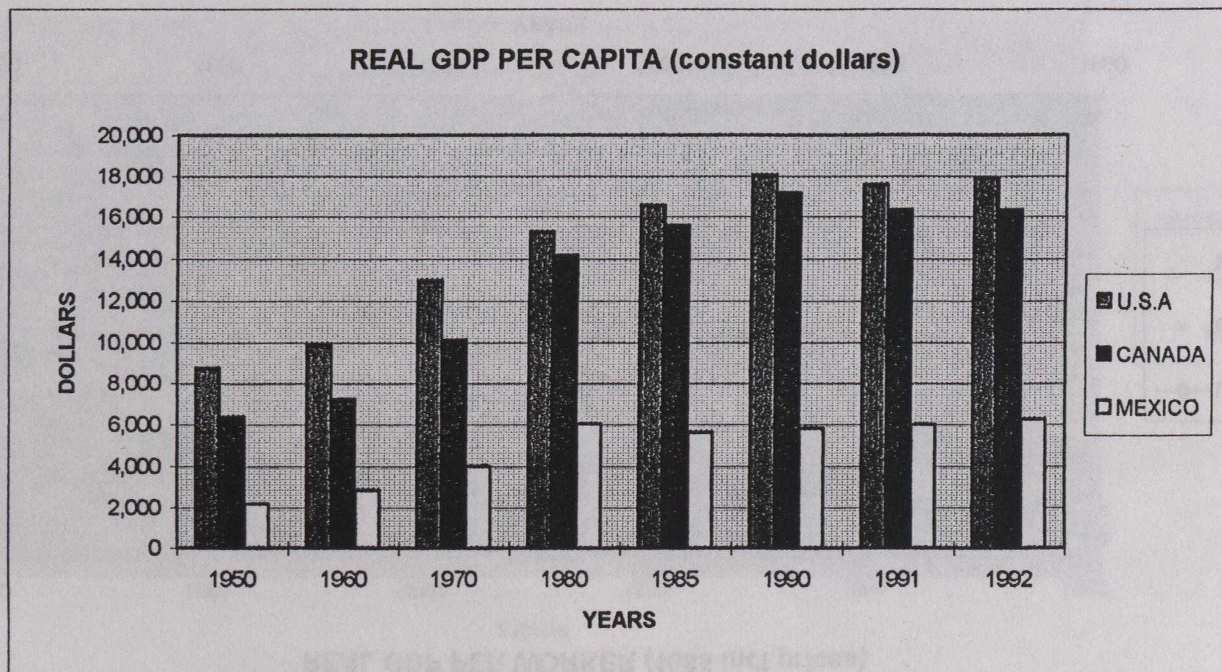
Population

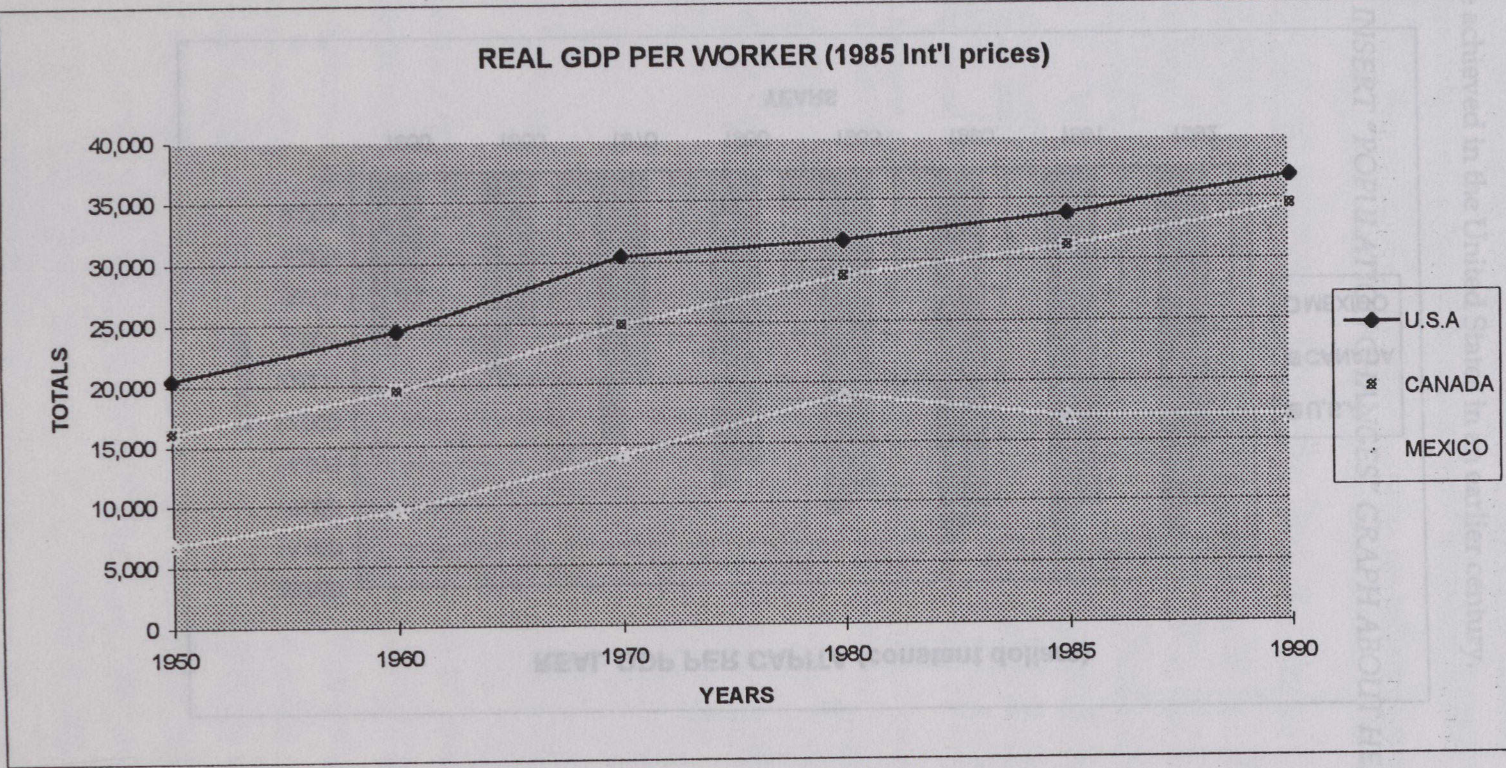
The United States is by far the most populous of the NAFTA nations. Canada, on the other hand, is only about 10 percent the size of the United States. The United States' large population has made it the least dependent on trade of the NAFTA countries. The huge domestic market means that many producers have the luxury of not having to export in order to produce at the large scale necessary to reach minimum average cost.

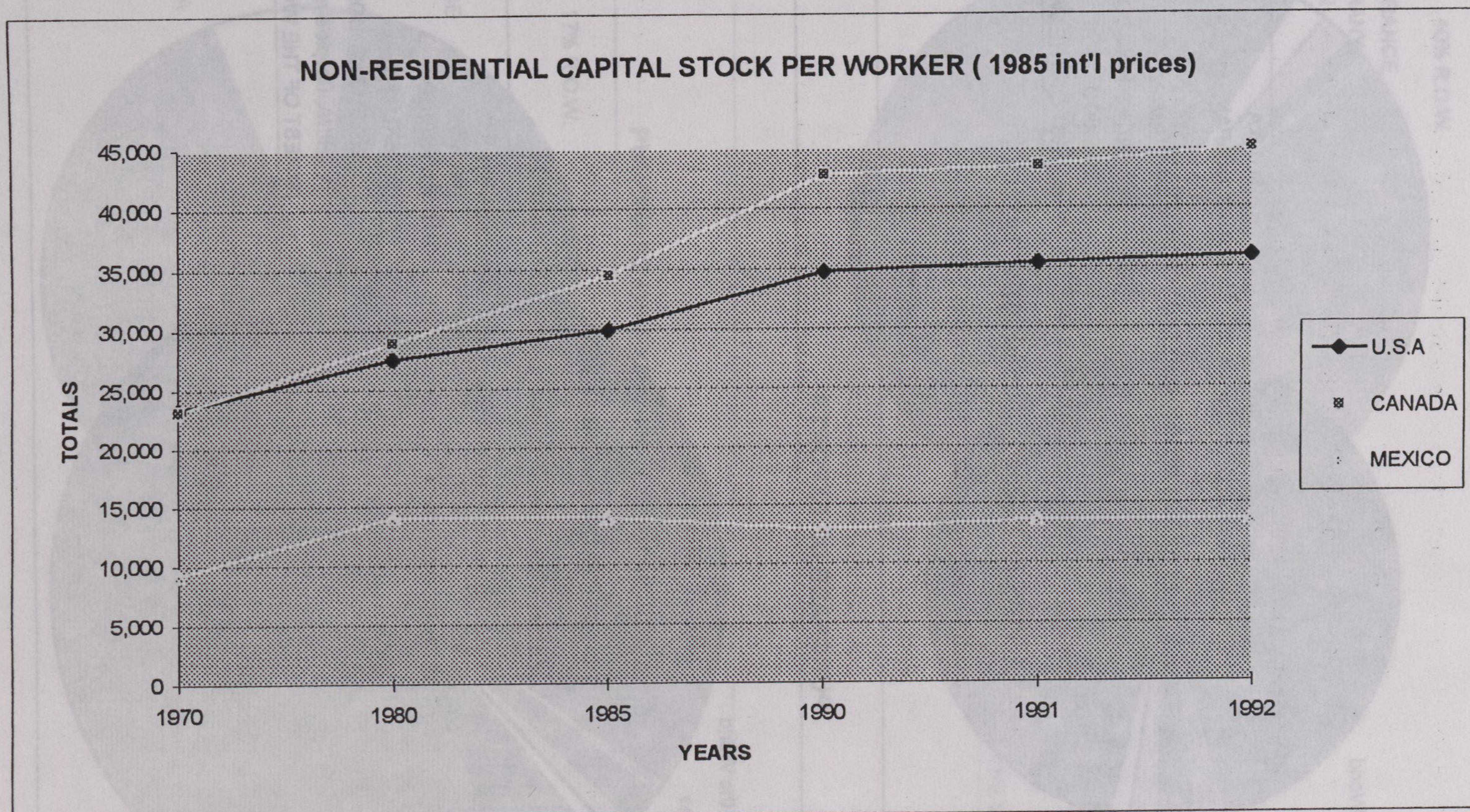
Mexico is intermediate between the United States and Canada, with a population slightly over one-third the size of that of the United States. Note how these relative sizes have changed, however. In 1950, Mexico's population was approximately one-sixth that of the United States. By 1990, only forty years later, it had grown fast enough to equal about one-third of the U.S. population.

It is interesting to note that Mexico's rapid population growth during the last fifty years is no faster than the growth that the United States experienced in the nineteenth century. Nevertheless, relatively rapid population growth puts additional strains on savings and investment to keep up. Mexico's ability to save is probably much less than the rates that were achieved in the United States in an earlier century.

INSERT "POPULATION CHANGES" GRAPH ABOUT HERE


REAL GDP PER CAPITA (constant dollars)
DOLLARS
20,000
18,000
16,000
14,000
12,000
10,000
8,000
6,000
4,000
2,000
0
1950
1960
1970
1980
1985
1990
1991
1992
YEARS
U.S.A
CANADA
MEXICO

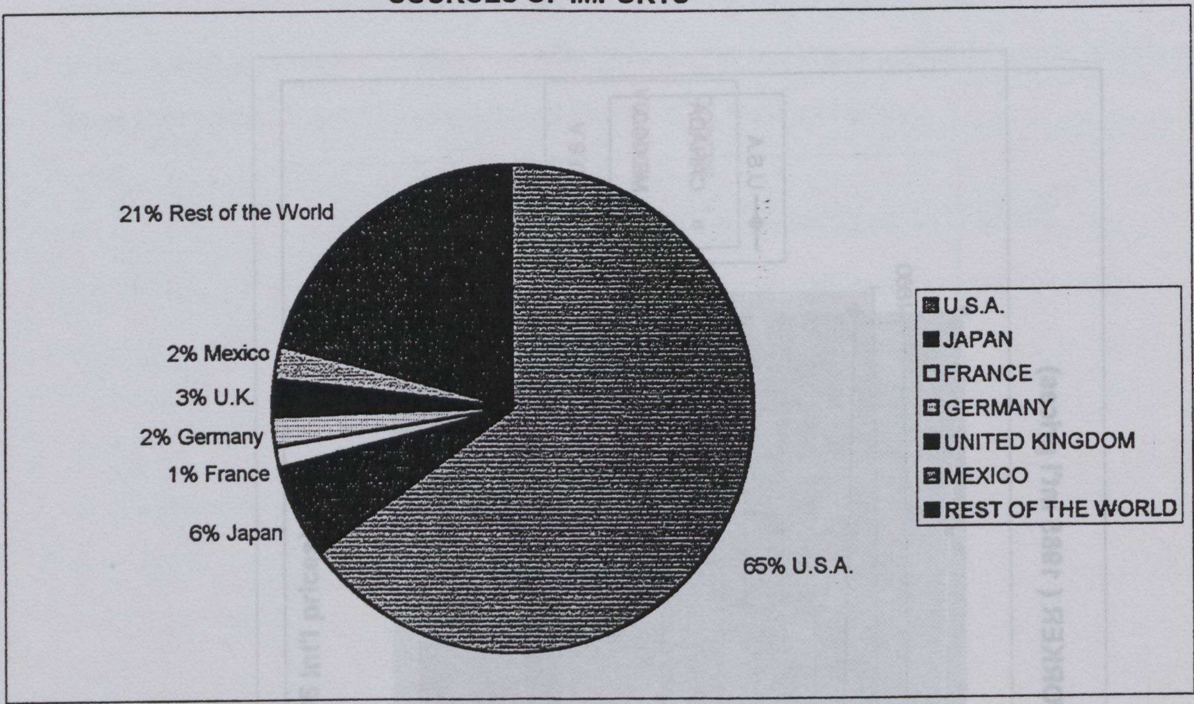

REAL GDP PER WORKER (1985 Int'l prices)
TOTALS
40,000
35,000
30,000
25,000
20,000
15,000
10,000
5,000
0
1950
1960
1970
1980
1985
1990
YEARS
U.S.A
CANADA
MEXICO



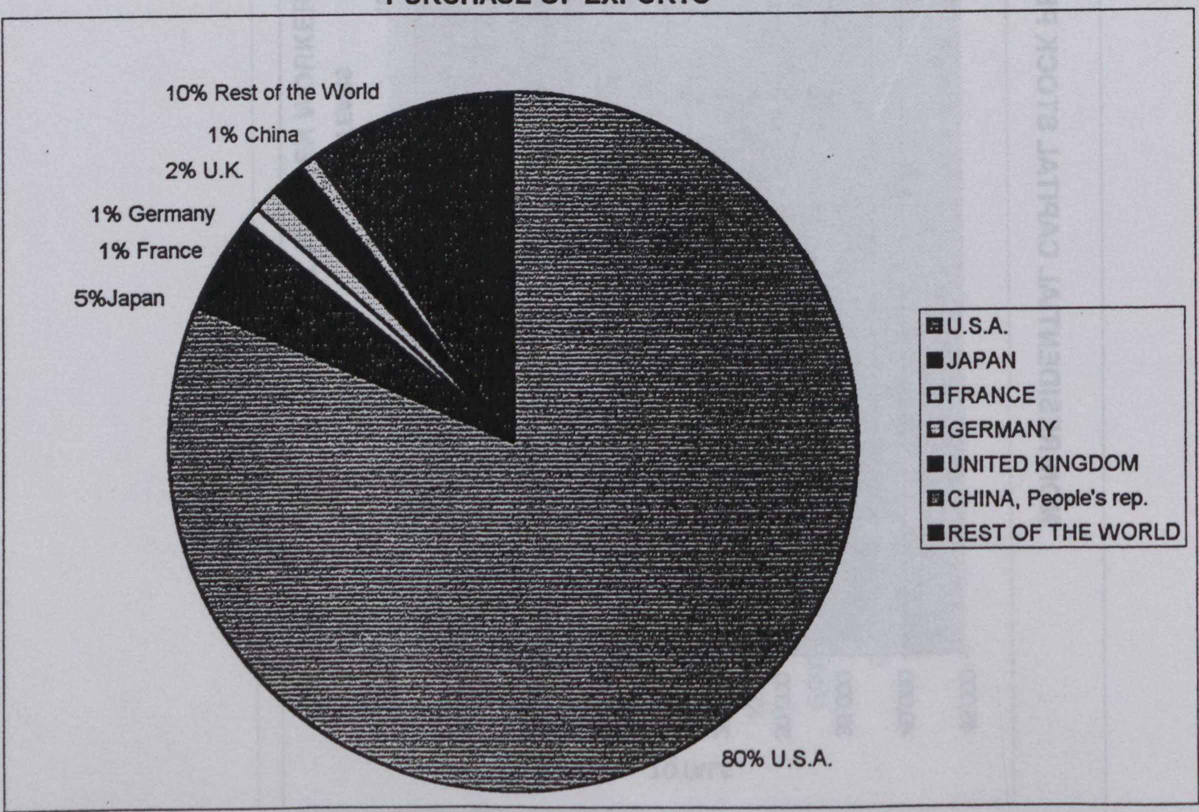
NON-RESIDENTIAL CAPITAL STOCK PER WORKER (1985 int'l prices)
TOTALS
45,000
40,000
35,000
30,000
25,000
20,000
15,000
10,000
5,000
0
1970
1980
1985
1990
1991
1992
YEARS
U.S.A
CANADA
MEXICO

CANADA: ~~PRINCIPLE~~ PRINCIPAL TRADING PARTNERS ~~AS~~ (1993)

SOURCES OF IMPORTS



PURCHASE OF EXPORTS



MEXICO: ~~PRINCIPLE~~ PRINCIPAL TRADING PARTNERS ~~AS~~ (1993)

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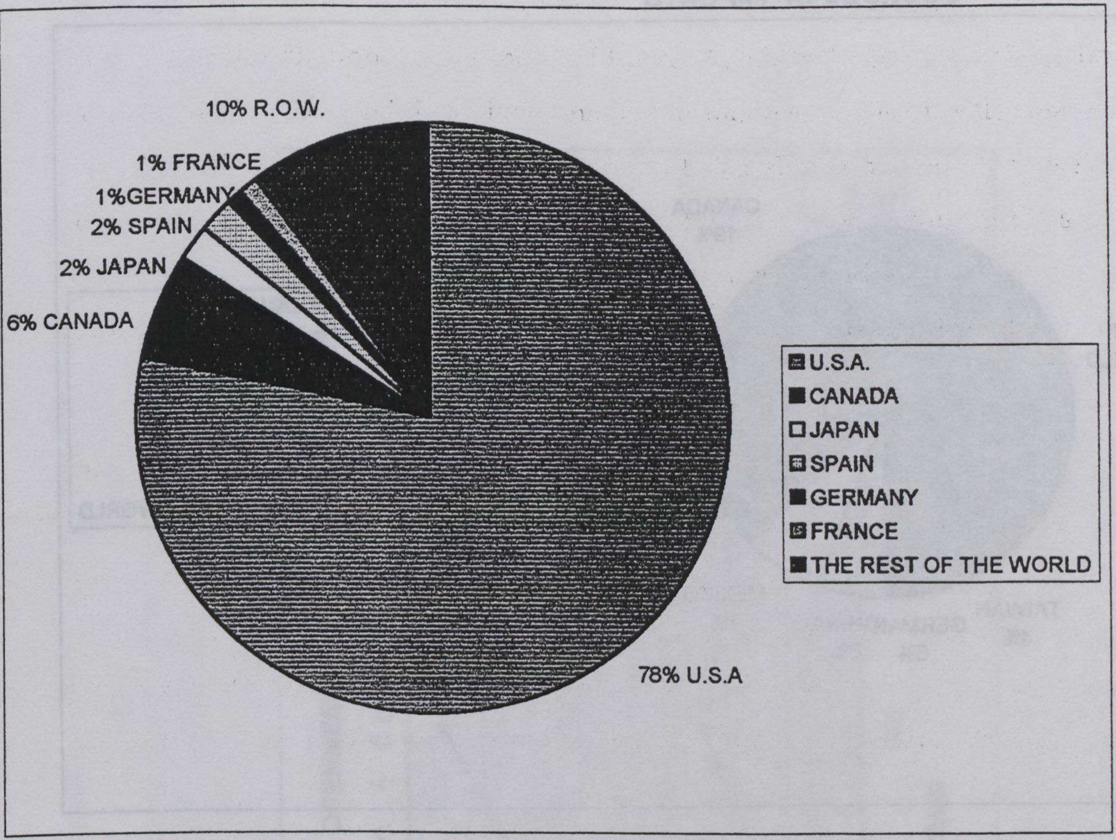
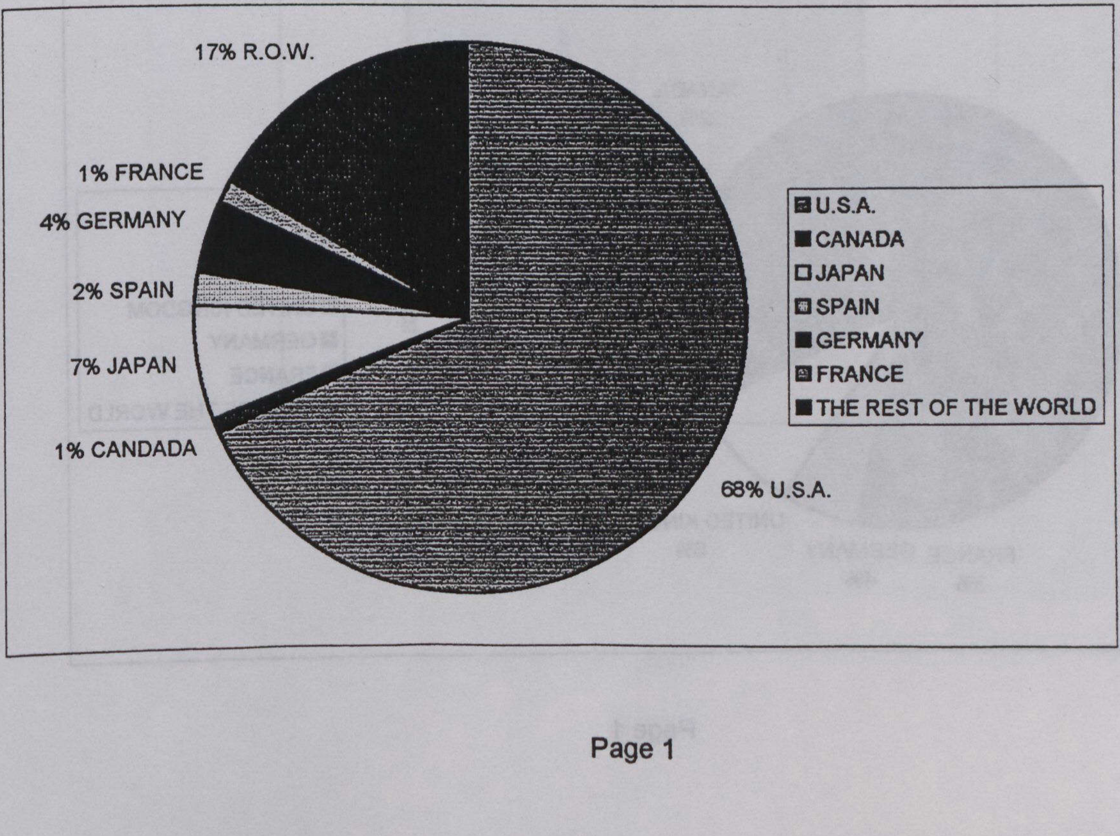
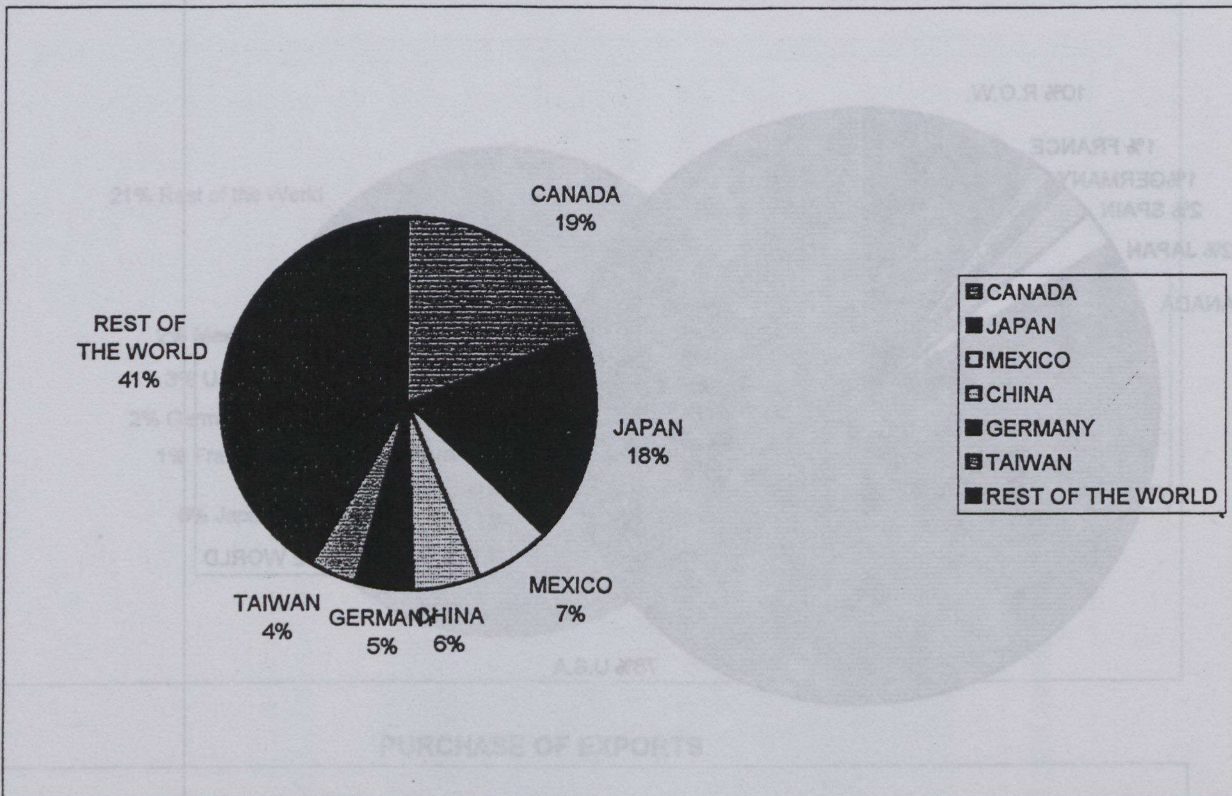


PURCHASE OF EXPORTS

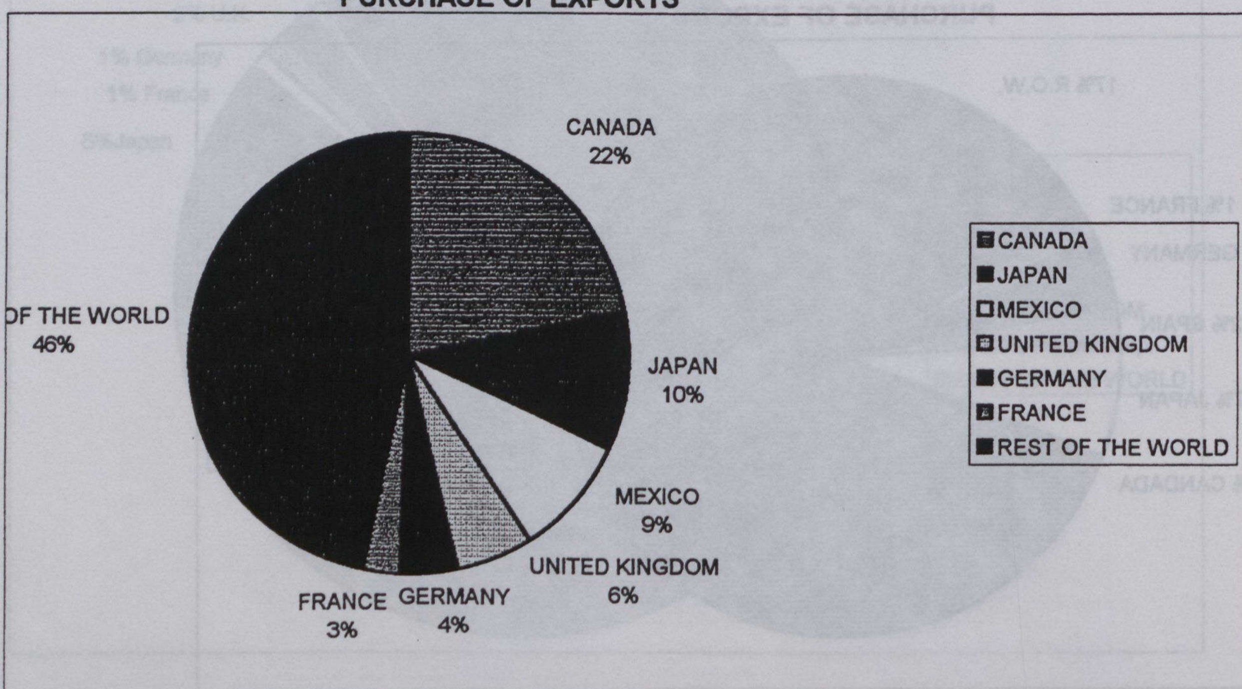


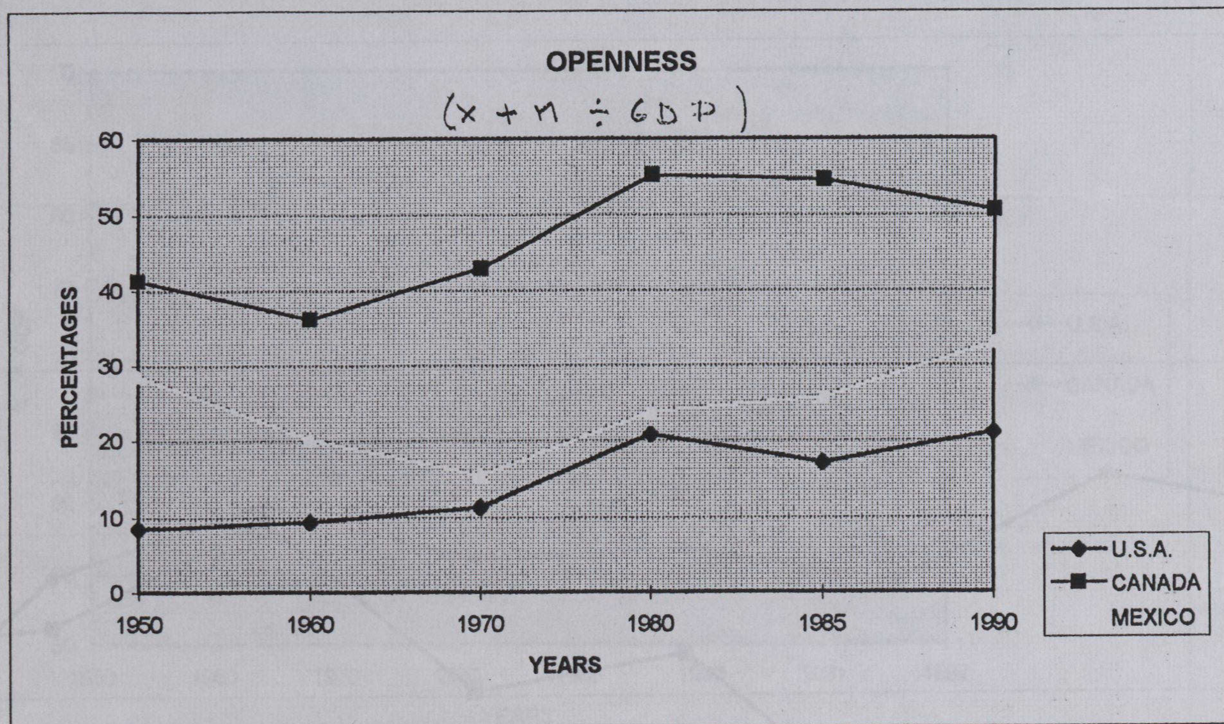
U.S.A.: ~~PRINCIPLE~~ PRINCIPAL TRADING PARTNERS AS 1993

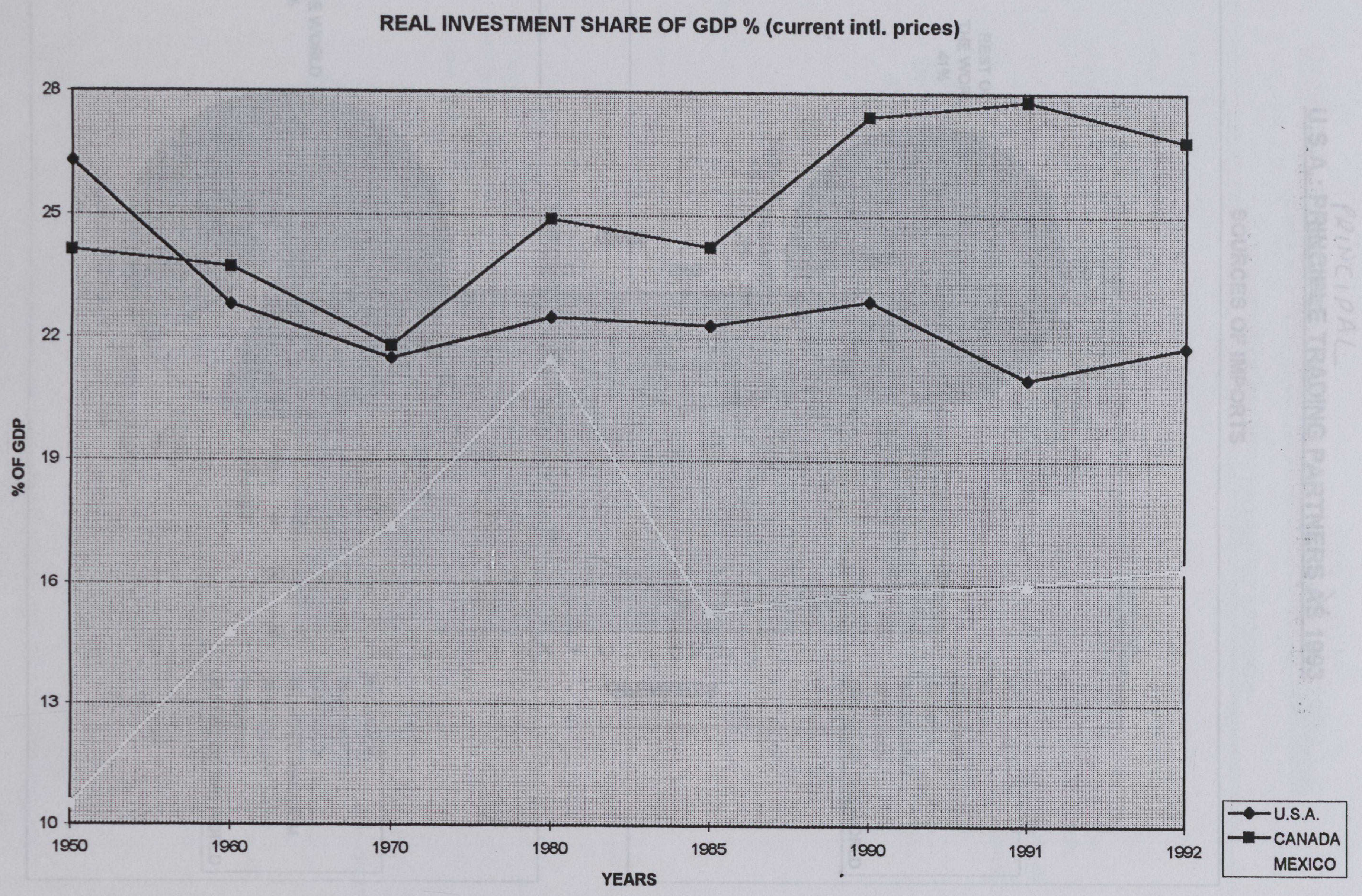
SOURCES OF IMPORTS

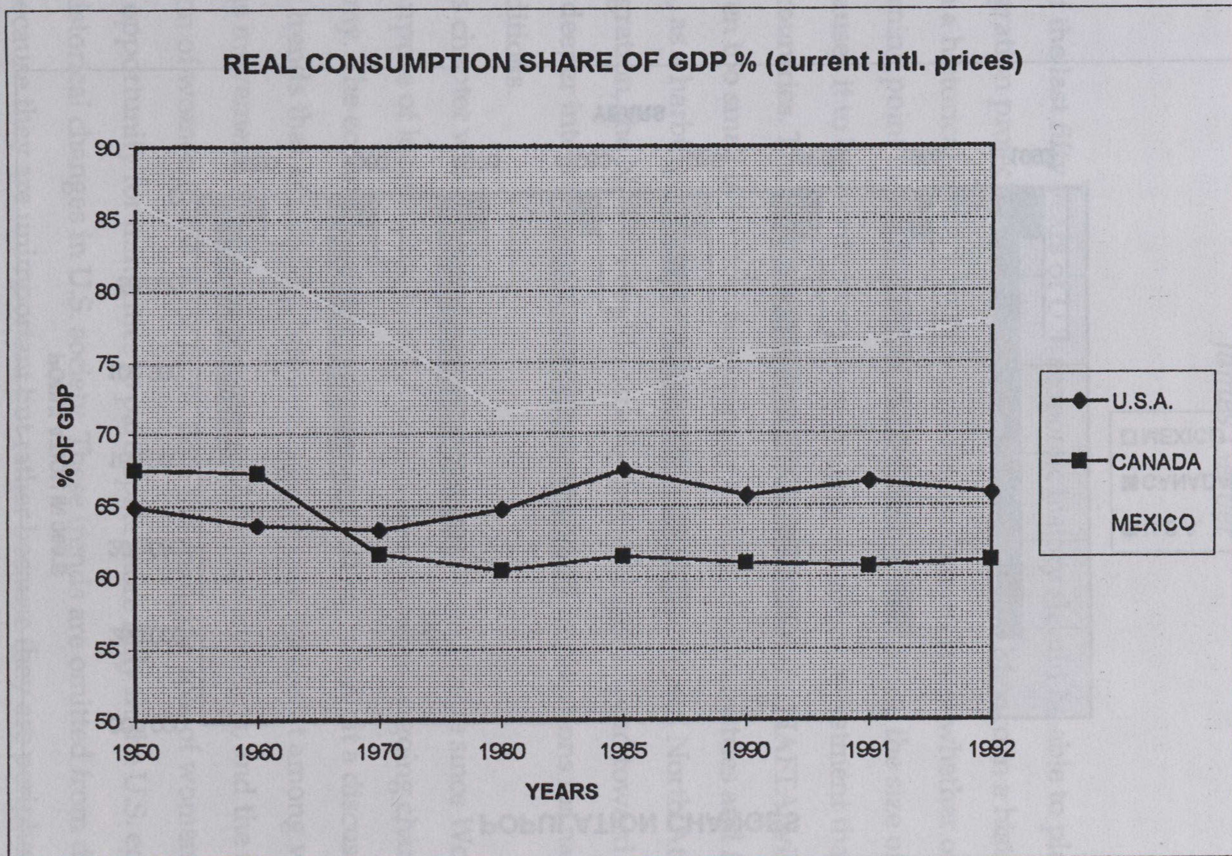


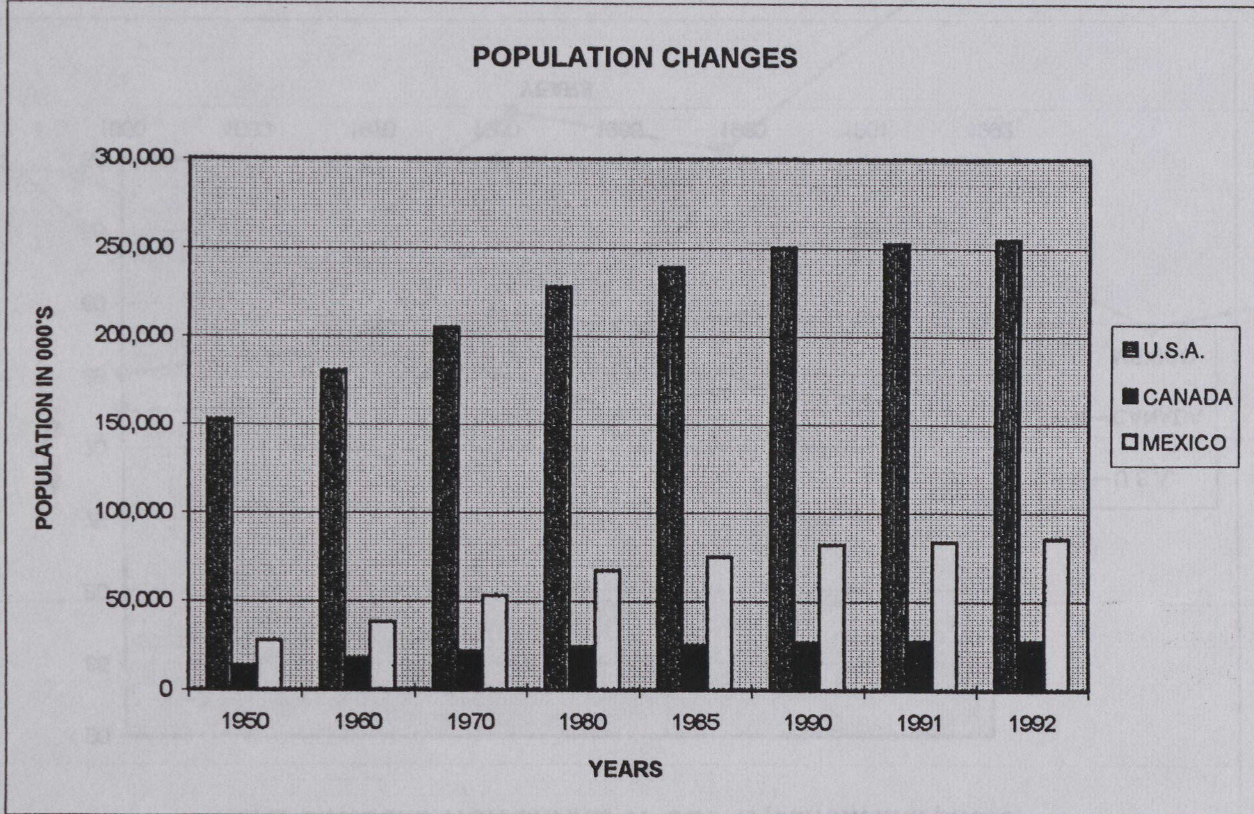
PURCHASE OF EXPORTS




OPENNESS
(X + M ÷ GDP)
PERCENTAGES
60
50
40
30
20
10
0
1950
1960
1970
1980
1985
1990
YEARS
U.S.A.
CANADA
MEXICO


REAL INVESTMENT SHARE OF GDP % (current intl. prices)
% OF GDP
28
25
22
19
16
13
10
1950
1960
1970
1980
1985
1990
1991
1992
YEARS
U.S.A.
CANADA
MEXICO


REAL CONSUMPTION SHARE OF GDP % (current intl. prices)
% OF GDP
90
85
80
75
70
65
60
55
50
1950
1960
1970
1980
1985
1990
1991
1992
YEARS
U.S.A.
CANADA
MEXICO


POPULATION CHANGES
POPULATION IN 000'S
300,000
250,000
200,000
150,000
100,000
50,000
0
1950
1960
1970
1980
1985
1990
1991
1992
YEARS
U.S.A.
CANADA
MEXICO

CHAPTER 4

Growth, Trade, and Investment in the Post–World War II United States

James Gerber

A survey of the last fifty years of U.S. economic history should be able to place the economic integration project of the United States, Canada, and Mexico in a historical perspective. In a historical sense, however, it is far too soon to know whether or not it marks a turning point in U.S. economic history. On the one hand, the size of the U.S. economy causes it to be less dependent on trade and foreign investment than most other industrial countries. The ultimate direct economic impact of the NAFTA will be small, perhaps even too small to be noticed except by a handful of industries and firms. On the other hand, as a harbinger of increased Western Hemispheric and North Atlantic economic integration, the NAFTA could mark the beginning of a trend toward a much wider and deeper integration which will have profound implications for national economic conditions.

This chapter will focus on U.S. economic growth and trade since World War II, with the purpose of locating the NAFTA within the context of ongoing changes in the U.S. economy. The economic focus (and space limitations) prohibit a discussion of many events and trends that are of deep historical significance, foremost among which are the Civil Rights movement, the changing status of African Americans, and the increased participation of women in the labor force. Both the changing role of women and the increasing opportunity for minorities to participate more fully in the U.S. economy are ongoing, historical changes in U.S. society. These trends are omitted from discussion here, not because they are unimportant but rather because they are peripheral to the forces that led the United States into the NAFTA and that, perhaps, will lead toward future economic integration in the Western Hemisphere and the North Atlantic.

Before Industrialization

From the vantage point of the post–World War II era, it is frequently assumed that the United States has always favored free and open markets. It is often noted that the Declaration of Independence, proclaiming the separation of the thirteen colonies from Great Britain, was written in the same year (1776) as the publication of Adam Smith's *The Wealth of Nations,* proclaiming the benefits of nonintervention by governments into economic matters (laissez-faire). Still, the idea that the "Founding Fathers" of the Republic were believers in the free market could not be farther from the truth. Adam Smith's ideas were considered too radical for adoption by most American leaders, and they were interpreted to imply a dereliction of the responsibility of government to foster economic development through direct support and through infrastructure construction. In 1791, Alexander Hamilton, the first secretary of the treasury, issued *The Report on Manufactures* which remains to this day a classic statement of the infant industry argument in favor of high tariffs and government support for industry. Although direct subsidies for industry were rare, most states took seriously their obligation to create an environment in which commerce could grow and develop, and the federal government, empowered by the Constitution to regulate international commerce, maintained a high tariff on imports. In addition, both states and the federal government were the main sources of backing for the construction of roads and canals in the first fifty years of the Republic. In the era of the railroad, which began in the 1840s but took off in the 1850s, the federal government (and some states) provided large tracts of land which were used by the railroad companies both to site their tracks and to sell in order to finance construction.

From the standpoint of the nation, the construction of pathways on which commerce could travel made sense both economically and politically. In the interior of North America, the British still held sway, along with the Spanish and French. Ultimately Napoleon was forced to sell his land claims in order to raise money to fight his war with England, but the United States feared that without settlement and commerce, the interior of the great continent would be lost to foreign powers. In terms of legislation, no other issue consumed as much time or led to the passage of as many bills as the settlement of the West. Should the land be given away or sold, and if sold, for how much? Should the government supply credit, or require cash? Should speculation be permitted on frontier land, and how would surveys be done to reduce conflict and fraud? These issues consumed the attention of the nineteenth-century congresses more than any other single issue.

Obviously the presence of so much land, with a relatively small population, meant that there were shortages of labor. In the prerevolutionary era, the labor shortages had been minimized by preventing settlement east of the Appalachian mountains and by recruiting large numbers of indentured servants from England, Ireland, Scotland, and Wales. In return for passage to the New World and a modest cash settlement at the end of their term of labor, these individuals agreed to work for three to seven years, essentially as family members on farms, in shops, and in businesses of every sort. More than a third of all whites who came to the thirteen colonies came as indentured servants. However, the development of the slave trade, spurred by the invention of the cotton gin in 1797, essentially ended the supply of indentured servants. Slaves' working conditions were so miserable that no free worker would voluntarily enter a labor market in which they competed with slaves.

The introduction of the cotton gin mechanized the removal of cottonseed from cotton fibers and made it economical for growers in the South and elsewhere to grow the hardier but relatively lower quality short-fiber cotton. The significance of this event is that it suddenly expanded the demand for slaves and slave labor. Prior to the spread of cotton, slavery was probably a dying institution; cotton production gave it a new economic base. Through the first five decades of the nineteenth century, cotton and slavery spread from the seaboard of the Southeast across Alabama and Mississippi and as far inland as Texas. By most accounts, it led to the overspecialization of the southern economy and limited its urbanization and manufacturing. The failure of the South to develop industries and cities on par with the northern half of the United States (and the South's smaller share of the total population) undoubtedly contributed to its defeat in the Civil War (1861–1865).

While the Civil War was fought in the decade before industrialization began its takeoff into sustained growth, one business enterprise had already begun its ascent into the industrial world—the railroad. Historians dispute the importance of railroads as contributors to U.S. economic growth, but several facts are beyond question. The railroads were the first modern business enterprise in the United States. All previous enterprises, including textile mills (which were the largest industrial operations in the United States before the railroads) were small-scale businesses which raised capital locally or within the family. The railroads required outside financing due to their huge fixed costs, and this led to the development of stock and bond markets in the United States. In addition to creating modern financial institutions, the railroads were the first enterprise to require professional management. Unlike almost every previous business enterprise, they crossed regional boundaries and involved many levels of control and coordination in order to avoid accidents while keeping to tight schedules with well-maintained equipment and roadbeds. By the mid-1850s, the first interregional networks were constructed, connecting the East Coast with points as far inland as Chicago.

Economic and Demographic Comparisons

Transportation infrastructure such as the railroads, together with the institutional framework created by the U.S. Constitution, shaped the United States into a single market. This fact is essential to the nation's early industrialization and to its economic leadership throughout the twentieth century. A few figures will convey both the absolute and relative size of the United States.

U.S. GDP in Comparison

Table 4.1 shows per capita real GDP, measured in international prices and expressed in 1985 U.S. dollars. (The numbers in parentheses are per capita GDP relative to the United States.) Between 1890 and 1913 the United States passed the United Kingdom to become the richest economy in the world. Although the countries in table 4.1 are a small sample, they represent the NAFTA nations and the leading industrial economies; between 1890 and 1950 the gap between the United States and most other nations (with the exceptions of Canada and Mexico) continued to widen; after 1950 the difference narrows. The reasons are briefly explored in a later section.

INSERT TABLE 4.1 ABOUT HERE

Population and Immigration

The U.S. market in the twentieth century was not only rich, it had the additional advantage of being large. By 1913, the United States had more than twice as many inhabitants as its nearest economic competitor, and over the course of the twentieth century the population advantage grew to more than four times more people than each of the leading industrial economies, except Japan (table 4.2).

INSERT TABLE 4.2 ABOUT HERE

Population growth in the United States has been fueled in part by immigration. In the half-century prior to 1930, between 25 percent and 54 percent of each decade's increase in population was a result of immigration (Borjas 1994). After the passage of immigration restrictions in the 1920s, the immigrant flow as a percentage of the net change in population fell dramatically until the 1960s, when it began to increase once again. During the 1980s, immigrants accounted for more than one-third of the total increase in population.

INSERT TABLE 4.3 ABOUT HERE

U.S. Goals in the Early Post–World War II Period

The early years of the post–World War II period mark the zenith of the United States' political hegemony and the point of greatest economic difference between the United States and other industrial nations. It is important to note that the United States' economic advantages did not stem solely from the destruction of Europe and Japan in World War II but had been growing throughout the twentieth century. World War II was important to the emergence of the United States as a world leader, however, because it created a vacuum in world leadership; the United States' economic and military power made this country the obvious front-runner to fill this vacuum.

The goals of the United States in the realm of the international economy were fourfold: (1) to ensure that nations did not repeat the mistakes of the 1920s and 1930s by reestablishing protectionist trade regimes after the war; (2) to create stable international institutions to smooth over the problems of international payments imbalances and to act as an international lender of last resort; (3) to ensure the rebuilding and return to prosperity of the war-torn economies of Western Europe and Japan; and (4) to contain the spread of communism, partly through military means but also through the demonstration effects of prosperity in advanced industrial economies. Needless to say, these goals were interdependent, and none of them could succeed in isolation from the others.

Learning the Lessons of the 1920s and 1930s

One of the first goals of the United States in the postwar period was to avoid the mistakes of the 1920s and 1930s. With respect to international trade, this meant avoidance of a return to the policy of trade restrictions that had characterized most industrial economies between the world wars. This was a significant policy shift for the United States, which had been highly protectionist throughout most of the nineteenth and early twentieth centuries. The capstone of U.S. protectionism was the Tariff Bill of 1930, better known as the Hawley-Smoot Tariff. Hawley-Smoot was similar to the tariff policies of many industrial economies in that it was an attempt to protect the domestic economy from the worst effects of the general economic downturn that had begun in 1929. The resulting downward spiral in U.S. and world trade did not help any nation, and it hurt many.[1]

In 1934, near the depth of the Great Depression,[2] President Roosevelt succeeded in passing the Reciprocal Trade Agreement Act (RTAA), amending the Tariff Bill of 1930. The RTAA was a watershed in U.S. commercial policy because it is the first legislative enactment of a bill that reflects a liberal bias in favor of free trade. The chief architect of the bill, Secretary of State Cordell Hull, favored free trade less for its economic advantages than for political reasons. Hull shared the view common to political liberals that free trade and economic integration reduced international tensions and made wars

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[1] Between 1929 and 1933, U.S. imports fell from $5.9 billion to $2.1 billion; as nations retaliated against U.S. trade restrictions, exports fell from $7.1 billion to $2.4 billion. The net effect on the U.S. economy, a drop in net exports of $0.7 billion, is too small to have played a significant role in the causing the Great Depression.

[2] In the United States, the Great Depression is dated from mid-1929 through 1933. After 1933 the economy began to recover, but it slipped back into a serious recession in 1937–1938. For this reason, people often refer to the entire decade of the 1930s as the Great Depression.

far less likely. In Hull's mind, part of the blame for World War II was the collapse of trade during the 1930s.

The RTAA emphasized *reciprocity* as the basis for bilateral trade relations. Reciprocity is a familiar theme in U.S. commercial policy history; essentially it implies equal treatment, or that the United States would provide access to its market in exactly the same way and to the same degree that other countries provided access to U.S. producers. In practice, throughout the 1950s and 1960s, the United States was willing to forgo complete reciprocity in cases in which the sensitive industries of trading partners were involved. In other words, the prosperity of foreign producers was a part of U.S. foreign policy goals, and it often took precedence over equal market access. In the 1950s and 1960s, the cost of this trade-off was low because the United States enjoyed large productivity advantages in most industries. This changed in the 1970s and particularly in the 1980s and 1990s. With the end of the Cold War in 1989, equal market access moved to the front of U.S. concerns, and the willingness to trade off market access in order to achieve foreign policy goals has more or less disappeared.

It should also be apparent that the concept of reciprocity is not the same as free trade, and that the goal of U.S. policy was not to remove all trade barriers but rather to gradually move in the direction of more open markets. In U.S. policy circles, the distinction was made between a liberal trade regime and a free trade regime, a differentiation that was carried over into the U.S. position in the multilateral forum of the General Agreement on Tariffs and Trade (GATT). Every GATT round of tariff cutting, from the first round in 1947 until the most recent round in 1986, has had liberalization as its primary objective.

The U.S. thrust toward liberalizing trade relations was made easier by an important institutional feature of the presidency and Congress. From the passage of the RTAA in the mid-1930s until the early 1970s, the U.S. president was automatically given the authority by Congress to negotiate bilateral and multilateral *reciprocal* reductions in U.S. tariff rates without seeking congressional approval. This system insulated Congress from the pressures of industry lobbyists and moved the United States toward a far more liberal trade regime than had existed before the war.

Bretton Woods and the Desire for Stable International Institutions

In addition to avoiding the mistake of creating closed economies, the United States sought to encourage the development of a stable international economic order through the creation of institutions that would oversee international monetary arrangements. The most important efforts in this arena were the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD or, as it is more commonly known, the World Bank), both of which developed out of the talks held in Bretton Woods, New Hampshire, in July 1944. Forty-four nations attended the Bretton Woods Conference, but much of the work of the conference had been done before it took place, and the institutions that resulted were largely the creation of the United States.

Again, the U.S. goal was to avoid the mistakes of the 1920s and 1930s, when international debt and payments problems, coupled with the lack of a "lender of last resort," had resulted in international default and financial chaos. The IMF filled this role by acting like a bank for countries that found themselves unable to honor their international obligations. The United States and other industrial economies recognized that private capital markets were incapable of filling this role, and that a multilateral agency technically independent of national governments had the best chance of succeeding.

A second goal of the United States in the creation of the IMF and the Bretton Woods exchange rate system was to reduce the possibility for countries to engage in competitive devaluations as they had done in the 1920s and 1930s.[3] In theory, nations were to be limited in their ability to devalue their currencies, although in practice this turned out not to be important. The goal of preventing competitive devaluations was to remove currency devaluations as a source of international tensions between nations and to prevent national economies from growing by reducing growth elsewhere.

[3] A competitive devaluation is when a country devalues its currency in order to gain competitive advantages for its exports and import-competing industries. The Bretton Woods exchange rate system was a fixed exchange rate system in which nations specified the value of their currency in terms of dollars, and the dollar was valued in terms of gold at $35 per ounce. The United States stood ready to exchange dollars for gold, while other countries could settle their international payments in either gold or dollars. In practice, all nations (including the United States) settled nearly all payments in dollars. From the U.S. perspective, this removed the incentive to practice restraint in the printing of money and by the early 1970s was a contributing factor in the rise of inflation.

Rebuilding Europe and Japan

In addition to the goals of creating a more liberal international trading system and establishing a stable international monetary system, the United States sought to rebuild the war-torn economies of Europe and Japan. Originally, the International Bank for Reconstruction and Development (World Bank) was designed to handle the financial flows for reconstruction, but it was soon apparent that the World Bank's funding would prove inadequate to the task. Accordingly, the United States established the Marshall Plan as a system of financial grants and loans to the nations of Western Europe and created the Office of European Economic Coordination to manage the disbursement of funds provided through the Marshall Plan.[4] Theoretically, aid could have been provided through the IMF or the World Bank, but it would have meant increasing dramatically the flow of U.S. funds through those organizations, as well as explicitly granting them permission to make loans that had no chance of being repaid. The Marshall Plan was in effect between 1947 and 1953, during which time it provided funds equal to about 2.5 percent of European GNP, or almost twenty times more than IMF and World Bank funding (Eichengreen and Kenen 1994).

Japan received U.S. aid under the U.S. military occupation. Initially, transfers were much less than under the Marshall Plan for Europe; nevertheless, a similar plan, the Dodge Plan, succeeded in controlling inflation in 1949 and led to Japan's take-off into sustained growth. In addition, the beginning of the Korean War in 1950 proved to be a boon for Japan, as the United States encouraged Japanese suppliers to fill the demand for war goods.

In both Europe and Japan, U.S. aid smoothed the transition toward more open markets by providing funds that helped reduce the internal conflict over economic distribution. In turn, this helped to minimize dissension among people who found themselves on the losing end of the market liberalization, and to limit the influence of those who offered a more radical critique of trade and markets.

[4] The Marshall Plan was named after its originator, General George Marshall, U.S. secretary of state in the administration of President Truman. The OEEC later became the Organisation for Economic Co-operation and Development, or OECD.

Containing Communism

The primary security and defense issue for U.S. foreign policy in the postwar period was to contain communism. The onset of the Cold War in 1947 coincided with the first round of tariff reductions under the GATT accord and the beginning of Marshall Plan aid to Europe. Although it is unlikely that the former event was directly related to the Cold War, there is no doubt that the latter event was. European and Japanese prosperity became much higher priorities with the onset of the Cold War, while at the same time there was an increase in the United States' willingness to trade some of its economic gains from trade liberalization in exchange for support for its political objectives.

The U.S. Growth Record since 1950

The economist Angus Maddison created the term "The Golden Age" to refer to the period from 1950 to 1973 (Maddison 1991). The beginning and ending years are somewhat arbitrary, but it is clear that they bracket extraordinary years of world economic growth. Nearly all countries in all regions of the world experienced rates of real economic growth that were greater than their average rates and were, in most cases, their fastest rates for any period of the twentieth century.

The United States (and Canada and Mexico) followed this pattern. From 1913 to 1950, real U.S. per capita GDP rose at the average annual rate of 1.6 percent (Canada, 1.5 percent; Mexico, 1.0 percent). During the Golden Age, the U.S. rate increased to 2.2 percent (Canada, 2.9 percent; Mexico, 3.1 percent). After 1973, real per capita growth fell in all nations, with some notable Asian exceptions (Maddison 1994). The reasons that growth rates increased during the Golden Age, and subsequently declined, are explored below. First, however, we turn to an explanation for the emergence of the United States as the world's leading economy.

Sources of Strength in the "Golden Age" and Before

Around 1950, the income gap between the United States and other leading industrial nations reached its zenith. The United States' lead in per capita GDP was built around three main factors: (1) an early commitment to mass production; (2) an abundant base of natural resources; and (3) the existence of a large, unified, single market. Each of these will be discussed in turn.

The United States was the first country to develop widespread applications of mass-production technology. Beginning in the 1870s, the United States entered the period known as the Second Industrial Revolution, in which systems of mass production began to replace the earlier system known as craft production. Table 4.4 compares and contrasts the two production systems.[5]

INSERT TABLE 4.4 ABOUT HERE

As late as the beginning of World War II, most European countries were far behind the United States in the application of mass-production techniques.[6] The reasons are not difficult to understand. Mass production requires far greater investments of capital than craft production. In order to pay for itself, the volume of production must be enormous. That is, the more units of output there are, the wider the capital costs of the expensive machinery can be spread and the lower the cost of production per unit.

In order to make this system work, the machinery must be kept running as much as possible. The huge fixed costs of the physical capital do not disappear in the same way that labor costs do whenever the machinery is shut down. Therefore, bottlenecks or other disruptions in the supply lines are potentially disastrous. In addition to a continuous supply of inputs, firms also need an assured outlet to markets. That is, if goods cannot be brought to market, it has the same threatening effect on the firm's economic health as a disruption in the supply of inputs.

The United States was unique in that it has (1) an abundant resource base and, therefore, did not have to go across national boundaries for its inputs, and (2) a large market and, therefore, did not have to export in order to sell all of its output. Conse-

[5] In the view of many, a third type of production system has appeared on the world stage. Variously known as lean production or flexible manufacturing, it combines the speed and machinery of mass production with the small batch size of craft production. This enables producers to have the low average costs of mass producers with the individualized attention to customer needs of craft producers. The system first developed in the Japanese auto and machinery industries

[6] In fact, the United States' ability to produce planes, trucks, and ships at a rate much faster than Germany or Japan was key to the Allies' success in the war.

quently, the investment of enormous sums of financial capital in mass-production machinery was less risky in the United States than anywhere else in the world. European producers lacked the same access to resources and to output markets because, in both cases, they had to cross national boundaries. This was especially a problem during the interwar years (1913–1950), when two world wars and a major worldwide depression caused nations to turn inwards and to cut their linkages with each other.

After World War II, the situation changed dramatically for manufacturers in all the advanced industrial nations. The IMF, the World Bank, and the Bretton Woods fixed exchange rate system, together with the GATT and U.S. military and political hegemony, provided a stable set of liberalizing institutions in which there was a high probability of increased market access to inputs and output markets.

Naturally, as European and Japanese producers moved toward greater reliance on mass-production systems, they began to catch up to the United States in terms of both their GDP per capita and labor productivity. In statistical terms, the catch-up is represented by the strong negative correlation between the rate of growth from 1950 to the present and the initial level of real per capita GDP. In other words, the pattern of growth (among advanced industrial nations) since 1950 is that the countries with the lowest per capita GDP in 1950 grew the fastest (Baumol, Blackman, and Wolff 1989). In the United States, the high per capita GDP in 1950 resulted in slower growth.

Relative Economic Decline after 1973

One of the unsettled mysteries of economic growth in the twentieth century is the cause of the growth slowdown after about 1973. The slowdown occurred throughout the Western Hemisphere and the entire European continent, and across Africa, Australia, New Zealand, and Japan. The only exceptions were East and South Asian countries, where a combination of good policies, stable institutions, and unknown positive factors coincided to produce a growth surge after 1973. Four explanations for the growth slowdown are commonly offered, and all but the first seem plausible: (1) the oil price increases of 1973–1974 and 1979; (2) the decline in investment; (3) a decline in technological innovation; and (4) a shift in economic policy. Each will be briefly discussed.

Given that 1973 is also the year of the first of two oil shortages and price hikes (the other occurred in 1979), most people's first thought is to blame oil for the growth slowdown. Between January 1973 and the end of 1974, the real price of oil increased nearly fivefold. Gas at the pump, which had been $0.25 a gallon in 1973, was almost $1.25 by the end of 1974. The problem with the oil price hike thesis is that when the world price of oil collapsed in the early 1980s, growth in the United States and abroad did not return to former levels.

In the United States, a more reasonable explanation for the growth slowdown is the decline in savings and investment rates. For example, the U.S. stock of machinery, equipment, and buildings used by producers[7] grew at an average annual rate of 3.38 percent from 1950 to 1973, and 2.2 percent from 1973 to 1989. Similar slowdowns in the rate of capital accumulation occurred in most places around the world, including Mexico and Canada (Maddison 1989, 1994).

Adding to the mystery of slower growth since 1973 is the fact that the contribution of technology appears to have shrunk. Economists use a technique known as *growth accounting* to measure the contribution of labor and capital to economic growth. The part of growth that remains to be explained after all the measurable factors have been taken into account (e.g., the quantity of labor and capital, the level of education, the change in the structure of the economy, and so forth) is usually attributed to technological improvements that cannot be directly measured. For some reason, the contribution of technological improvements fell dramatically after 1973, implying that there was a slowdown in the rate at which industries were able to introduce new technologies. This is a long-run trend; while some have speculated that in the late 1980s and early 1990s we were at last beginning to see increases in economic growth coming from new computer and information technologies, it is too early to say for certain if this is occurring.[8]

A final factor used to explain the growth slowdown after 1973 (in the United States and the rest of the world) is a permanent shift in economic policies. Between the

[7] Economists refer to this conglomeration of inputs as the "nonresidential fixed capital stock." It goes without saying that when investment falls, the rate at which new capital is added to the economy falls too.

[8] It may seem odd to assert that computers have not yet improved productivity much. New technologies, however, require new organizational forms, and these often take decades to develop. The contribution of electricity to growth, for example, took approximately forty years from its introduction in the 1880s until it had measurable effects in the 1920s. Today many businesses use their computers to do what a secretary with a pencil used to do—write memos. The fonts may be prettier, but there is no gain in productivity or economic growth.

end of World War II and the late 1970s, the two primary goals of U.S. macroeconomic policies were low rates of unemployment and high levels of economic growth. In other words, the United States (and most advanced industrial economies) pursued Keynesian economic policies of demand management.[9] In the Keynesian system, governments ran deficits during recessions in order to stimulate the level of aggregate demand; during expansions they were expected to run budget surpluses in order to prevent the economy from growing too fast and to pay off the deficits accumulated in the recession. In practice, most governments were fully capable of running deficits, but few had the political courage or ability to run surpluses during economic expansions.

Inflation became a serious problem in most advanced industrial economies during the 1970s. In part this was due to the inflationary bias of Keynesian policies as practiced by most countries, and in part it was a result of the oil shortages of 1973–1974. In addition, large-scale crop failures in 1973 in the Soviet Union pushed up world grain and food prices. Furthermore, in the United States the Vietnam War continued to be fought with borrowed funds rather than tax increases, adding to government expenditures at the same time that there was a growth in social spending on antipoverty programs that had been developed in the late 1960s and early 1970s.

INSERT FIGURE 4.1 ABOUT HERE

Figure 4.1 shows how inflation rose dramatically (by U.S. standards) after 1972, reaching its first spike of 11.0 percent in 1974 and its second spike of 13.5 percent in 1980 (*Economic Report of the President* 1993). The unprecedented increase in inflation caused a shift in the focus of U.S. economic policy from an emphasis on maintaining high levels of economic growth to an emphasis on reducing inflation.

The shift in policy was signaled in 1979 by the central bank of the United States, the Federal Reserve (the "Fed"). The Chair of the Fed, economist Paul Volcker, announced that the Fed would focus its efforts on controlling the money supply rather

[9] British economist John Maynard Keynes is the most important economic thinker of the twentieth century. Keynes's major contribution was to show that national governments could manage the level of aggregate demand as a means to smoothing out the business cycle and to counteract recessions. In the context of most political systems, these ideas proved to have an inflationary bias, for which reason many governments rejected Keynesianism in the 1970s and 1980s.

than the alternative and previous target of controlling interest rates. Given the high levels of inflation, interest rates rose and the U.S. economy went into recession, briefly in 1980 and more severely in 1981–1982.

The shift in macroeconomic policy from fighting slow growth and high unemployment to fighting inflation did not occur solely in the United States. Most other industrial nations followed this pattern, although the exact timing varied by country. Although it has not been proven that this shift is related to the growth slowdown in North America and Europe, it remains a viable hypothesis. In addition, the slowing of growth among the industrial economies would exert a similar pressure on developing nations due to their dependence on the markets of high-income countries.

Trade and Foreign Investment Post–World War II

International trade has been less important to the U.S. economy than to most other industrial nations. One reason is that as the technological leader, the U.S. economy was capable of producing most of the sophisticated and complex goods that were available through trade.[10] A second reason for the relative unimportance of trade is the size of the U.S. market. The United States was capable of attaining sufficient size to produce at the point of minimum average cost in most of its domestic industries. Producers in less populous countries (such as Canada) were unable to attain the scale economies associated with large output volumes without selling outside the national market.

Trade and Investment during the Golden Age

Figure 4.2 illustrates the growth of merchandise exports and imports as a share of GNP from 1950 to 1993. Between 1950 and 1973, merchandise exports average 3.8 percent of GNP, while imports averaged 3.3 percent. As can be seen in figure 4.2, there is no tendency before 1972 for exports to increase as a share of GNP. By contrast, imports began

[10] Note that technological leadership is not the same as economic leadership. However, the United States' development of industrial laboratories and close university–business relations in the first decades of the twentieth century meant that its technological capacities were at the frontier of most manufacturing sectors. There were exceptions, however; Germany had clear technological advantages in chemical industries, for example.

a gradual rise in the early 1960s, but they did not surpass the level of merchandise exports until 1971.

INSERT FIGURE 4.2 ABOUT HERE

In general, between 1950 and 1973 the United States ran small trade surpluses, and trade remained relatively inconsequential to U.S. economic conditions. At the same time, the United States was successful in the pursuit of its trade agenda of steady liberalization of world markets through the GATT. Progress toward liberalization was relatively easy since most nations began in 1947 from a starting point of high tariffs, and this allowed room for successive rounds of cuts. It was not until the 1980s, when tariffs were low, that further liberalization required more difficult negotiations and the GATT process came close to breaking up.

One feature of U.S. international economic relations in the 1950–73 period was the slow and steady growth of foreign investment. As a trade-surplus nation, the United States continued to invest more abroad than foreigners invested in the United States. The trade surplus was not the only factor driving foreign investment, however. In many cases, U.S.–based multinational corporations found that they could supply goods abroad more efficiently with foreign manufacturing plants than through trade. That is, rather than export from U.S.–based plants, many multinationals chose to locate production facilities in the markets they wanted to sell to. This decision to invest abroad rather than export is particularly strong in cases in which the foreign market and its resource endowments (labor, capital, and natural resources) are similar to the home market. The general result is that the more similar countries are, the more important are their investment relations relative to their trade relations.[11]

The general rule should not be interpreted to mean that trade is unimportant, but rather that we should look for foreign investment to grow most rapidly between countries with relatively similar resource endowments and income levels. In the case of the United States, outward foreign investment grew most rapidly in Europe and Canada. In the Canadian case, the U.S. auto industry spread across both the United States

[11] A formal explanation of this general rule can be found in Markusen 1995.

and Canada. It ultimately grew large enough to become instrumental in the creation of the U.S.–Canadian Auto Pact of 1965, creating free trade in autos and automobile parts. The Auto Pact permitted the industry to rationalize its investments between the United States and Canada by consolidating production where it was most effective.

Canada is the second most important location of U.S. outward investment. The United Kingdom is the first, and Europe as a whole dominates all other regions as a location for outward U.S. investment. This point is important because it is often mistakenly assumed that most U.S. foreign investment flows to less developed countries of the world; the reality is just the opposite. The locational disadvantages of developing nations usually make it easier for U.S. multinationals to supply those markets through exports rather than through local production in the developing country. Furthermore, the gross differences between advanced industrial economies and developing economies cause most trade between them to be based on differences in resource endowments (comparative advantage). Given the differences in land, labor, and capital, production systems that are suitable for the United States are less suitable for developing countries and vice versa.

Figure 4.3 illustrates this point. Total assets of U.S.–owned firms outside of the United States are compared by their region of location. Europe accounted for 58 percent of U.S.–owned foreign assets in 1992. The advanced industrial nations of the world (Europe, Canada, Japan, Australia, and New Zealand) accounted for 80 percent of all U.S. foreign investment. To return to the earlier point about the relative importance of trade and investment, the total value of U.S. exports of goods and services to Europe in 1992 was $178.8 billion, while sales by U.S.–owned firms located in Europe totaled $746.1 billion in the same year, more than four times as much.

INSERT FIGURE 4.3 ABOUT HERE

Trade and Budget Deficits

Figure 4.2 illustrates the opening of the U.S. merchandise trade deficit after about 1972. The broader measurement of the trade balance, called the current account balance, shows that U.S. trade began its greatest deterioration around 1982 or 1983, about a decade after the first appearance of the merchandise trade deficit.[12] Figure 4.4 shows the dramatic decline in the United States' current account balance after 1982–1983.[13] It bottomed out in 1987 at $167.3 billion, from which it improved until it began to deteriorate once again in 1992. By 1994 it was $155 billion, and it has continued to grow through the first half of 1995.

INSERT FIGURE 4.4 ABOUT HERE

The more or less simultaneous deterioration in the accounts of the U.S. federal government led many experts to assert that the trade and current account deficits were the result of the sudden surge in the federal budget deficit. In 1982, the U.S. federal budget deficit jumped to $127.9 billion, from $78.9 billion in 1981. Since then it has rarely fallen below $100 billion and has been as high as $282 billion (in 1992).

While it is correct to argue that the growth in the federal budget deficit put additional pressures on an already low level of U.S. private savings, it is incorrect to think that there is a one-to-one correspondence between budget deficits and current account deficits. Private savings and investment are additional macroeconomic variables in the relationship; if savings are sufficiently large or investments sufficiently small, then the United States could finance both a budget deficit and maintain a current account surplus (which is equivalent to financing net foreign investment). In other words, let S_p equal private savings by households and businesses, and S_g equal public or government savings. If S_g is positive, then the government budget is in surplus; if negative, then it is in deficit. $S_p + S_g$ is the total supply of domestic savings available to an economy. It can be shown that the relationship between domestic savings, investment, and the current account balance is as follows:[14]

[12] The current account balance includes: (1) merchandise trade; (2) trade in services; (3) investment income received from abroad minus income paid to foreigners; and (4) net transfers from foreigners. In practice, for most countries the first two categories make up the vast majority of the current account balance.

[13] The year 1991 stands out in figure 4.4 as a year in which the United States almost returned to balance. In reality, 1991 was an exception because the United States received about $40 billion in transfer payments from nations that contributed to the cost of fighting the Persian Gulf War.

[14] Let Y = GNP; then $Y = C + I + G + CA$, where C is consumption, I is investment, G is government spending on final goods and services, and CA is the current account balance. The definition of private national savings is $S_p = Y - C - T$, where T is (net) taxes. Then $Y = C + S_p + T$. Setting the two definitions of GNP

$$S_p + S_g = I + CA,$$

where I is investment and CA is the current account balance. If S_g is negative, the budget is in deficit, and it reduces the supply of savings available to finance investment (I) and the current account (CA). In the U.S. case, the relatively low level of private savings (around 18 percent of GNP), together with the budget deficits of 2 to 4 percent of GNP, reduced the supply of funds available for domestic investment. In the end, the United States had to run large current account deficits (negative CA) in order to maintain its level of investment. Current account deficits are equivalent to capital inflows, which is to say that foreign capital was used to finance investment equal to about 1 to 2 percent of GNP. Note that this is essentially the same sort of problem encountered by Mexico in 1994, which resulted in the peso crash of December 1994. In both cases, the nations were trying to invest more than their pool of savings permitted, and the difference was made up by a large inflow of foreign capital. In the U.S. case, however, the outcome has been much less debilitating, partly because the inflow of capital was smaller relative to U.S. GNP and because the United States has continued to attract foreign capital.

Trade Conflict with Japan

The U.S. trade and budget deficits did not occur in a vacuum. One of the most significant domestic events in the early 1980s was the decline of the U.S. auto industry. In the early 1980s, U.S. cars cost more, got worse mileage, and were of lower quality than Japanese imports. Given that the auto industry and related sectors employed tens of millions of Americans, it was politically impossible to ignore their cries for government intervention.

At more or less the same time as the explosion in the U.S. budget deficit and current account deficit, a persistent and large trade deficit opened with Japan (figure 4.5). Between 1980 and 1987, the U.S. merchandise trade deficit with Japan jumped from approximately \$12 billion to almost \$60 billion. Since 1987, it has varied somewhat but has stayed more or less in the range of \$45 to 65 billion.

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equal to each other results in: S_p + (T-G) = I + CA. But T-G is government receipts minus government expenditures, or government (public) savings, S_g. Therefore, that $S_p + S_g = I + CA$.

INSERT FIGURE 4.5 ABOUT HERE

It is difficult to argue that this increase in the deficit is Japan's fault. Between 1980 and 1994, U.S. exports to Japan grew by $31 billion, or 149 percent. Imports, meanwhile, grew by $86 billion, or 260 percent (Bureau of Economic Analysis 1994). In other words, U.S. firms had very good success selling in Japan, but the low savings rate and high consumption of the U.S. economy sucked in Japanese goods at an enormous rate. (It should be noted that the success of some U.S. firms does not imply that the Japanese market is completely open.)

Through the 1980s and into the 1990s, several strategies have been used to try to reach the goal of reducing the bilateral trade deficit with Japan. The various strategies have been macroeconomic, microeconomic, and structural. Macro strategies have focused on bringing down the value of the dollar vis-à-vis the yen; it was first attempted in 1985 with the Plaza Accord in which the Group of Seven (G-7)[15] agreed to coordinate their efforts to depreciate the value of the dollar. The Plaza Accord succeeded in reducing the value of the dollar and in cutting the trade deficit with Japan with the usual lag of about 1.5 years. Subsequent appreciation of the dollar after 1989, however, reversed the effects of this effort.

Microeconomic efforts have included the Market Oriented Sector Specific (MOSS) talks, which took place in 1985–87 and dealt with a number of sectors in which the United States argued that Japanese red tape and bureaucratic obfuscation made it impossible to enter the market. In addition, bilateral talks have been ongoing in a number of sectors on a case-by-case basis. Structural strategies began with the Structural Impediments Initiative (SII) discussions which took place in 1989–91. These talks dealt with problems related to the differing economic structures of the two countries, such as the low savings rate in the United States and Japanese protection of small domestic retailers. The SII had some success but was unrealistic in its expectation that it might increase U.S. savings or Japanese consumption. More recently, the United States has begun a series of talks called the Framework for a New Economic Partnership, which

[15] The G-7 include the United States, Canada, France, Germany, Italy, Japan, and the United Kingdom.

address specific issues of deeper economic integration. These include each country's competition policies, investment policies, and industrial support policies.

Pathways to Protection

The U.S.–Japan trade conflict is the point of greatest pressure on U.S. trade relations, but it is only one of several changes that have occurred in the 1970s and 1980s and that have raised the level of political heat focused on Congress and the president. Another source of political pressure is the internal congressional reforms of the mid-1970s that removed much of the insulation from industry group lobbyists that Congress had enjoyed in the 1950s and 1960s (Destler 1994). A third factor is the end of the Cold War and the decline in the United States' willingness to sacrifice trade gains for political objectives. A fourth factor is the rise of the newly industrializing super-exporters of East Asia and the pressure they have put on U.S. industries. A fifth factor is the rise of the trade deficit in the United States and the fear (which probably reached its highest level in the late 1980s) that numerous U.S. industries had lost their ability to compete. And finally, with the signing of the NAFTA, an old fear has been given new life: that the low wages of our trading partners will cause job losses and declining wages. The latter fear is made more palpable by the fact that median average U.S. wages have been stagnant since the early 1970s and have declined in real terms for those without college degrees.

This is not to argue that these fears are accurate perceptions of the real forces shaping the U.S. economy. There is very weak evidence, for example, that trade has had much of an effect on wages, while the evidence is strong that technological changes have had effects (Burtless 1995). The point is that each of these fears is a source of pressure on the U.S. political system, and each contributes to the growth of strongly nationalistic views and demands for more inward-looking policies.

In the U.S. system, the pressure on Congress and the president to supply special protection to specific industries is channeled through one of two procedures. One is to appeal directly to the president. For example, the U.S. restrictions on Japanese auto imports in the early 1980s occurred through presidential action. A more common method for obtaining protection is through an administrative procedure, of which there are four types: (1) *countervailing duties*, which are levied in retaliation for foreign subsidies; (2)

antidumping duties, which aim to counteract the selling of goods below "fair value";[16] (3) *escape clause relief*, a temporary tariff in response to a sudden surge of imports that threaten to destroy a domestic industry; and (4) so-called *Section 301 retaliation*, which is a tariff imposed in response to some unfair trade practice not addressed by one of the other administrative procedures. In each case, a firm, an industry trade association, a labor union, or some other interest group petitions the federal government to investigate specific trade practices of a foreign firm or its home country. If the investigation determines that there are unfair foreign trade practices, then a second investigation is conducted to determine if the unfair trade practice has actually harmed the U.S. industry. If the second investigation results in a positive finding, a temporary tariff is imposed. It is not uncommon for the first investigation to determine that a foreign practice is unfair and for the second investigation to find that it has had no harmful effect on U.S. industry.

In practice, antidumping duties are by far the most common form of special protection granted, but Section 301 duties probably generate the most media attention. Section 301 is named after the section in the U.S. Trade Act of 1974 that requires the president's chief trade negotiator (the U.S. trade representative, or USTR) to retaliate with import tariffs against any nation that persistently engages in unfair trade practices. In virtually all cases, there is a lengthy investigation and a series of negotiations before retaliation is contemplated. Note, however, that it is left to the United States to determine the meaning of "unfair." Application of Section 301 against U.S. trading partners is widely regarded outside the United States as arbitrary, one-sided, and harmful to multilateral agreements such as the GATT and the new World Trade Organization (WTO).

To make matters worse, growing congressional anger at the failure of President Reagan to conduct Section 301 investigations in the 1980s (primarily because he favored foreign policy objectives far more highly than trade) led to the passage of a trade bill in 1988 which contained a so-called Super 301. Super 301 requires the USTR to produce a

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[16] In the United States, the concept of "fair value" is generally the average price of a good in the exporter's home market or its average price in a third-country market. Selling at a price below the cost of production is selling at below fair value, but firms may sell at a price greater than the cost of production and still be below "fair value." Firms sometimes use high prices in their home markets to subsidize the selling of goods at a very low price in a foreign market, where they hope to establish themselves and gain a larger share of the market. Antidumping duties are designed to counteract this tactic.

list each year of the names of countries that systematically engage in unfair trading practices and to open negotiations with them. If the negotiations are unsuccessful in resolving the problem, the bill requires the president to retaliate. Presidents Reagan, Bush, and Clinton, each of whom has held office under this bill, have worked hard to avoid complying with the bill; but in some years congressional pressure has prevailed and the USTR has produced the required list. Generally, the effects have been limited because the list is manipulated to contain relatively insignificant trading partners. Nevertheless, it is important because it illustrates the subcurrent of nationalistic opinions beneath the surface of U.S. policy that threaten to erupt whenever populist movements gain strength, as they have recently.

Bilateral Alternatives

Perhaps the most important lesson of U.S. commercial policy in the 1970s, 1980s, and 1990s is its tendency to seek bilateral solutions rather than multilateral ones. This is not to say that the United States does not favor the GATT or the new WTO as a forum for achieving solutions. However, the pressure of issues that have a visible and immediate effect on U.S. industries generally results in a bilateral response.

There are several reasons for the U.S. preference for bilateral responses to trade problems. First, it is a much faster way to deal with a problem than taking it before the GATT or the WTO. Second, the United States has more power in a bilateral negotiation and in many cases is more likely to prevail. The U.S. market is critically important to a very large number of countries, both rich and poor; the threat of losing the U.S. market, even on a temporary basis, is a powerful incentive for many countries to reach agreement. In a multilateral context, the threat of reducing access to the U.S. market is a much riskier gamble and undermines the fundamental U.S. policy objective of liberalizing world markets.

A third reason for bilateral approaches to trade problems is that they permit the United States to experiment with new solutions which may ultimately be brought to the WTO if they prove successful. Fourth, they enable negotiations in areas not covered by the WTO. For example, the 1995 U.S. dispute with Japan over autos and auto parts was partly a dispute over competition policies.[17] Neither the Japanese nor the United States nor independent observers could say whether the issues were included within the WTO's areas of coverage.

A fifth and final reason for favoring bilateral approaches is that they are a powerful force in shaping multilateral talks. In many respects, from the U.S. view, this was a major reason for favoring the Canada–U.S. Free Trade Agreement (CUSFTA) of 1989 and its extension to Mexico in 1994. Recall that the multilateral GATT talks of the Uruguay Round began in 1986 and immediately ran into difficulties, so that by 1988 many commentators were arguing that the GATT was dead. At the time, the United States and Canada were concluding their free trade negotiations; the prospect of the two going their own way was an added incentive for other nations to struggle to complete the GATT talks. The enlargement of the CUSFTA to include Mexico intensified the perception that the United States, in particular, was capable of pursuing its goal of liberalizing world markets outside the GATT process. This prospect, from the United States' viewpoint, was instrumental in helping to bring a successful conclusion to the Uruguay Round.

Conclusion: Issues for Deeper Integration

The success of the GATT in bringing down tariffs and limiting the use of nontariff barriers is one of the more remarkable features of the second half of the twentieth century. In the United States, both tariffs and quotas (including voluntary export restraints, or VERs) are extremely limited in their application, in spite of the publicity generated by one or two cases, usually involving Japan. The one important exception is in the area of textiles and apparel, the "Mount Everest of U.S. protectionism" (Hufbauer and Elliott 1993).

U.S. commercial policy is unexceptional in the levels of protection it affords. Virtually every industrial nation has low levels of tariffs and quotas, usually with one or two exceptions, most often agriculture or textiles and apparel. As a result, the United

[17] Competition policies (called antitrust policies in the United States) are national policies that determine the limits of fair competition. They include rules regarding mergers, collusion between firms, and regulation of monopolies.

States, along with other industrial and many industrializing nations, has begun to address a set of obstacles to deeper economic integration that are more contentious than tariffs and quotas because they are intertwined with domestic policy. The majority of these issues are in five main areas: (1) environmental policies; (2) labor standard policies; (3) competition policies; (4) industrial support policies; and (5) investment policies.

At least three of these areas figured prominently in the NAFTA debates: environmental, labor, and investment policies. Two (environment and labor) were far enough outside the tradition of trade negotiations that they could not be included directly in the NAFTA treaty. In the future, the United States will look for ways to directly include these issues in its negotiations over trade. In fact, the future of all U.S. trade negotiations, whether bilateral or multilateral, will undoubtedly consist of negotiations in one or more of these five areas.

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A thorough look at the challenges to open markets posed by the growth of high-technology trade, with many specific cases presented in detail.

Table ~~b~~ 4.1

International Comparisons of Per Capita GDP, 1985 US Dollars at International Prices

Country	1890	1913	1950	1992
United States	3,101	4,846	8,772	17,945
Canada	1,846 (59.5)	3,515 (72.5)	6,380 (72.7)	16,362 (91.2)
Mexico	762 (24.6)	1,121 (23.1)	2,198 (25.1)	6,253 (34.8)
France	1,955 (63.0)	2,746 (56.7)	4,176 (47.7)	13,918 (77.6)
Germany	1,660 (53.5)	2,506 (51.7)	3,295 (37.6)	14,709 (82.0)
Italy	1,352 (43.6)	2,079 (42.9)	2,840 (32.4)	12,721 (70.9)
Japan	842 (27.2)	1,153 (23.8)	1,620 (18.5)	15,105 (84.2)
United Kingdom	3,383 (109.1)	4,152 (85.7)	5,651 (64.4)	12,724 (70.9)

Source: Maddison (1994), and National Bureau of Economic Research (1994). Numbers in parentheses are per capita GDP as a percentage of the US level.

Table ~~2~~ 4.2
International Comparisons of Population, in Thousands

Country	1913	1992
United States	97,606	255,000
Canada	7,582	27,445
Mexico	14,971	84,967
France	41,690	57,372
Germany	40,825	65,120
Italy	37,248	57,809
Japan	51,672	124,000
United Kingdom	42,622	57,848

Sources: See Table 1.

Table ~~3~~ 4.3
Immigrants in the US Population

Period	Percent of Population Foreign Born, Period Beginning	Immigration as a Percentage of Population Growth
1910-1930	14.6	32.7
1930-1950	11.6	5.6
1950-1970	6.9	11.2
1970-1990	4.7	26.9
1990	7.9	NA

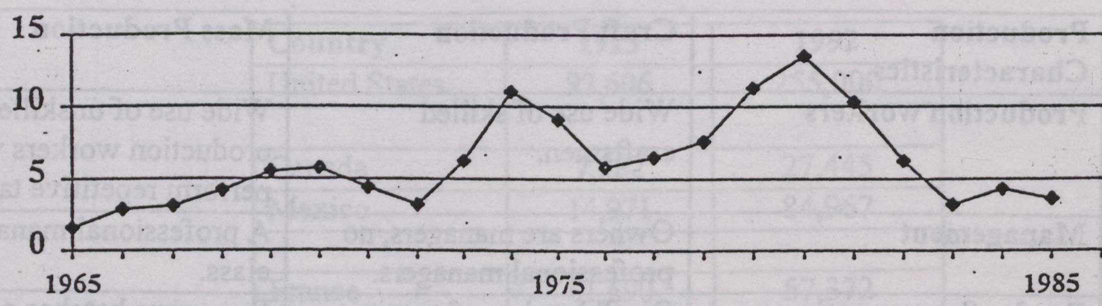
Source: Borjas (1994).

Table 4. 4

A Comparison of Craft Production with Mass Production

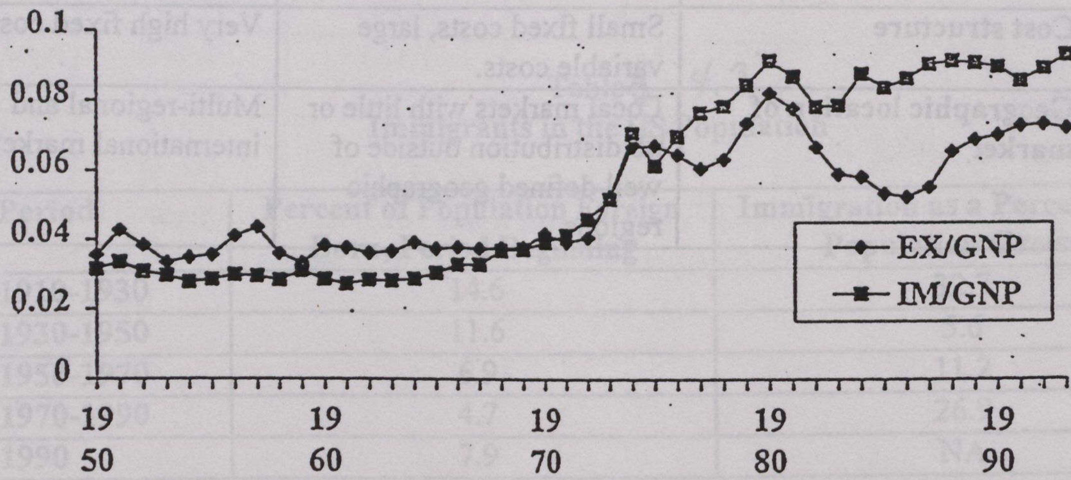
Production Characteristics	Craft Production	Mass Production
Production workers	Wide use of skilled craftsmen.	Wide use of unskilled production workers who perform repetitive tasks.
Management	Owners are managers, no professional managers.	A professional managerial class.
Production runs	Small batches of output.	Enormous batches of output.
Product	Each item slightly unique.	Standardized, identical products.
Capital equipment	Simple tools.	Huge quantities of continuous process machinery.
Cost structure	Small fixed costs, large variable costs.	Very high fixed costs.
Geographic location of market	Local markets with little or no distribution outside of well defined geographic regions	Multi-regional and international markets

Figure ~~1~~ 4.1
Annual Change in Consumer Prices, 1965-1985



Source: *Economic Report of the President, 1995.*

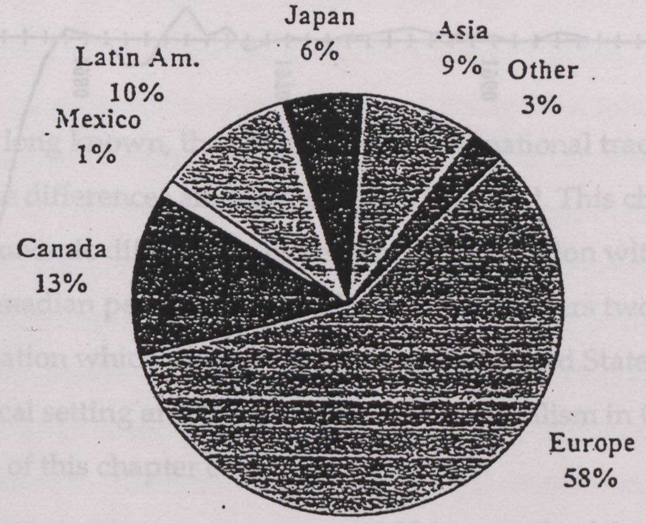
Figure ~~2~~ 4.2
Imports and Exports as a Share of GNP, 1950-1993



Source: *Economic Report of the President, 1995.*

Figure ~~3~~ 4.3

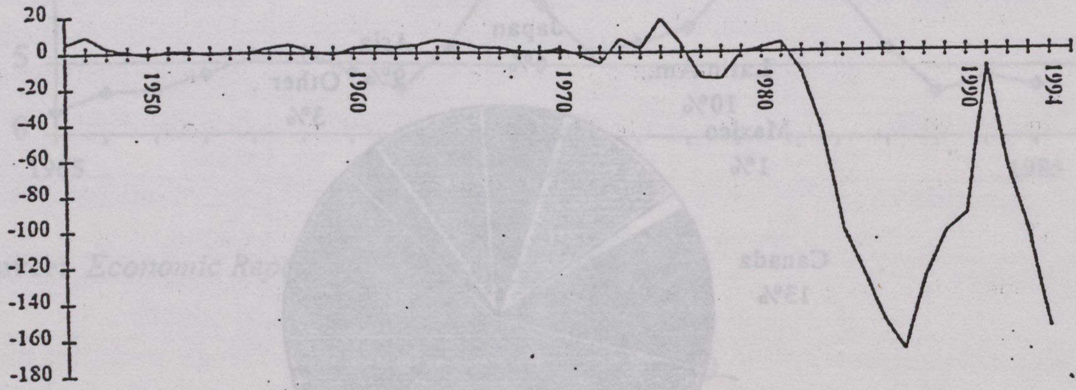
Distribution of US Investment Abroad, 1992



Source: Bureau of Economic Analysis, *Survey Of Current Business,* Vol. 74, No. 6. June, 1994.

Figure 4 4.4

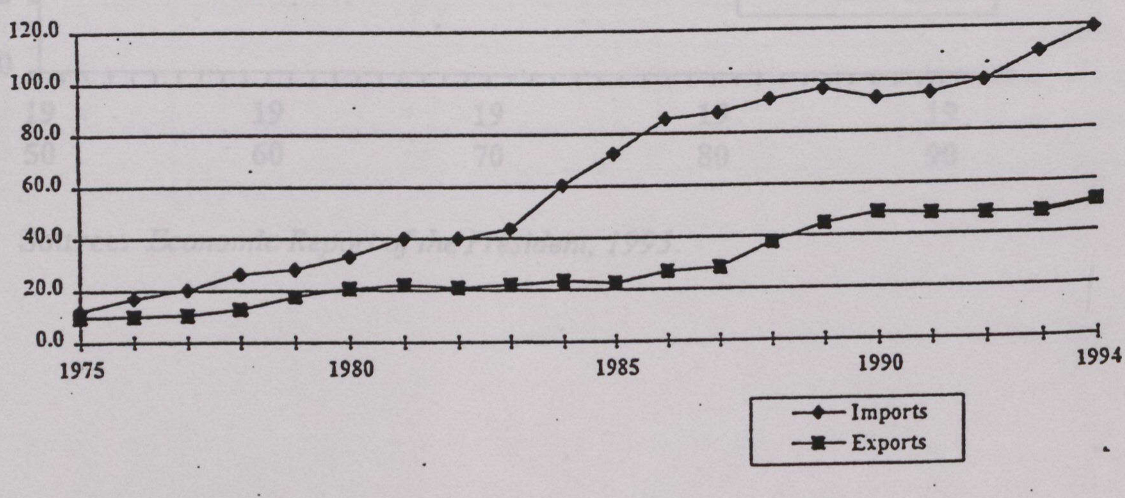
US Current Account Balance, 1946-1994
(billions of US dollars)



Source: Bureau of the Census, 1994.

Figure 5 4.5

US Trade with Japan, 1975-1994 (billions of S)



Source: Bureau of the Census, 1994.

CHAPTER 5

Canada's Economic Development and Integration

Alan J. MacFadyen and Stanford Shedd

As economists have long known, the advantages of international trade and integration stem largely from the differences among the parties involved. This chapter deals with the dual issues of economic differences and economic integration within North America as viewed from a Canadian perspective. This introduction covers two important aspects of the Canadian situation which differentiate it from the United States and Mexico: Canada's geographical setting and the importance of regionalism in Canada. Subsequent sections of this chapter cover:

- a brief history of Canada's economic development prior to World War II, with special emphasis on a specific theory of economic development (the "staples" theory) and on policies of that era relating to international trade and integration;
- a review of the Canadian economy since World War II, with particular attention paid to evolving trading relationships and the question of whether these have affected the performance of the economy or the ability to exercise independent economic policies;
- a brief survey of Canada's economic resources in the 1990s, with special emphasis upon its people ("human capital"); and
- a discussion of a number of recent trade-related policy issues in Canada, including Canada's social and regional development programs, the place of "cultural" industries, foreign ownership, interprovincial trade barriers as indicated by the "beer wars," separation in Quebec, and self-government for indigenous peoples.

Geography and All That

With an area of ten million square kilometers (over 3.8 million square miles), Canada is the second largest country in the world; but given its population of only about thirty million, it is one of the least densely populated. In 1993 Canada had under three persons per square kilometer as compared to about twenty-eight persons in the United States and forty-seven in Mexico. It has been argued that Canadians, more than most people, tend to define the world and their place in it in terms of geography. In part, this may reflect the feeling of space and unlimited resources that results from low population density. In part, it may stem from the very uneven population distribution occasioned by Canada's northern climate: some 80 percent of Canadians are estimated to live within 320 kilometers (200 miles) of the southern border with the United States. This in turn generates the strong feelings felt by a small population living immediately adjacent to a very large and powerful one; "like a mouse living with an elephant," as former prime minister Pierre Trudeau liked to put it.

Also of significance are key natural features of the Canadian landscape which, as is often remarked, tend to push commercial trade into north-south flows within North America. Movement is easier by sea than by land along the Atlantic and Pacific coasts, and unrestricted movement east and west is inhibited by great natural barriers: the barren, exposed Precambrian rock of the Canadian Shield as it dips down to the Great Lakes, separating heavily populated southern Ontario from the western prairies, and two great mountain chains, the ancient Laurentian-Appalachian chain in the East and the newer Rockies in the West.

Thus the dictates of geography generate a uniquely Canadian situation. A thin ribbon of population stretches east to west along the American-Canadian border, bound together by the (perhaps fragile) threads of national identity, while commercial attraction pulls toward the ease of north-south trade with the much larger neighbor. In light of this, it is not surprising that Canada is an example of what economists call a "small-open economy." Canada's GDP is the smallest of the G-7 group of industrial countries,[1] and trade is extremely important. In 1994 exports of goods and services amounted to about 33.2 percent of Canadian GDP, as compared to 10.4 percent for the United States and 17.0 percent for Mexico in 1993 (IMF 1995). Some countries do have higher export dependence than does Canada,[2] but none trades as heavily with a single

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[1] The G-7 countries are the United States, Germany, France, the United Kingdom, Japan, Italy, and Canada.

[2] At the other extreme, Singapore's exports in 1992 were 165 percent of GDP, compared to Canada's 29 percent for the same year.

other nation; nearly 80 percent of Canada's exports go to the United States. The dependence of the small Canadian economy upon external trade, and the overriding importance of the United States as a trading partner, help to explain why international economic policies have often been so controversial in Canada.

Regionalism

It is hardly surprising that regional factors are important in a large country such as Canada. The barriers to east-west movement, noted above, tend to reinforce such regionalism. So does Canada's history, including its beginning as a colonial extension of the two "founding nations" (England and France), and the preservation of a vibrant French-speaking culture centered in Quebec. But this offers an insufficient explanation of the importance of regionalism in Canada. For one thing, the English-French separation is far from perfect, with sizable primarily English-speaking populations in Quebec (that is, in the west of Montreal and southeast of Montreal in the Eastern townships) and with French-speaking centers in Acadian New Brunswick in the Maritimes and in towns scattered throughout Ontario and the Prairies. In practice, and to a limited degree officially, Canada is multicultural. Canada has an aboriginal population (Indian and Inuit) of just over one million, as well as many Metis of mixed Indian-European lineage. Early immigrants came from all parts of Europe, and they have been joined by others from throughout the world.

The unusual importance of regionalism in Canada stems from the very high degree of decentralization of the Canadian federal system of government, far more so than that of either Mexico or the United States. Canada has ten provinces.[3] The sparsely populated North has been divided into two (soon to be three) territories administered by the federal government in Ottawa. We shall not elaborate in detail on reasons for the strength of the provincial governments. One factor may be Canada's relatively peaceful founding, which did not involve a central federal authority establishing the nation with

[3] The provinces can be divided into several regions. The Maritimes provinces are Nova Scotia, New Brunswick, and Prince Edward Island. The Maritimes and Newfoundland are referred to as the Atlantic provinces. Quebec and Ontario are each considered to be separate regions although together they are sometimes referred to as Central Canada. Manitoba, Saskatchewan, and Alberta are the Prairies. The last region is the most westerly province, British Columbia.

the use of force (as, for example, in the War of Independence and Civil War in the United States). Moreover, the acceptance of the French-fact as a part of the colonies and nation gave explicit recognition to regional differences. (For example, the British North America Act [BNA Act], passed by the United Kingdom parliament in 1867, which brought together four British colonies as Canada, formally recognized the French language and special civil law code in Quebec.)[4]

However, at another level the strength of the Canadian provincial governments is somewhat puzzling, since the Canadian politicians who negotiated the terms of the BNA Act were at pains to ensure a strong federal government, influenced in part by the example of regional division in the American Civil War. Thus the BNA Act set out a specific list of powers for the provinces (immigration and agriculture shared with Ottawa) and reserved any unspecified area for the federal government. (The American Constitution gave residual powers to the states.) In addition, limits were imposed on the power of the provinces to impose taxes (i.e., no provincial "indirect" taxes). Unlike the United States, however, the provinces were not prohibited the use of deficit financing. Why, then, are the Canadian provincial governments so powerful as compared to lower levels of government in most other countries? In part it reflects the fact that many areas of provincial responsibility (such as education, health, and welfare) became areas of high growth in the twentieth century. Moreover, primary responsibility for natural resources was allocated to the provinces.[5] Further, several areas of provincial responsibility (including "property and civil rights," powers of "direct" taxation, "local works," and "matters of a merely local or private nature" in the province) could be interpreted very broadly. It was undoubtedly a factor that the presence of only ten regional governments—in contrast, for example, to fifty states—made it easier for the provinces to find areas of common interest and for well-established procedures of consultation to evolve between the federal government and the provinces. It is likely that growing provincial powers generated a positive feedback loop in which citizens

[4] Complete independence for Canada awaited the Statute of Westminister of 1931, which transferred control of foreign policy from the United Kingdom. Until the Constitution Act of 1982 the main element in the Canadian Constitution remained the BNA Act, a law of the United Kingdom parliament.

[5] Offshore fisheries went to federal government, and agriculture was shared. In the Prairie provinces, control over natural resources followed a 1930 amendment to the BNA Act.

became increasingly conscious of being citizens of the provinces as well as of Canada and looked to the provincial government to express regional interests.

In some respects the Constitution Act of 1982 can be seen as the culmination of Canadian regionalism, as expressed through provincial governments. This act was reached with the agreement of all the provinces except Quebec. It repatriated the BNA Act and affirmed provincial primacy over natural resources, removed limitations on provincial taxation, formally recognized the necessity of provincial approval of amendments to the Constitution, required periodic consultations between the "First Ministers" (prime minister and provincial premiers),[6] and brought the concept of equalization into the Constitution.[7] The equalization program is a commitment by the federal government to make financial payments to provinces that have below-average tax bases, thereby helping to ensure that all provinces can provide roughly the same level of services to their citizens. It is, perhaps, a prototypical example of Canadian regionalism. It explicitly looks to a regional definition of inequality (rather than, for example, an individual's personal income regardless of location of residence). Some economists have argued that in transferring resources to poorer regions, the equalization program supports continued regional differences by inhibiting the migration of resources to the better-off areas of the country. Finally, while the program is a transfer of funds by the federal government, the transfer is to provincial governments and not to individuals.

To summarize, it is important , when looking at Canada, to appreciate the strongly regional nature of Canadian federalism. Provinces have primary power over economic matters within their borders, and many changes in Canadian economic policy, even at the federal level, proceed through a process of formal and informal consultation between the federal government and the provinces.

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[6] Canada has a parliamentary form of government. Voters elect members to a legislative assembly. Federally that legislature is called Parliament. The party with the most members forms the government. The leader of that party becomes the head of government. Federally the leader is the prime minister. Provincial leaders are called premiers.

[7] The failed Meech Lake and Charlottetown Accords were largely attempts to bring Quebec into the Constitution. Their failure reflects, in part, disagreement in Canada about Quebec's place in the Confederation. In addition, discussion of these proposals raised a large number of other questions about the ideal constitution for Canadians, which did not relate directly to the Quebec question but which alienated potential supporters of the Accords.

Canadian Economic Development prior to World War II

By the year 1000, what is known as Canada was sparsely populated by a number of traditional aboriginal economies living in close touch with nature. Trade took place among these economies, but they were largely self-sufficient. The "discovery" of North America by European explorers opened it to flows of goods, services, capital, and labor from across the Atlantic. The Vikings arrived around 1000 and maintained a small settlement in Newfoundland for several hundred years. Continuous ties with Europe began when John Cabot, sailing under the English flag, landed in Cape Breton (1497) and Newfoundland and the adjacent mainland coast of Labrador (1498). Soon thereafter, fishermen from Britain, France, Portugal, and Spain began to exploit the rich fish stocks off the Atlantic Coast. French contact with Quebec began when Jacques Cartier sailed up the St. Lawrence (1534–35) and saw establishment of a settlement at Quebec City by Samuel de Champlain (1608). Thus began a process of economic growth in what we now know as Canada.

Economists argue that economic growth can be generated in two ways: by increases in the quantity of inputs in the economy, and by increases in the quality (productivity) of those inputs. While both sources of growth were important in Canada in the period we are discussing, the immigration of labor and capital from offshore was particularly important. We shall not provide a comprehensive review of Canadian economic development. Rather, discussion will be organized around two general themes: a theory of economic development called the "staples" theory, which has been particularly influential among Canadian social scientists; and the evolution of Canada's international trade and integration policies.

The Staples Theory

The staples theory was developed primarily by Canadian political economists (Innes 1930; Mackintosh 1923; Watkins 1963), although it has been widely applied elsewhere, including in some of the arguments advanced by spokesmen from developing nations in the North-South debates. In this view economic growth in a small-open economy is driven by the external demand for natural resource products ("staples"). The precise way in which growth occurs depends on the economic linkages associated with the particular staple product. Linkages may be backwards, drawing inputs into the economy, or forwards, involving the further processing of the staple. The distribution of the earnings from the staple is also important. The staples theory lends itself readily to a dualistic view of the world as consisting of powerful "metropolis" areas and powerless "hinterlands." Initially France and Britain were the metropoles and the Canadian colonies were the hinterland. What happens in the staples-producing hinterland is largely determined in the outside metropolis. This dualistic view (metropolis versus hinterland) has colored feelings of regionalism within Canada as well. Historically, freight rates have tended to encourage the production of staples in the Atlantic and Prairie provinces (the new hinterland) and manufacturing in Central Canada—Ontario and Quebec (the new metropolis).[8]

A brief extension of this discussion may help clarify some of the arguments in Canada over trade policies. The staples theory could be characterized as an argument in political economy and contrasted with the narrower view prevalent among economists and commercial interests. The staples theory can be recast in the narrower view, where forces of supply and demand determine the prices of goods and inputs as well as trade flows and migration patterns; export demands by the metropolis and staples production technologies are key factors in the operation of the economic markets. However, staples-influenced analyses typically go beyond this to emphasize the importance of the power relationships underlying trade and the social and cultural changes that may occur along with economic growth. Traditional economic analysis tends to see trade flows as stemming from more efficient ways to meet the demands of relatively fixed tastes, thereby improving standards of living for both trading partners. Issues of culture and social values are a matter of domestic tastes and, possibly, policies for the domestic government. On the other hand, the broader staples view tends to see tastes, culture, and social values as malleable, prone to largely hidden processes of change and subject to the influence of external sources. That is to say, the metropolis will determine taste,

[8] This view of central Canada is typified in the following story. A prairie farmer in the 1930s loses his wheat crop to drought, his topsoil to winds, his wife in childbirth, and his eldest son to influenza. Standing on his front porch he shakes his fist and shouts, "God damn the CPR." Events outside his control in the hinterland are blamed on powers in the metropolis—the Canadian Pacific Railway in Montreal.

culture, and social values in the hinterland. It is not surprising that proponents of these two approaches will often evaluate trade policies differently.

According to the staples approach, Canadian economic development can be understood by tracing through time the influences of a sequence of export staples. The staples were natural resources in demand by foreign markets: fish, followed by furs, followed by timber, followed by wheat, over the five hundred years from 1500 to the early twentieth century. (It will be appreciated that a new staple product does not completely displace an earlier one. Canada in the 1990s is, in fact, still a net exporter of all four of the staples just mentioned.) As noted, each staple had its own demand, production, and income distribution characteristics which set the timing and exact nature of its influence.

The first staple, for example, had minimal linkage effects, since cod were caught by boats in the Grand Banks which sailed from Europe, fished, and returned to Europe without necessarily landing on North American soil. Linkage effects were more pronounced with the fur trade, as trading routes and posts spread inland along the water system. Obviously a certain number of trappers and traders were required, so there was stimulus to small-scale farming and retailing (along the St. Lawrence River, for example) to provide supplies for traders and ships landing to take on beaver and other pelts. Coordinating and financing this activity necessitated some party taking an entrepreneurial role. This was handled largely by French fur traders, the Hudson's Bay Company (organized in England in 1670), and the North West Company (which began in 1775 with a group of Montreal-based fur traders). Conflict between English and French fur traders in the seventeenth and eighteenth centuries mirrored the hostilities between France and England in Europe. In the Treaty of Paris of 1763 the French colonies in North America were ceded to England.[9] Subsequent English rule left a fair degree of autonomy for the French-speaking culture centered in Quebec.

The third great staple product, lumber, rose to prominence early in the nineteenth century. The Napoleonic War disrupted the movement of timber from the Baltic region to England. England turned to British North America instead, imposing

[9] The Treaty of Paris left St. Pierre and Miquelon, two small islands in the Gulf of St. Lawrence, in French hands. The Hudson's Bay Company absorbed the North West Company in 1821.

high tariffs on Baltic wood as an incentive. Harvesting trees and producing lumber from sawmills required local labor and entrepreneurship. Agriculture and food processing for the local market were also stimulated. In addition, the empty ships coming to Canada to pick up timber were an ideal passage space for people. The importance of timber as a staple product peaked by the mid–1800s, partly because of the common property nature of trees, which were generally cut without replanting. The cleared land served as a further stimulus to farming.

The second half of the nineteenth century is generally seen as a period of relative economic stagnation, followed by a wheat boom at the turn of the century as the Prairies were subject to a flood of settlement. Expansion of grain production generated a demand for agricultural inputs (equipment and rail links) as well as providing a growing market for consumer goods.

Of course, the staples theory provides an oversimplified picture of the increasingly complex Canadian economy. Criticism of a staples-based approach becomes particularly severe following the wheat boom. On the one hand, there were new natural resource exports that arose after World War I—a variety of metals and then petroleum after the Leduc find in Alberta in 1947. However, these were not dominating export products to the same degree as the earlier staples. Moreover, with its growth, the Canadian economy became increasingly reliant on its own internal demands and less so on the external demands emphasized in the staples theory.

Even today, as noted above, Canada is more export dependent than either the United States or Mexico. Natural resources, exported in a relatively unprocessed form, still form a higher share of Canada's exports than any of the other G-7 countries. In 1995 agriculture and fish, energy, forestry, and mineral products (before significant processing) made up about 35 percent of Canadian exports. The United Nations reported that the share of food and raw materials in total exports was 31 percent for Canada in 1992. For Japan the figure was 2 percent; it was 13 percent for the European Union and 18 percent for the United States. Still, most analysts concede that Canada moved past the staples economy stage early in this century.

Trade Policy

Economic development does not proceed in a policy vacuum, though the discussion up to now may suggest this. We now review the major features of government policy regarding international economic relations in Canada prior to World War II.

The colonial period was dominated by the British mercantilistic outlook up to the early 1840s, long after mercantilism had been discredited by economists such as David Hume and Adam Smith. Under mercantilism, colonies would ship raw materials to the home country in return for manufactured products. It was inevitable, then, that Canada would trade primarily with France (before 1763) and Britain, and that the trade would be in staples. However, when the British move to free trade came, it came very quickly. Duties were chopped on both timber and grain in the 1840s, thereby removing the protection the colonies had received in the British market.

Canadian producers were forced to reevaluate their markets. It was natural that their eyes should turn to the South. By 1850 the population of the United States had passed twenty-three million, a large portion living in the Northeast, where substantial industrialization had already occurred. After negotiating a free trade agreement among themselves, the British colonies had Britain negotiate for them on tariff reductions with the United States. As part of these negotiations, the Americans insisted on gaining access to the coastal fisheries in the Atlantic. Once this concession was granted, the Reciprocity Treaty of 1854 was signed, under which a large number of agricultural and primary goods would move free of duty between the United States and the British North American colonies.

The Reciprocity Treaty was short lived. Either party could, after ten years and with one year's notice, abrogate it. The United States did so, and the Treaty ended in 1866. Canadian exports to the United States increased substantially while it was in effect, from \$8.6 million in 1854 to \$34.8 million in 1866. However, the role of the Reciprocity Treaty in stimulating economic development is controversial. Waite (1987), for example, argued that "Prosperity had come in the wake of the Reciprocity Treaty," but Norrie and Owram (1991) have suggested,

> the problem, of course, is that there are many other important developments in this period in Canada, the United States, and abroad

that might have affected trade between the two nations at least as much as the Treaty.

If analysts are unable to agree on the significance of the first free trade agreement between the United States and Canada in the 1850s, it should not surprise us that disagreement exists today about the CUSFTA and NAFTA.

The BNA Act forming Canada came in 1867, hard on the heels of the end of the Reciprocity Treaty. Creighton (1961) argues that the "Fathers of Confederation were optimistic that the greatly increased size of the market would ensure prosperity for the four provinces when they united."[10] However, Innes and Easterbrook (1960) argued,

> Canada in 1866 was very much on her own: she was burdened with a huge national debt incurred for a transportation system with an unused capacity which reflected its failure to capture United States traffic; she was committed to a policy of economic expansion which allowed no turning back; and she feared a movement of population from the United States northward to the thinly-settled wheat-lands of western Canada or the Pacific coastal strip with its little known resources.

Geography and politics were combining to limit Canada's trading options. Free trade in Britain removed the protection Canada required in a distant market, and tariff barriers in the United States limited access there while exposing Canadian producers (and territory) to expansionist American interests. Over the next decade a policy evolved, largely under the direction of Canada's first prime minister, Sir John A. Macdonald, known as the National Policy. Essentially it involved a Dominion (national) land policy designed to encourage settlement of the Prairies, a transcontinental railroad to bring the country together and allow easy export of grain, and the raising of tariff barriers to protect domestic industry. Once again, the effects of the trade policy have

[10] Canada was initially made up of four provinces—Nova Scotia, New Brunswick, Quebec, and Ontario—the latter two much smaller than they are today. In 1869 Canada bought the western territories of the Hudson's Bay Company. Manitoba entered Confederation in 1870, British Columbia in 1871, Prince Edward Island in 1873, Saskatchewan and Alberta in 1905, and Newfoundland in 1949.

been controversial. Some analysts have emphasized the importance of tariffs in stimulating a Canadian manufacturing sector. Others have argued that tariffs inhibited the development of efficient exporting manufacturers; rather they drew foreign capital into Canada to build small, inefficient "branch plants" for the local economy while forcing reliance on staple resources for export earnings.

Controversy about the desirability of high tariffs made itself manifest in policy differences between the two main political parties. Macdonald's Conservative Party saw high tariffs as an essential ingredient in maintaining a strong national identity, especially in the face of Canada's powerful neighbor to the South. After the mid–1890s, the Liberals, under Wilfred Laurier, who initially favored free trade, saw tariffs as a revenue source but were skeptical about their protectionist benefits. Canadian policy in the first third of the twentieth century alternated between the poles of higher and lower tariffs. The Liberals came into power in 1896, and by 1900 the average tariff stood at about 17 percent, down from 22 percent in the 1880s. More dramatically, the Liberals negotiated a new free trade agreement with the United States. However, the Liberals lost the 1911 election, fought largely on the free trade issue; the Liberal cause was not helped by President Taft's suggestion that the new Reciprocity Treaty was a practical step toward union between the two countries. The newly elected Conservatives continued the policy of minor tariff reduction until the start of World War I in 1914.

Instabilities in the international economy after the war led most countries to move toward higher tariffs once again, a process that became more pronounced with the Great Depression, beginning in 1930. However, an attempt to stimulate the domestic economy by raising tariffs—a "beggar your neighbor" policy—serves to make everyone poorer if everyone practices it. The election of a Liberal government under Mackenzie King in 1935 marked a shift in Canada's trade policies back to a tariff reduction orientation, starting with an agreement with the United States. Since that time Canadian trade policy has been consistently oriented toward multinational negotiations to reduce tariffs as well as periodic negotiations with the United States to reduce them on a bilateral basis.

Canada's Economic Performance since 1945

It is clearly not possible to provide a detailed review of Canada's economic policies over the past fifty years. Rather, we shall provide summary comments on two main issues: Canadian policies regarding international trade; and general trends in the macroeconomic performance of the economy, with particular emphasis on how recent years differ from earlier periods.

The stage can be set by reference to a framework for economic policy that the reigning Liberal Party adopted in the 1945 election. It was a Keynesian framework. Trade liberalization formed part of the approach. It also involved a strongly expanded role for the government (as initially proposed, the federal government). There would be expanded social programs, and the government would pursue active fiscal and monetary policies in order to maintain full employment and relatively stable prices. (Whether finance ministers always took this prescription seriously is debatable.)

Trade Policy

Since 1945 Canada has been supportive of trade liberalization. This is seen in part in its backing for multilateral tariff reductions through the General Agreement on Tariffs and Trade (GATT). Average Canadian tariff levels, which had risen to 20 percent in the mid–1930s, were down to 8 percent by 1950, varied up and down slightly in the 1950s, then resumed their fall, reaching about 4 percent by 1979 and continuing to decline.[11] Tariffs on some goods, however, remained high until the signing of CUSFTA.

Somewhat more controversial have been the various bilateral negotiations with the United States. The controversy stems in large part from the ever present fears of some that it is detrimental to Canada's interests to strengthen connections with its giant neighbor. In 1944, Canada removed tariffs on agricultural machinery coming from the United States (thirty-one years after the United States had removed their tariffs against similar Canadian products). But the first major move to bilateral tariff reductions between the two countries in the postwar period was in the 1965 Auto Pact. It was, with some safeguards, a free trade agreement between the two countries for automobiles and

[11] Small changes in the average tariff, up or down, can be hard to interpret since the average tariff reflects both tariff rates and trade flows. An average tariff value masks a wide range of specific tariff rates.

parts. The Auto Pact had a dramatic effect on the Canadian auto industry and ultimately on the Canadian economy. Prior to the pact the Canadian industry had been protected by a relatively high tariff (17.5 percent). Only 3 percent of the cars purchased in Canada were made in the United States. Most "American" cars were produced in Canadian factories on short production runs. While American duties on Canadian-produced cars were substantially lower, the higher production costs in Canada were sufficient to prevent much exportation to the United States. Prior to the Auto Pact only 7 percent of Canadian production was exported to the United States. Within four years that figure had reached 60 percent. Moreover, the price of cars in Canada dropped significantly, and the wages of workers in the auto industry rose to roughly the American level. These gains were possible because of the rationalization of production that the Auto Pact allowed. Canadian plants specialized in a few models or components, thereby permitting much longer production runs with substantial economies of scale. Most Canadian production was sold south of the border. Far fewer Canadians drove Canadian-built cars, but Canada built more cars.

The Auto Pact was not the only important bilateral trade agreement of the 1960s. Canada and the United States also signed the Canada–United States Defense Production Sharing Agreement. This agreement allowed Canadian producers to bid on American defense contracts. During the last years of the decade, Canada had an export surplus on defense materials because of the United States' involvement in the Vietnam War.

On January 1, 1989, reciprocity was finally back. On that date the new Canada–United States Free Trade Agreement (CUSFTA) took effect. This agreement was viewed by many as a dramatic change. In some ways it was. On the other hand, it can be seen as the logical conclusion of the process that began in 1935 with the bilateral agreement to reduce tariffs between the two countries. It can even be seen as the conclusion of 120 years of Liberal policy on trying to reinstate the Reciprocity Treaty. Ironically, it was not a Liberal government that negotiated the agreement. The Liberals were in opposition to the Conservatives under Brian Mulroney, who negotiated and signed the CUSFTA and, later, the NAFTA, when the free trade agreement was expanded to include Mexico.

North America was not alone in pursuing lower tariffs in the postwar period. Falling tariffs are one of the factors that have stimulated international trade over recent decades. (It is, of course, difficult to separate the effects of trade liberalization from other factors contributing to globalization.) In Canada, as in most countries, the share of the economy directly involved in international trade increased significantly. Canadian ties to the United States became stronger. Whether these are beneficial changes has been a controversial issue in Canada, one to which we will return later in this chapter.

Macroeconomic Performance

This is not the place for a detailed review of Canadian macroeconomic policies and performance in the postwar decades. Rather, we shall focus on a few key macro issues, those that have proven particularly significant or that relate most immediately to the international economy. A policy issue that develops to become of concern can most readily be illustrated by way of contrast. In what follows we shall often compare the situation in the current decade to that of earlier decades. Occasionally the contrast will be with other trading partners, specifically the United States.

The years immediately following World War II started out as years of extremely strong macroeconomic performance, at least from the perspective of the 1990s. Up to the early 1970s, economic growth was generally high, except for a brief recession in 1954 at the end of the Korean War and a larger recession from 1957 to 1961, when the unemployment rate passed 7 percent. Inflation was generally low, apart from a burst when price controls were taken off after the war and in 1951 at the start of the Korean War. With the exceptions noted, both inflation and unemployment were generally below 5 percent, and interest rates were also low, right into the 1970s.

Despite the official recognition given to Keynesianism in Canada, this performance seems due more to the exceptional economic climate in the world economy than to deliberate government macroeconomic stabilization policies. For example, a tax cut in 1954 which helped stimulate the economy seems to have been motivated largely by the presence of a budget surplus. A more explicitly Keynesian orientation was apparent in the early 1960s, most notably in a conflict between the governor of the Bank of Canada (the Canadian central bank), who emphasized a tight monetary policy to control prices, and the minister of finance, who was concerned with high unemployment rates. An important agreement specified that the minister would have final say in macro policy.

One peculiarity of Canadian economic policy in this period was the adoption, for much of the time, of a flexible exchange rate, despite the norm of fixed exchange rates specified in the Bretton Woods Agreement which set up the International Monetary Fund (IMF). The Canadian dollar rose from its fixed value of $0.9045 during the war to a premium over the U.S. dollar for most of the 1950s. However, in 1962 the dollar began to fall and was fixed at $0.925 U.S. for the rest of the 1960s. In the 1940s Canada showed a surplus on both its goods (i.e., trade) and its current (i.e., goods and services) accounts with the rest of the world; Canada was a net capital exporter. The 1950s, however, saw the pattern emerge that has been the norm since then—a surplus on goods but an overall deficit in the current account. That is, a sizable deficit in services (including interest and dividend payments on foreign capital) more than offsets the trade surplus. Thus Canada has generally been a net importer of capital. Associated with this was a key economic controversy over foreign investment. Proponents argued that it was quite appropriate for Canada to borrow abroad, using the funds to finance an excess of imports of goods and services over exports. In this way more goods, particularly capital, were made available to the economy, and this increased economic growth. Opponents argued that the foreign capital brought with it business and social practices that were undesirable and that increased Canada's vulnerability to unwelcome external pressures. This was particularly so, it was argued, for the direct ownership investment from the United States which had become very important after World War I. Moreover, it was said, excessive reliance on foreign investment tended to be a vicious circle, because more borrowing was needed to cover the interest and dividend charges on past borrowing. The positions in this debate foreshadow the later controversies over the CUSFTA—proponents extolling the economic advantages of freely flowing capital versus opponents warning of the loss of Canada's identity.

This relatively satisfactory macroeconomic performance through to the early 1970s serves as a convenient comparison point for a number of the problems that have come to the fore in recent years. Figures 5.1, 5.2, and 5.3 show comparative values for Canada and the United States on three key macroeconomic indicators for years from 1964 through 1995.

INSERT FIGURES 5.1, 5.2, AND 5.3 ABOUT HERE

Figure 5.1 shows annual percentage increases in real GDP, that is, in the real quantity of goods and services produced in the economy. The variability in economic growth over time is apparent, but there seems to have been a reduction in average growth since the late 1960s and early 1970s. (The average annual rate of increase was 5.6 percent for Canada and 3.9 percent for the United States for 1964–1973, compared to 2.8 percent for both for 1984–1993.)[12] Canada has generally had a higher growth rate than the United States, but this seems largely to have disappeared in the past decade. Readers are reminded that growth reflects increases in the quantity of inputs in the economy as well their quality, and that Canada's population has grown faster than that of the United States since the 1960s.

Figure 5.2 shows unemployment rates in the two countries. The low rates of the late 1960s have not been matched since, but it is in Canada that the persistence of high unemployment is particularly apparent. From 1964 to 1973 the Canadian and U.S. unemployment rates were relatively close; the Canadian rate averaged 5.0 percent, 16 percent above the United States' rate of 4.2 percent. However, from 1984 through 1993 the Canadian rate was 50 percent higher (9.6 percent for Canada versus 6.4 percent for the United States).

Inflation rates are shown in figure 5.3, based on the consumer price index (CPI). The stagflation—high unemployment plus high inflation—of the mid–1970s to early 1980s is apparent from figures 5.2 and 5.3. During this period Canadian inflation generally exceeded that of the United States, as did the unemployment rate. Inflation has declined sharply since then. In the early 1990s it was at levels roughly comparable to those of the late 1960s in the United States, but considerably lower than that in Canada. If one supposes that there is a trade-off between employment and inflation, it is noticeable that inflation rates at the level of the late 1960s now seem to go with higher unemployment. The recent higher unemployment rates in Canada than in the United States are consistent, in this view, with Canada's lower inflation rate. (However, note

[12] These comparisons are indicative only, making no allowance for factors such as phases of the business cycle.

that Canadian unemployment was higher in the mid– to late 1980s even when price rises were somewhat higher on average in Canada than in the United States.)

Figure 5.4 illustrates another dimension of the Canadian economy that shows appreciably poorer performance in the 1980s and 1990s. Shown are changes in the size of the federal government budget deficit for both the United States and Canada. Immediately after World War II, government budgets typically moved between positions of surplus and deficit. The 1960s generally saw small deficits, but, as the figure shows, the size of the deficit increased sharply thereafter. (It should be noted that part of the increase reflects inflation, as dollars become of less value over time.) To allow comparisons, the Canadian and U.S. federal government deficits have been indexed to a value of 100 for the average of the years 1974 to 1976 (a base period that was chosen arbitrarily). Continual deficits imply a growing government debt. In 1989 the federal government budget deficit was 25 percent of GDP for Canada and 27 percent for the United States. It is hard to know what meaning to ascribe to continued high government deficits. There is a widely accepted but normative presumption that they imply that the government is spending in an imprudent manner, unless there is clear evidence that it is building up valuable capital assets for the future. Some express fear that high borrowing by the government will squeeze out private investment spending, thereby reducing the growth rate of the economy. If the funds are borrowed abroad, then foreigners have a future claim on the country's output. (Interest and debt repayments to domestic citizens are a transfer from one group of taxpayers to another.) In 1975 less than one-quarter billion dollars of the federal debt in Canada was owed to foreigners; by 1990 the figure was over $60 billion. (Comparable figures for the United States are $66 billion and almost $400 billion.) Rising debt also makes financing government activities difficult, since a greater sum must be devoted to interest payments. In the 1990s both federal governments have begun to address their large budget deficits, necessitating rather painful decisions about increasing taxes and/or reducing spending. It should be noted that persistent high unemployment, especially in Canada, ties into the budget problems, because it translates into higher welfare payments and reduced tax revenue. But fiscal tightening may worsen unemployment.[13]

[13] Figure 5.4 shows the federal budget deficit. Canadian provinces also saw a tendency to higher budget deficits in the 1980s and early 1990s. In 1995 expenditures by provincial governments were 98 percent as large as federal spending (net of transfers to other levels of government). Local government spending was

INSERT FIGURE 5.4 ABOUT HERE

Figure 5.5 shows the Canada–United States exchange rate (U.S. dollar against the Canadian dollar) from 1964 to 1993. As can be seen, the Canadian dollar appreciated in the early 1970s but then fell considerably in value after 1976, trading up and down since then but at a substantial discount to the U.S. dollar. The depreciation of the Canadian dollar after 1990 probably contributed to the resumption of economic growth in 1992, which observers have seen as export driven.

INSERT FIGURE 5.5 ABOUT HERE

Since 1970, Canada has generally shown a positive trade balance but has had a deficit on the entire current account. Figure 5.6 shows these values for the years since 1977, with the only exceptions apparent (a small current account surplus from 1982 to 1984). The current account deficit worsened sharply after the mid–1980s. For comparative purposes, U.S. values are also shown; the United States has shown persistent deficits on both accounts, which become larger after the early 1980s. (Unlike Canada, the United States has often shown a surplus on the services account, so that the current account deficit was generally smaller than the trade deficit.)

INSERT FIGURE 5.6 ABOUT HERE

We turn from this brief description of Canadian macroeconomic performance in the postwar period to a discussion of macroeconomic policy. A useful, if somewhat fictitious, starting point is to assume that Canadian policy in 1946 reflected an early version of Keynesianism, as indicated by the government's 1945 "White Paper" on employment. In this view, active fiscal and monetary policies could be used to keep the economy near full employment with low inflation. From the perspective of the 1990s this Keynesian view seems naive at both the theoretical and empirical levels.

40 percent as large as federal spending. Hence the finances of lower levels of government are significant in

Theoretically, this early Keynesian view now strikes most macroeconomists as far too simple. We shall touch on only two of the many reasons for this. First, it soon became apparent that Keynesian policy prescriptions were more complicated in an open economy like Canada's. Thus, for example, an expansionary fiscal policy will be dampened somewhat by increased imports; and changes in monetary policy, which affect interest rates, might translate most readily into changes in flows of international capital, with attendant changes in the exchange rate (or foreign exchange reserves, in the few years the dollar was fixed).

More fundamentally, a number of developments in macroeconomic theory began to cast doubt on the simple Keynesian model. Many of these stemmed from the search for a firm grounding for macroeconomics in models of the behavior of individuals. Economists turned to their usual models, which assumed rational behavior on the part of individuals. But a world in which individuals are rational and markets readily clear—as is commonly assumed in microeconomics—provides no obvious basis for extensive involuntary unemployment. Furthermore, it became apparent to some economists that the assumption that people are fundamentally rational should also apply to their use of knowledge, including the formation of expectations. But models of rational expectations yielded surprising conclusions, including the suggestion that the government's macroeconomic policies might prove ineffective because rational economic agents will have anticipated the policy before it occurred. Macroeconomic theory entered an era of considerable disarray. Neo-Keynesians found it important to look at the impacts of less than fully rational behavior and imperfect markets as possible sources of unsatisfactory macroeconomic performance. Neoclassical economists usually argued that the economy tended quite quickly to some "natural" rate of employment, and that government policy impacted almost entirely upon price variables (the inflation rate, interest rates, the exchange rate). Their analysis therefore concentrated on factors that might affect the natural rate of unemployment. Did increases in welfare and unemployment insurance benefits in Canada make people more willing to accept unemployment? Might technological changes, and resultant modifications in the economy's mix of job skills, raise the natural unemployment rate or induce a cyclical

Canada.

dimension to it? The net effect of these theoretical developments has been that the focus of government fiscal policy has shifted from a Keynesian stabilization emphasis to a "structural" emphasis on issues such as industrial policies, research and development, education and training, labor mobility, and the like.

It is difficult, therefore, to provide an easy assessment of Canadian fiscal policy in the postwar period. By the early 1990s it seems fair to suggest that the fiscal policy environment was dominated by two conflicting factors. Unemployment rates seemed to be stuck at unacceptably high levels (around 10 percent), and it was widely accepted that budget deficits were a problem that had to be addressed. Since tax increases were generally perceived as unacceptable, governments turned to expenditure cuts. This is the precise opposite of traditional Keynesian expansionist policies. However, in theory at least, there is still room for reevaluation of the pattern of government expenditures with more programs aimed at structural problems in the economy.

Monetary policy in Canada has, for the past several decades, been aimed largely at the stable price objective. This may reflect a predilection of policy makers, but it is also consistent with those views that cast doubt on the ability of monetary policy to have much of a real effect on the economy. It has been suggested that authorities in the Bank of Canada may elect one of two main types of variables upon which to focus: interest rates (i.e., the price of money) or the size of the money supply. Over the years the Bank's focal point has, apparently, varied. In the mid–1970s the Bank first announced a policy of "monetary targeting" in which the key decision would be the supply of money. A slow, steady rise in money supply would support economic activity while generating very low inflation. Figure 5.7 shows changes in a key interest rate (the U.S. and Canadian central banks' lending rate in panel a), the difference between the Canadian bank rate and the U.S. rediscount rate and the difference between the Canadian bank rate and the Canadian rate of inflation in panel b, and changes in currency and demand deposits in panel c.[14] Once again, for comparative purposes, both Canadian and U.S. data are shown.

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[14] There are many different interest rates, of course. Since the term structure of rates may change, not all interest rates will generate the same pattern as shown in figure 5.7(a). Similarly, there are different definitions of money supply, which may change at different rates from the narrow definition (or M1 definition) of figure 5.7(c).

INSERT FIGURE 5.7 (AND ALL SUBCOMPONENTS) ABOUT HERE

It can be seen from figure 5.7(b) that Canadian interest rates almost always exceed U.S. rates. It is presumed that flows of short-term capital are responsive to the size of the interest rate differential; by implication, so is the value of the Canadian dollar. Higher interest rates could reflect one or more of at least three factors: (1) higher interest rates designed to fight inflation; (2) higher interest rates designed to maintain the value of the Canadian dollar; (3) higher interest rates as a by-product of the combination of a monetary targeting policy and current economic conditions (in Canada and abroad). Figure 5.7(b) also shows the difference between the bank rate and the annual inflation rate; this provides an indication of the real rate of interest and, therefore, the tightness of monetary policy. It can be seen that the real bank rate is much higher after the late 1970s than before. If monetary policies do have real economic effects, this would help explain the higher unemployment in recent years.

Figure 5.7(c) shows the annual percentage change in the supply of money (narrowly defined). Once again, there is great variability in the Canadian data, more so than is generally seen in the United States. The data suggest those periods in which the Bank of Canada has followed monetary targeting (maintaining relatively slow and stable increases in the money supply). Such targeting began in the mid–1970s and held to the early 1980s, beginning again in the late 1980s. Monetary policy since the late 1980s might be referred to as a war on inflation with the goal of unconditional surrender.

In conclusion, what was Canada's economic situation in 1996, the year this chapter was written? Tight monetary controls had brought the rate of inflation to a very low level. The Canadian dollar has continued to trade at between 71 cents and 75 cents U.S., significantly lower than it had been twenty years earlier and also somewhat lower than suggested by the relative value of goods in the two countries.[15] This relatively low value for the Canadian currency might reflect the assessment of currency traders about some of the more problematic aspects of the economy. The unemployment rate (in the

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[15] On a "purchasing power parity" basis, many observers suggest that the Canadian dollar should be trading at about 80 cents U.S.

order of 10 percent) is of particular concern, especially as it remains at much higher levels than in the United States. Despite the evidence of substantial unused productive capacity, Canada continued to borrow significantly from abroad—more than $130 billion in the first five years of the decade. (That is, Canada continued to run a sizable current account deficit.) It was more than 12 percent of current account credits in all years in the 1990s except 1994 (when the deficit was 9.2 percent). This deficit continued to reflect the investment income and services portion of the balance of payments. The balance of trade was still positive, although the surplus would likely have been lower had Canada's unemployment been less.[16]

In much of Canada the most hotly disputed economic issue in the first half of the 1990s has probably been the size of government deficits. Most provinces have moved to reduce these deficits, emphasizing expenditure cuts, usually with an objective of no deficit, or even surpluses to allow retirement of the provincial debt. In its 1995–96 budget the federal government announced a substantial reduction in its deficit, with further reductions projected. The current Liberal government, however, does not plan to eliminate the deficit completely, arguing that rising federal debt is quite manageable so long as the economy continues to grow. Major questions remain. The cutbacks by government seem likely to exacerbate, rather than help, the unemployment problem. It is obvious that improving the financial position of the government by cutting expenditures raises very difficult questions about where cuts are to take place and whether such cuts will endanger the various educational, social, health, and cultural programs to which Canadians have become accustomed. A related issue, of somewhat longer-term horizon, is the fate of the government-run Canada Pension Plan, which has been unfunded in actuarial terms. As the Canadian population ages, it will be necessary to increase contribution rates and/or reduce benefits and/or fund pension payments out of general tax revenue; none of these options is politically attractive.

Finally, many are suggesting that considerable structural changes in the Canadian economy may be necessary both to address the problems just described and to position the economy in increasingly global markets. The role of the government in

[16] That is, higher output and incomes, as unemployed workers are drawn into production, would induce higher imports.

structural adjustments is subject to much debate. Does the government have an essential role to play in initiating and coordinating the changes necessary in the Canadian economy? Will the changes require an active government role to ensure that the benefits of wider participation in the world economy are shared equally? Or are taxes and existing government programs one of the main factors inhibiting the structural adjustments needed? These questions set the agenda for one of the most critical public policy debates of the 1990s; the free trade debate, to which we will turn after a brief discussion of the resources, specifically human resources, available to the Canadian economy.

Canada's Resources

The economic strength of a country derives from the quantity and quality of its resources. It is useful to consider three broad groups of these resources: human resources, natural resources, and accumulated capital resources which can be used in the production of other goods and services.

It is not the purely physical dimension of these resources that counts, but their "knowledge-augmented" value. Vast resources of petroleum lie under the Canadian Prairies, but their exploitation awaited the necessary geological knowledge and drilling technologies. Capital equipment ranges from the simple hammer to the most sophisticated computer chip, from a small warehouse to a large robotic factory. Many economists insist that it is essential to view people as "human capital," that is, as individuals with a wide range of acquired skills and talents. It is evident that the knowledge-augmented natural and capital resources suggest that another important resource group is also essential for a nation's productive activity. This group may be called "coordinating resources." They consist of the management skills necessary for production and a wide range of institutional features, often regulated by the government, including definitions of property rights and the scope of market exchange mechanisms. In Canada, there are large numbers of people with good management skills, and economic exchange takes place to a significant extent through well-established markets under generally stable government regulations.

A nation's economic productivity is the result of all these resources. There is no single formula for success. Countries like Canada, the United States, Australia, and

Saudi Arabia boast natural resource wealth and high incomes. However, many other countries are endowed with natural resources but are still poor. Switzerland and Japan have limited natural resources but are very productive. Similarly, a large population does not guarantee high per capita production, nor does a small population necessarily generate low production per person. The key element seems to be what we have called human capital, in the form of a highly skilled population and a significant stock of knowledge-augmented capital. (Even this combination need not generate success, as illustrated by the former Soviet Union, which has a well-educated labor force and a large stock of capital equipment, much of it quite sophisticated, but which lacked effective coordination resources.) We shall comment briefly on Canada's natural and capital resources and then focus in on its human resources, with particular emphasis on education and training.

Canada is wealthy in natural resources. As discussed earlier, the staples view of Canadian economic development stresses natural resources as the engine of growth. Canada still relies heavily on primary production of natural resources and secondary processing of resource products for a significant share of its output and trade. In economic terms, Canada has a comparative advantage in the production of many natural resources. Some attempts have been made to provide meaningful measures of Canada's natural resource wealth, but inherent uncertainties make the task difficult. (What value would one have ascribed to Alberta's petroleum resources in 1947, before the key Leduc discovery?) It is clear that the fisheries and forests, temperate agriculture, and minerals will continue to be major contributors to the economy into the indefinite future.

The stock of physical capital in Canada is also large. The capital resource base has been measured, generally in terms of the cumulative undepreciated expenditures on capital equipment. However, this quantitative measure fails to capture the qualitative, knowledge-augmented, dimension of the capital stock.

Canada has a relatively well educated labor force. According to a recent Statistics Canada study (Statistics Canada 1991), only 7 percent of the adult population is completely illiterate. However, this figure is based on the lowest definition of literacy, out of four levels of reading ability. The highest level required the ability to read at a fairly advanced level—for example, to read a long newspaper article and evaluate the arguments and evidence in that article. Only 62 percent were judged literate by that standard. Similarly, 86 percent were numerically literate at the lowest level, but only 62 percent met the highest standard.

Compared to the United States, Canada has a somewhat higher proportion of individuals who have not graduated from high school and a somewhat lower proportion of individuals who have graduated from university. While these gaps are narrowing, they are still significant. The last census reported that the median years of formal schooling for Canadian adults (whether male or female) was 12.5 years. This was up slightly from 1986, when the corresponding figure was 12.2 years, while in 1976 the median level of formal schooling was only 11.2 years (Statistics Canada 1993: 203). The median level of schooling is remarkably uniform across Canada. Except for Newfoundland and the Northwest Territories, all provinces and the Yukon Territory had medians in 1991 between 12.2 and 12.8 years. The Newfoundland median was 11.4, and the Northwest Territories were low at 11.2 years. The median age of schooling decreases with age. In 1991 the median for those aged 25–44 was 13.2, for those aged 45–64 it was 11.7 years, and for those 65 years or older it was only 10 years.

In 1992 about 43 percent of the adult population had some postsecondary education. Specifically, 11.8 percent had a university degree and another 22.3 percent had postsecondary certificates or diplomas (including trade certificates). The remaining 8.8 percent had attended a postsecondary institution but had not graduated. For the 1990–91 school year there were 532,000 full-time university students enrolled, up 39 percent from 1980–81. There were 249, 000 enrolled in trade and vocational programs, about the same as in 1985–86 but down from 1983–84.

Total government spending on all levels of education for fiscal 1991–92 was a little over $53 billion, or about 7.8 percent of 1991 GDP. Since the early 1980s, funding in real terms for education has increased relatively little. With the recent deficit reduction policies, several provinces have actually cut education spending. Alberta has announced cuts of 20 percent to be completely phased in by 1997. The federal government funds a portion of higher education through transfers to the provinces. These transfers have been cut and will be cut more in the future. Such cuts in education raise concerns about the future rate of increase in the quality of the Canadian labor force. Governments introducing the budget cuts argue that existing resources can be used much more effectively and that an increasing share of the costs of increased education would fall on the students themselves. Critics feel that the government undervalues the social benefits of education and failed to realize the access problems created for students from disadvantaged backgrounds. They find it strange that governments that speak of the extreme importance of a flexible and well-trained population should use expenditure cuts in education funding to address their budget problems.

The above discussion refers to general educational expenditures. While there has been some political rhetoric, there really have been no significant special training or retraining programs introduced to meet any restructuring made necessary by the CUFTA and NAFTA.

There is another important element to the development of Canadian human resources. Canada has traditionally received a significant number of net immigrants each year. In 1993, 255,042 individuals immigrated to Canada. While in absolute terms the United States receives more immigrants, Canada receives a substantially higher number in proportion to its population. Recent changes in Canada's immigration laws have resulted in a shift in the type of immigrants who are landing. Essentially there are three categories of immigrants—family, refugee, and independent. Family and refugees are accepted on humanitarian grounds and may or may not bring needed jobs skills or strong educational backgrounds. Independent immigrants are admitted on a points basis, with points assigned for education and valuable job skills. In 1981, 35.0 percent of those landed were independent immigrants. By 1991 that proportion had fallen to 28.9 percent. Another recent change in immigration law essentially allowed immigrants to substitute financial capital for human capital. This allows individuals who invest the required amount in Canada to be eligible to immigrate. These changes mean that Canada may be less able to supplement its indigenous human capital than has been the case in the past.

It is difficult to compare labor legislation between the United States and Canada because both have a federal form of government, and therefore there are fifty-one sets of laws in the United States and thirteen (including federal, ten provincial, and two territorial) sets in Canada. However, in general, Canada's labor laws might be described as more "pro-labor" than American legislation. Certainly workers are more unionized in Canada. However, this may not be as important a difference as it would seem, because most of the difference in unionization rates can be explained by the strength of public-sector unions in Canada.

Economists will tell any one who will listen that absolute labor costs do not determine trade. Trade depends on all costs, not just labor costs, and reflects comparative, not absolute, advantage. However, it is certain that there will be those who wish to compare wage rates between countries. Table 5.1 gives average hourly wages rates for Canada for selected major employer categories for 1994. The value in U.S. dollars at the 1994 exchange rate is also given.

TABLE 5.1

1994 WAGES FOR SELECTED OCCUPATIONAL GROUPS

Industry	Wage Rate	In U.S. $
Mining, oil wells	21.68	15.87
Manufacturing	15.95	11.68
Services	12.59	9.22

Source: Statistics Canada, 1995.

The Canadian Free Trade Debate

This section examines a number of issues that emerged in the debate over the free trade agreements. Most of the issues to be discussed surfaced during the CUSFTA negotiations, although in some cases they reemerged during the later trilateral NAFTA talks. In general, Canadians were less concerned with the addition of Mexico to create a trilateral agreement than they had been about the initial bilateral negotiations with the United States. In part, this may have been because some of those opposed to a bilateral agreement had argued that Canada should not be tied to a trade agreement with just the United States but should be seeking a multinational agreement. It was difficult for them to oppose the addition of a third nation to the CUSFTA agreement. More importantly, the volume of Mexico–Canada trade is relatively small, so the addition of Mexico was not likely to have significant effects one way or the other, although some expressed fear that it might divert trade away from Canada to Mexico. Still, it was generally the opinion of those who studied the issue that if there were to be a Mexico–United States trade agreement, it was in Canada's interest to be part of it in order to reduce the chances of Mexico gaining trade advantages with the United States that might allow it to displace Canadian exports (Cadsby and Woodwise 1993: 450).

In the limited space available no attempt will be made to determine, in any comprehensive way, the validity or lack of validity of all claims made by the various groups who opposed the two trade agreements. It is important to realize that it is not the validity of these objections that makes them relevant politically. It is the tenacity of belief of those who hold them. Therefore, the purpose of this discussion is to outline briefly the arguments that emerged in the free trade debate. Since the economic arguments in favor of free trade are discussed in detail elsewhere in this book, we shall put more emphasis on the opinions of those opposed to the CUSFTA.

Opponents of the CUSFTA

A number of Canadians expressed the fear that free trade with the United States would result in Canadians becoming "hewers of wood and drawers of water." Of course, this objection runs counter to the experience over the last fifty years, during which tariffs have been coming down. During that period the proportion of Canadian exports that were manufactured goods has been rising. However, it is not a surprising position, given Canada's historic dependence on staples, as outlined above. Moreover, for more than a century Sir John Macdonald and his Conservative political successors had preached a national policy which argued that tariffs were necessary if Canada was to develop a large domestic manufacturing sector. A related objection saw the CUSFTA as a sellout of Canadian natural resources. Again there is some historical basis for the argument. The Reciprocity Treaty of 1854 was approved by the Americans only after they gained access to the fisheries in the Grand Banks. A later free trade proposal would have granted Americans fishing rights off the west coast of Canada. The image of Canadian water and oil flowing uncontrollably south is sufficient to arouse substantial and strong opposition. It seemingly reinforces the view that free trade will leave Canada as an exporter of raw materials to the United States and an importer of manufactured goods. Ironically, such critics see the CUSFTA as a new mercantilist policy.

It is not only the sellout of resources that opponents of free trade fear. They have also predicted the sellout of Canadian manufacturing industry. Foreign ownership remains a matter of concern for many of those opposed to free trade. The foreign ownership issue is not a simple one. Until World War I most foreign investment in Canada was British. As the British divested their Canadian holdings to finance two world wars, the balance shifted and the Americans became the dominant source of foreign investment. The form also shifted from portfolio to direct.[17] By the 1960s a significant proportion of Canadian industry was U.S. controlled, and nationalists of all political backgrounds became concerned. Legislation was passed that required the screening of foreign takeovers. By the 1980s the furor was abating and this legislation was watered down. However, some Canadians, particularly those on the political left, continue to voice concerns. They view the CUSFTA as providing U.S. multinationals the opportunity to buy up what was left of Canadian-owned industry. Paradoxically, the reduction of trade barriers also reduced one of the motives for foreign ownership. In the days of high tariffs, U.S. firms often established Canadian branch plants to avoid the tariff wall. Thus free trade could mean less foreign ownership. The opponents find little solace in this possible turn of events. They see no reason why removing tariffs should lead foreigners to sell back to Canadians. Even worse, perhaps, if a branch plant was established simply to avoid a tariff wall, there might be no reason at all to maintain the plant under free trade. Such plants might simply be closed or, with the advent of NAFTA, moved to Mexico to take advantage of the lower wages there. Either way, CUSFTA would generate undesirable effects. Some manufacturing plants would be closed and the jobs shifted south, and whatever manufacturing was still economic would be run by Americans.

It has been argued that the CUSFTA threatens cultural industries. Cultural industries can be viewed as "strategic goods" industries that are vital to a nation's independent existence. The Canadian negotiators of the CUSFTA recognized this and created a specific exemption for the cultural industries. Critics argue that the exemption

[17] Portfolio investment does not imply control, whereas direct investment does imply control.

may well be of limited usefulness, for there is also a provision that allows retaliation if the exemption is exercised. The recent controversy over the New Country Network tends to reinforce this view. When the Canadian Radio-Television and Telecommunications Commission ordered cable companies to replace the U.S. country music station with a Canadian country station, the U.S. station retaliated by ceasing to play most Canadian artists. The final result was a compromise under which the U.S. station bought a minority position in the Canadian station. Canada is not alone in its fear of American "cultural imperialism." Several other countries have legislated national content rules for radio, television, movies, and other cultural industries. In the meantime, Canada is beginning to export another music channel to Mexico. (As of June 1, 1995, the Canadian MuchMusic signal began to be available in Mexico.) The whole debate as it relates to television may become moot because of technology changes such as direct view satellites. However, it is likely to remain important for books, movies, and the recording industry.

Perhaps of greatest concern to those who have opposed the CUSFTA and NAFTA is the future of Canada's social programs. Many of Canada's social programs are not that different from their U.S. counterparts. The federal government in Canada provides a payment called Old Age Security to most Canadians over age sixty-five. For those with little or no other income, it is augmented by a program called Guaranteed Income Supplement. A third program, the Canada Pension Plan (or the Quebec Pension Plan), provides pensions to retired Canadians. Payments under this plan are based on the contributions made by employees and employers during the individual's working life. (Self-employed workers are also covered, but they must make both the employee and employer contributions.) While the exact nature and level of support in these programs are not the same as under U.S. Social Security and welfare programs, the differences are not so great as to cast doubt on the ability of free trade to function.

Canada also has a federally operated employment insurance (EI) program,[18] which has recently been changed. Some have suggested that the changes are a consequence of the free trade agreements. Canadian employment insurance has been raised by the United States in trade disputes (Bowker 1988: 94), the argument being that

[18] Until 1996, EI was called unemployment insurance (UI).

the government program gives an unfair advantage to Canadian businesses. However, the changes in the Canadian program probably would have been made in any case, because it had evolved into much more than employment insurance. In areas of chronically high unemployment, it had become a welfare scheme. It was also used as a job retraining program. A recent study (Sargent 1995: 47) concluded that the Canadian program was significantly more generous than the program in a "typical" U.S. state. Using the 1970 Canadian system as a base, as of September 1994 the Canadian program scored a generosity index of 114, compared to the "typical" state score of 81 with U.S. Federal Extended Benefits (FEB) included. However, New York State's program scored 128 with FEB included. It is hard for the United States to argue that Canada's program is incompatible with free trade when New York has an even more generous unemployment insurance program.

It was noted above that employment insurance has become a form of welfare in areas of chronically high unemployment. Canada has a serious problem of regional disparities. Certain areas—Newfoundland, the Maritimes, and parts of Quebec, Manitoba, and Saskatchewan—have substantially lower per capita incomes than the country as a whole. For some regions this problem has existed for generations. Unemployment rates in many of these areas are well above the national average. The federal government has tried a variety of programs, including subsidies to firms that will locate in these areas. Those opposed to free trade argue that Canada may be forced to reduce or eliminate many of these programs. (Some of those who supported freer trade have stated—possibly cynically—that it might be for the best if the programs were successfully challenged, since they inhibit relocation of Canadian resources.)

Canada's medicare system has drawn most attention. Americans often refer to the Canadian plan as socialized medicine. In point of fact, it is not the practice of medicine, but the medical insurance, that is socialized. Technically each province has its own program, and there are minor differences between provinces. The federal government does provide part of the funding for the provincial programs. Because the federal government subsidizes the programs, the federal government is able to maintain national standards. It requires that all provincial plans be universal and it prohibits extra billing.[19] Originally the federal government provided 50 percent of the funding; however, the federal share has dropped and will continue to do so. As the federal share decreases, so does the federal government's ability to enforce national standards.

Canada spends a significantly smaller proportion of GDP on health care than does the United States, but it has lower death rates and longer life expectancies. In 1990 Canada spent $1,837 Canadian per capita, or 9.2 percent of GDP, on health care. The United States spent $2,566 Canadian per capita, or 12.2 percent of GDP. Moreover, the rate of increase in costs in the United States has been higher than in Canada (Nair, Karim, and Nyers 1992: 175–78). A Canadian female's life expectancy at birth is 80.6 years, compared to 78.6 in the United States. The figures for males are 73.7 and 71.6 years, respectively. The age-standardized mortality rates are 727 per 100,000 in Canada compared to 820 per 100,000 in the United States. The infant morality rate in Canada is about 7 per 1,000. In the United States it is nearly 50 percent higher, at 10 per 1,000 (Nair, Karim, and Nyers 1992: 181). The greater efficiency of the Canadian health care system comes about in part because the proportion spent on administration is smaller.

Some U.S. interests view medicare as a subsidy to business. Most of the cost of the Canadian health care system comes out of general revenue, whereas many U.S. employers pay substantial premiums for their workers' insurance. For this reason it may seem to U.S. employers that their Canadian competitors have an advantage. However, it should be noted that Canadians pay higher taxes than do Americans. The higher taxes sometimes lead Canadian business to claim that they are the ones at a disadvantage. Opponents of free trade may use both of these arguments. Challenges by the United States, it is argued, could force Canada to abandon medicare and to open up medical services to competition from private U.S. insurance companies and medical clinics. In addition, Canadian businesses in competition with U.S. firms will force reductions in Canadian taxes to the lower levels assessed in the United States, therefore depriving Canadian governments of the financing required to fund Canadian social programs.

Those who fear that free trade is a threat to Canadian social programs are not all on the "anti-American left." They have some evidence to support their position. The

[19] The provincial government and the provincial medical associations negotiate a fee schedule. Individual doctors bill the province according to that schedule. They are not allowed to bill the patient.

recent debate over health in the U.S. Congress demonstrated that there are those who are strongly opposed to a Canadian-style health care system. Recent changes in Canadian drug patient laws were in part the result of U.S. political pressure and multinational drug companies' lobbying in Canada. U.S. medical insurance companies are ready and able to move into Canada should the institutional framework change to allow them to do so (Pedersen 1995). Moreover, U.S. legislation relating to trade with Cuba indicates the willingness of some U.S. legislators to use commercial policy to gain domestic political ends, even if the policy dictates actions by individuals and firms under the jurisdiction of another government.

Proponents of the CUSFTA

It is less necessary, in this book, to set out the arguments of those who supported the CUSFTA and NAFTA. In essence their argument is the classic economic defense of free trade. If individuals can trade freely, then producers can specialize in those activities in which they have a comparative advantage, the value of total output in the free trade areas can be increased, and the free exchange of goods and services make everyone better off. There are areas of special concern, such as the export of freshwater resources, the protection of cultural industries, and the maintenance of social programs. While disagreements may arise in these areas, the CUSFTA generally recognized them as special areas in which existing programs could be maintained and which would not be subject to unrestricted free trade. Moreover, there was no guarantee before the CUSFTA that the United States might not object to a variety of Canadian policies, including those in the areas just mentioned, and the CUSFTA has the advantage of setting up a formal dispute reduction mechanism.

Given the increasing globalization of the world economy and increasing worldwide competition, the Canadian government would have been under pressure to reduce taxes and streamline many social and cultural programs. Free trade, because it increases the wealth of the country, actually enhances the ability to maintain such policies. The fear that NAFTA will see a flood of Canadian businesses to Mexico, where wages are low and environmental standards less stringent than in Canada, is unfounded, and it implies that the opponents have failed to grasp the key argument in favor of international trade—that it hinges on comparative advantage, not absolute advantage. Of course, the CUSFTA and NAFTA will mean that Canadians must make adjustments. But even without the free trade agreements, changes in the world economy would necessitate adjustments in Canada. The point is that the adjustments required by the CUSFTA and NAFTA are ones that increase the well-being of the Canadian economy.

Other Issues

Several unique aspects of the Canadian economy deserve brief comment. The regional disparities issue has an interesting sideline. Canada itself is not a completely free trade zone. Some barriers to interprovincial trade still exist. The "beer war" is illustrative of such barriers. The "beer war" resulted from the Province of Ontario's efforts to place barriers on the importation of foreign beer, but it may have had its roots in the fact that until recently each province was able to prevent the importation of beer from other provinces. While interprovincial barriers are coming down, they still exist. In fact, some observers have suggested that under free trade the barriers to trade between Canada and the United States and Mexico will be less in some respects than the barriers to trade between provinces. It is partly for this reason that the government of Canada, under the terms of NAFTA, must provide compensation for provincial programs that violate the free trade agreement.

The position of Canadian aboriginal peoples is a hotly debated topic in Canada. There are unresolved land disputes and a feeling in many quarters that earlier agreements were not fair. Moreover, the aboriginal people exhibit economic, health, and social indicators at levels far below the average Canadian. Native groups currently have some special commercial rights on their reserves. Many of the native groups are seeking "self-rule." It is not clear what such self-rule would involve. It seems likely that it will involve some degree of what might be called home rule—the ability of natives to administer their own system of justice, to control natural resources and economic development on their reservations, and similar issues. It is not likely that self-rule would extend to matters of foreign or trade policy. It is also no more likely that Canada's aboriginal peoples will develop their own commercial policy than it is that aboriginal people in the United States will. The residents of transborder Indian reservations claim the right to transport goods across the border without restriction.

While this is a possible source of complications, akin to the black market cigarette trade that forced Canada to lower its tobacco excise tax, it is not a major or uniquely Canadian problem.

Finally, Quebec separatism remains a continuing possibility. While the 1995 referendum was won by the side supporting continuing union with Canada, the vote was almost evenly divided between the "yes" and "no" camps. While it remains clear that not all those voting to secede wished complete independence for Quebec, it is true that many within Quebec would like to see greater recognition of Quebec's unique Francophone culture and, perhaps, greater powers for the Quebec provincial government. It also seems clear that the issue of separatism will not subside. Quebec has, and likely will always have, a substantial group of people who feel that their potential and their cultural objectives can be realized only in an independent Quebec nation. Many of these people will be unpersuaded by arguments that Quebec already has large powers over social and economic matters, that independence would generate economic costs, or that preservation of the Francophone culture can be better maintained within a bilingual Canada than in an independent Quebec alone in a largely English-speaking North America. Therefore, the threat of Quebec separatism is unlikely to disappear. At the same time, this seems to be a problem that is largely internal to Canada, at least up to the point when separatism actually has to be negotiated. It is noteworthy that despite the tone of xenophilia that many observers have noted in parts of Francophone Quebec, the assumption of Quebec separatists has generally been that free trade within North America could continue even with Quebec's independence. (It is also noteworthy that many Canadians outside Quebec have expressed doubts about this.)

Conclusions

This section is called conclusions mainly because it comes at the end. NAFTA is still very new. It is not possible to reach conclusions. Rather, it is time to look into the future and see what is likely to develop.

While the implementation of CUSFTA and NAFTA in Canada was controversial, free trade is here and it is likely here to stay. That is not to say that the opposition is dead. It is not dead, and it will continue to be vocal. The opposition has strong historical roots which go back well before confederation. The British mercantilist policies of the Canadian colonial period and the role of staples in Canadian economic development have left an image of Canadians as hewers of wood and drawers of water. The United States has insisted on access to Canadian resources as a condition for freer access to U.S. markets ever since the original 1854 Reciprocity Treaty. This insistence has created the fear among many Canadians that the United States is only interested in Canadian resources. In the nineteenth century the Canadian colonies formed a nation. This nation building was in part a defensive act against perceived U.S. expansionism. The United States' concept of manifest destiny, the land claim disputes over the Pacific Northwest, and the unfortunate tactics of the campaign by the Taft administration to secure Senate approval of a trade agreement with Canada all tended to support the view that Americans wished to absorb Canada. In this century the rise of U.S. multinationals has only served to shift the fear of U.S. political domination to a fear of U.S. economic domination. Even the obvious benefits to Canada of the Auto Pact have not convinced doubters who feel that it only benefits the United States and the American big three auto manufacturers.

In spite of the continuing opposition, it is unlikely that any future government will abrogate either accord. Continuing argument about the CUSFTA and NAFTA also reflects the fact that far more has happened in Canada and the world since December 31, 1988, than the implementation of the free trade agreements. It can never be possible to sort out completely the effects of North American economic integration and the effects of all the other changes.

The "danger to social programs argument" is a difficult one. Clearly there is pressure on Canada's social programs. However, it is likely that pressure would have developed without free trade. The federal government and the various provincial governments have been running large deficits. There have been threats of downgrades by the bond rating services, and some provincial bonds and federal foreign currency–denominated bonds have actually been down rated. It has become widely accepted that governments must cut spending (or raise taxes) to reduce if not eliminate their deficits. The phrase "we can't afford it" is increasingly common. Except in the province of Saskatchewan, tax increases seem to have been regarded as politically unacceptable, although many governments feel that the introduction of "user fees" is a different matter. Therefore, many politicians and voters see a need to cut social programs. In the long run the problem is made worse by an aging population that will put heavier demands on old-age support plans and health care. Moreover as the federal government moves to reduce its deficit, it has announced that it will reduce transfer payments to the provinces. These reductions mean that the provinces will have less money to fund social programs, but also that the federal government has less political leverage to force national standards on the provinces.

Thus it is likely that Canadian social programs will be weakened not by free trade but by an internal shift to the political right. However, those opposed to free trade will see any reduction of social programs as a result of free trade even if it is, in fact, the consequence of internal politics. The situation will be further complicated by the fact that those wishing to cut social programs may claim that such cuts and the resultant tax savings were made necessary to meet international competition. While both claims are doubtful, they do indicate that the controversy will continue. Moreover, they point out that the frames of reference for those engaged in the debate are often quite different. Proponents of free trade see it as an economic issue, with the gains from trade increasing the ability of Canadian governments to develop and fund special Canadian social programs. Opponents of free trade tend to see the agreement in terms of economic and political power, with free trade transferring significant control over developments in Canada to the U.S. government and to foreign corporations that have little if any familiarity with Canadian values and no incentive to gain such familiarity. In fact, it is in their interest to promote U.S. values. In this way Canada will be changed forever, and we will not even know it is happening. To the extent that this characterization of the free trade dispute in Canada is accurate, it is necessary that the terms of the debate be considerably broadened beyond the "bread and butter" issues on which economists usually focus.

The fact that both the CUSFTA and NAFTA are in place does not mean that all issues between the countries are settled. There are a number of bilateral and possibly trilateral issues to be resolved. Each of the three countries could doubtless supply its own list of ongoing issues. High on Canada's list would be the West Coast Salmon dispute, the repeated reopening of the softwood lumber cases, and the current issue of trade with Cuba and sugar. The future of NAFTA will to some considerable degree depend on the ability of the member countries to resolve these difference.

The last issue relates to the possible expansion of NAFTA. Canada is likely to strongly support such expansion. From a Canadian perspective a multinational trade area is superior to a bilateral or trilateral one—first, because it would reduce U.S. political and economic influence, but also because it is in Canada's interest to develop new trading links. A strong multinational trade area would reduce Canada's dependence on the U.S. economy and bring the benefits of diversity.

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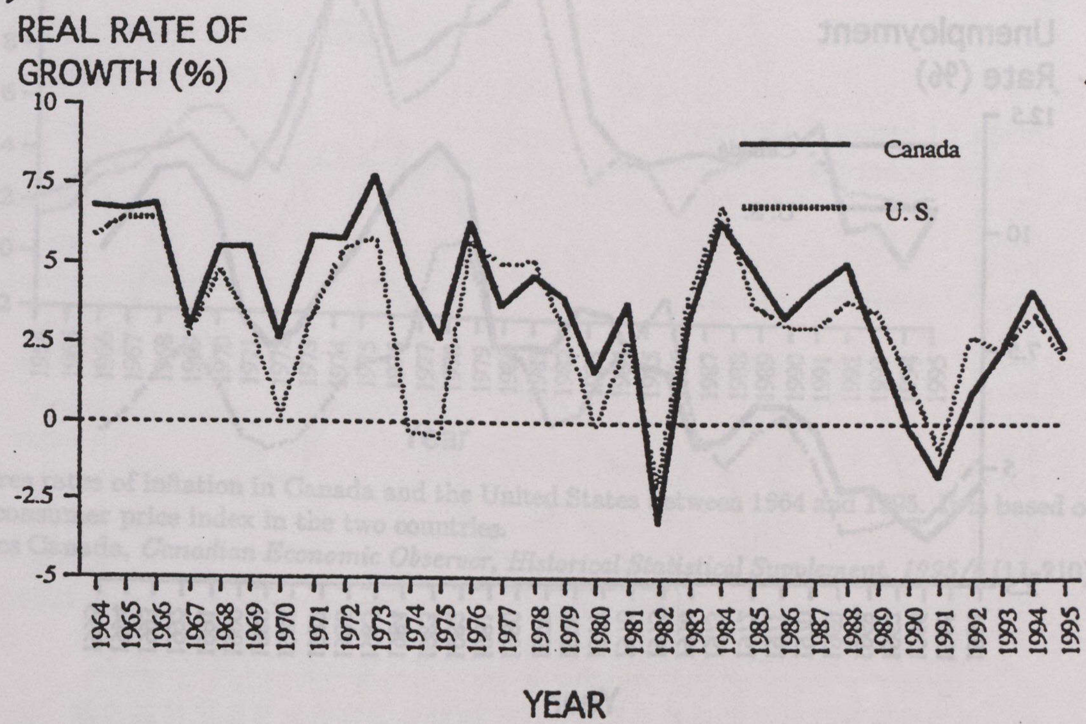
5.1

Figure 1 Real rates of growth in Canada and the United States 1964-1995



5.

Figure 1 compares the real rates of growth in Canada and the United States from 1964 to 1995. Over most of the period Canadian growth exceed American growth in real terms.
Source: Statistics Canada, *Canadian Economic Observer, Historical Statistical Supplement, 1995/6* (11-210).

Figure ~~2~~ 5.2 Unemployment in Canada and the United States 1964-1995

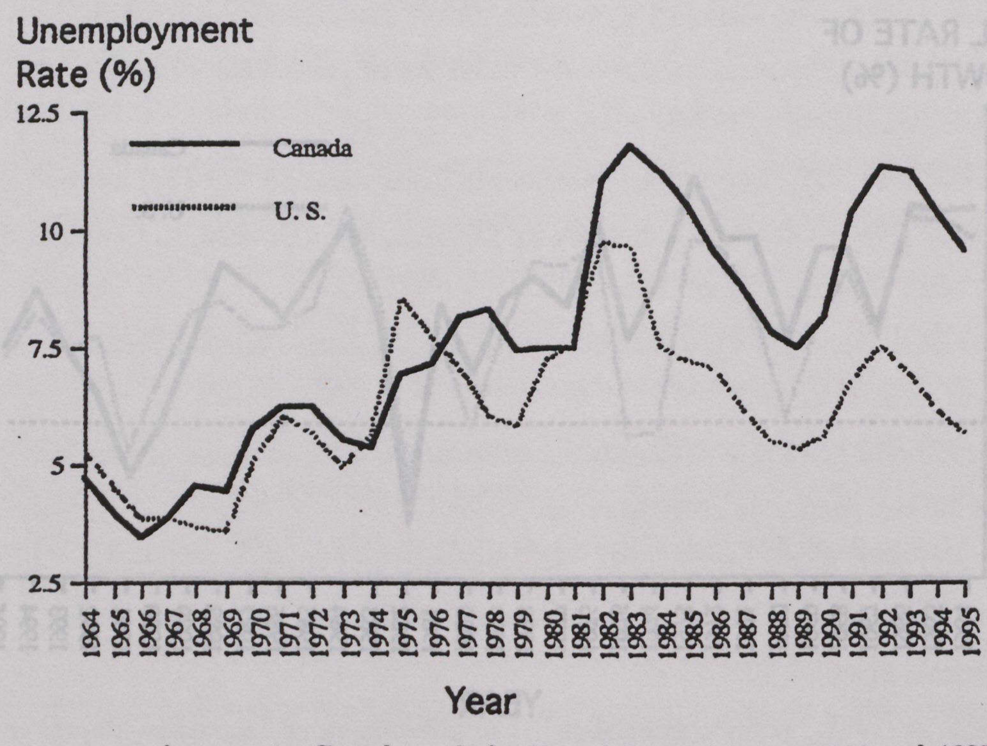


Figure ~~2~~ 5.2 compares unemployment in Canada and the United States between 1964 and 1995. Generally Canada has had higher unemployment the the United States.
Source: Statistics Canada, *Canadian Economic Observer, Historical Statistical Supplement, 1995/6* (11-210).

Figure ~~3~~ 5.3 Inflation in Canada and the United States 1964-1995

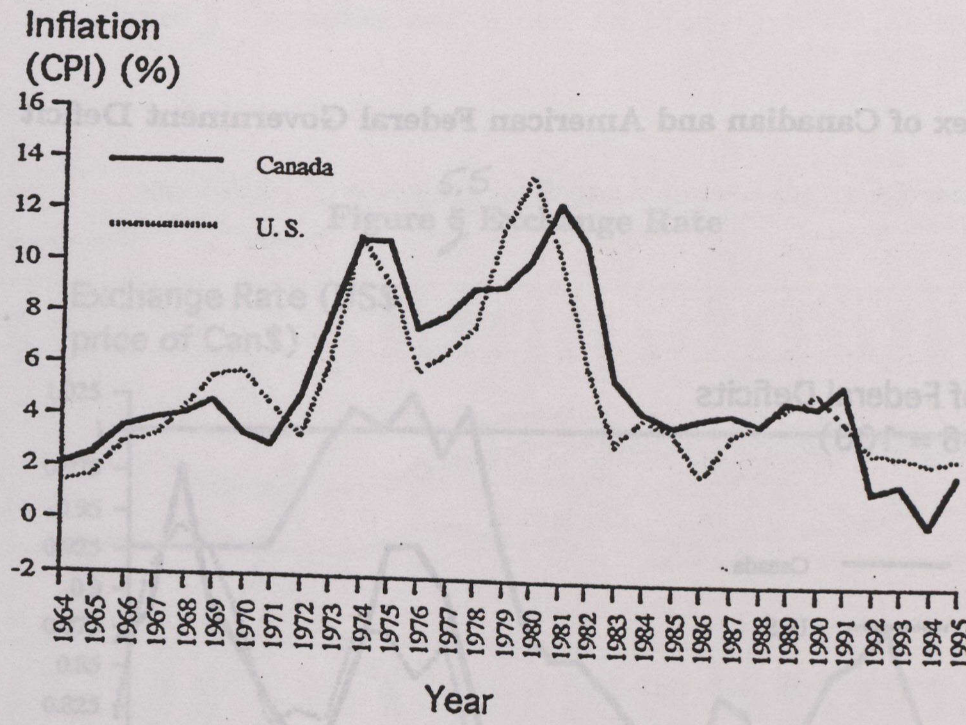


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Figure 3 compares rates of inflation in Canada and the United States between 1964 and 1995. It is based on changes in the consumer price index in the two countries.
Source: Statistics Canada, *Canadian Economic Observer, Historical Statistical Supplement, 1995/6* (11-210).

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Figure ~~4~~ 3 Index of Canadian and American Federal Government Deficit

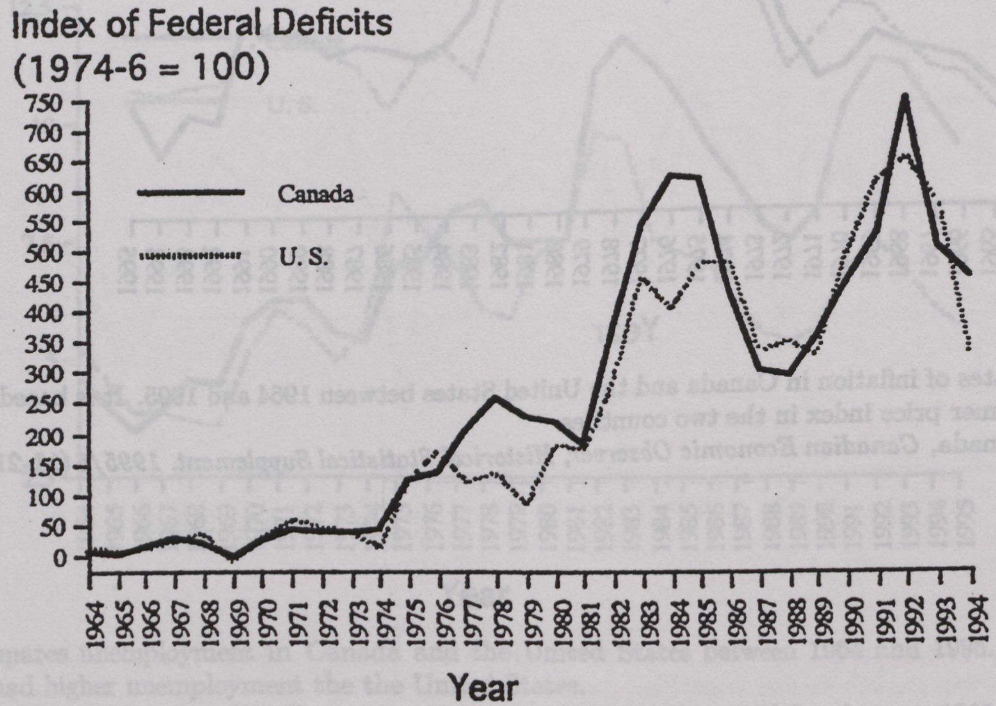

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Figure 4 compares the federal government deficits for Canada and the United States.
Source: International Monetary Fund, *International Financial Statistical Yearbook, 1995 International Financial Statistics,* September 1996.

5.5
Figure 5 Exchange Rate

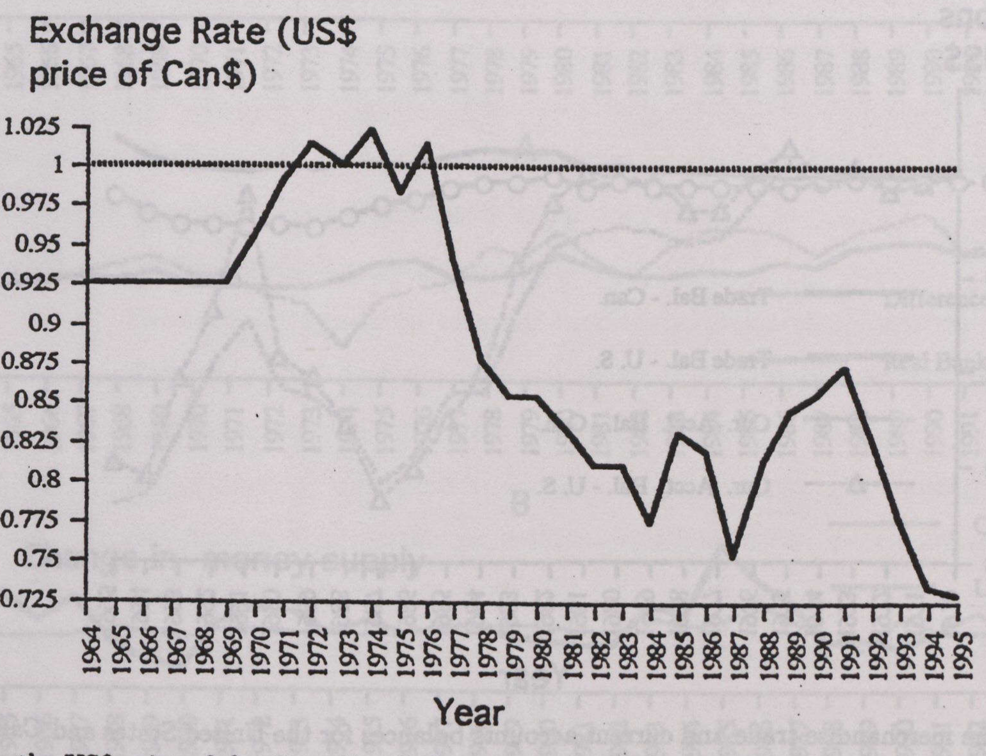

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Figure 5 shows the US$ price of the Canadian $. During most of the 1960's the Canadian dollar was pegged at $.925US. Since then it has been floating.
Source: Statistics Canada, *Canadian Economic Observer, Historical Statistical Supplement, 1995/6* (11-210).

5.6

Figure ~~6~~ Canadian and American Balance of Payments

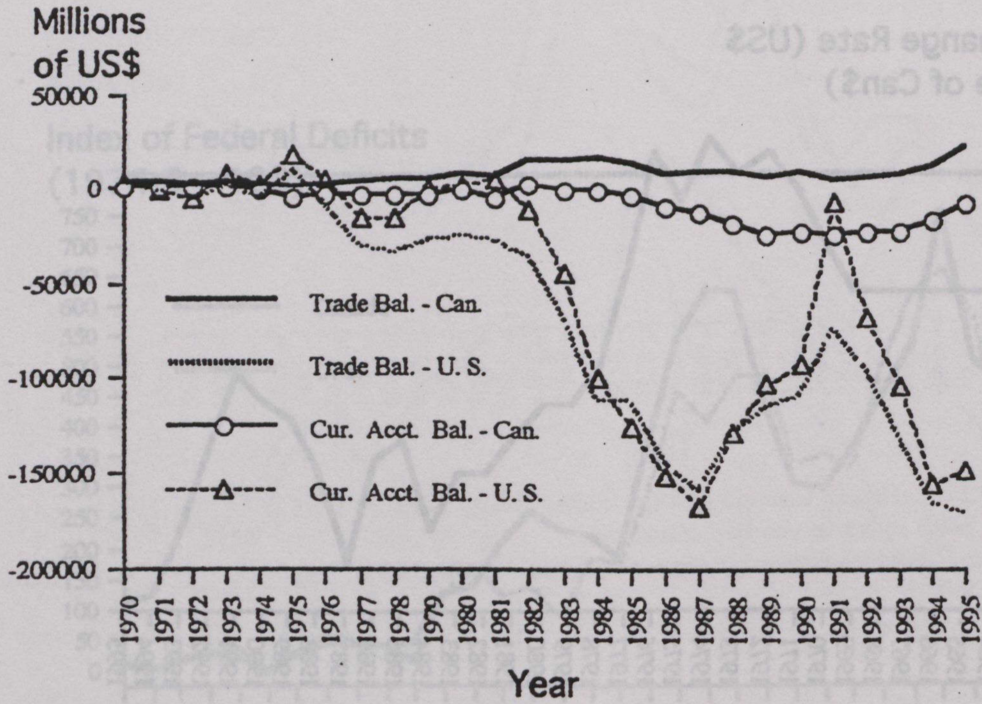

Figure ~~6~~ 5.1 shows the merchandise trade and current accounts balances for the United States and Canada. For comparison purposes all data is in US$.
Source: International Monetary Fund, *International Financial Statistics Yearbook, 1995 and International Financial Statistics*, September 1996.

Figure ~~7~~ 5.7 Canadian and American Monetary Variables

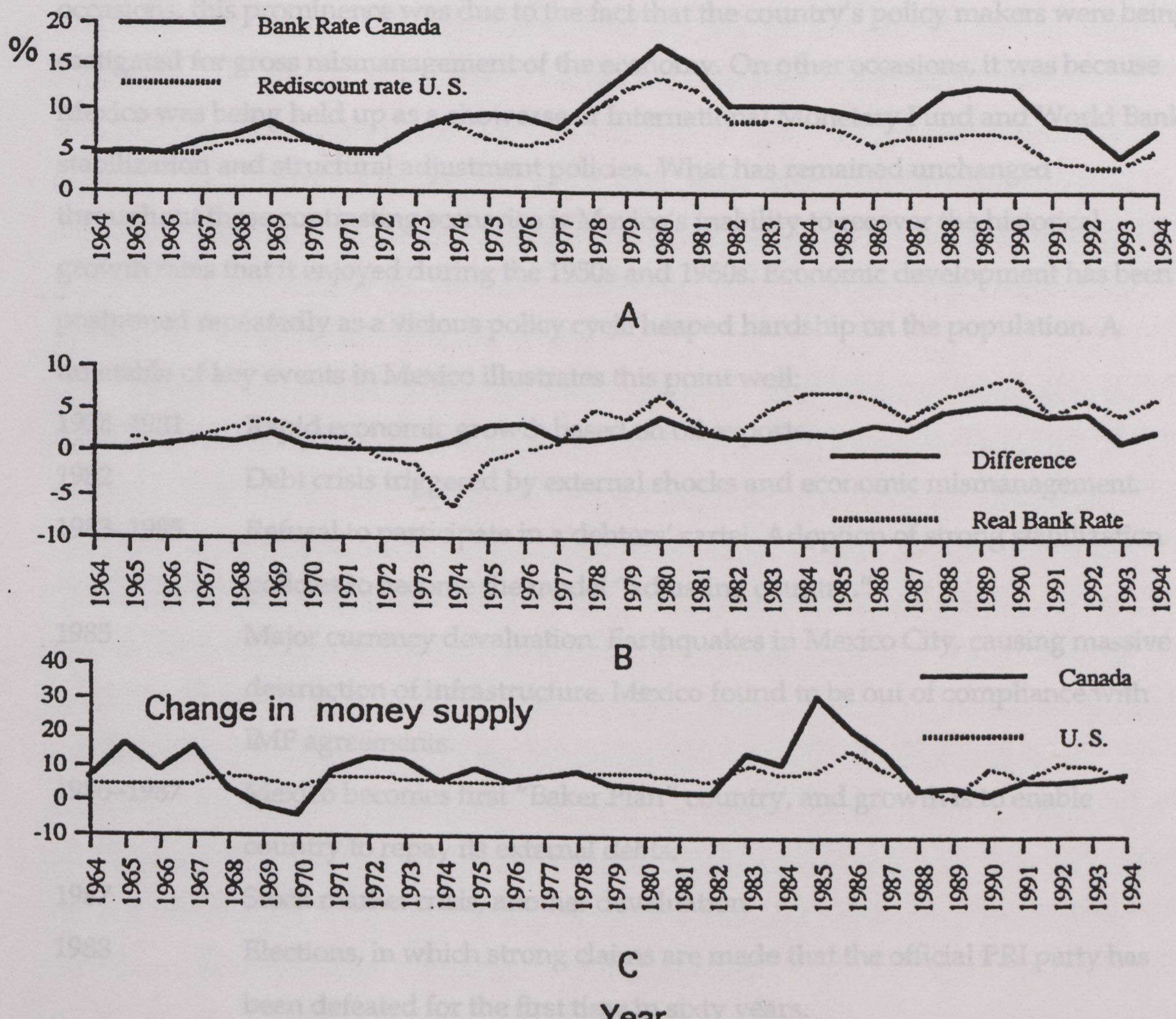

Figure ~~7~~ 5.7 shows a number a monetary variables. Panel A compares the Canadian bank rates with the American rediscount rate. Panel B gives the difference between the central bank rates in the two countries and the real Canadian bank rate. Panel C shows the change in the narrowly defined (M1) money supply in the two countries. Source: International Monetary Fund, *International Financial Statistics Yearbook*, 1995.

CHAPTER 6

The Political Economy of Mexico's Development

Eduardo Zepeda and Diana Alarcón

The Mexican economy has been at the forefront of economic news since 1982. On many occasions, this prominence was due to the fact that the country's policy makers were being castigated for gross mismanagement of the economy. On other occasions, it was because Mexico was being held up as a showcase of International Monetary Fund and World Bank stabilization and structural adjustment policies. What has remained unchanged throughout these contrasting scenarios is Mexico's inability to recover the historical growth rates that it enjoyed during the 1950s and 1960s. Economic development has been postponed repeatedly as a vicious policy cycle heaped hardship on the population. A timetable of key events in Mexico illustrates this point well:

1978–1981	Rapid economic growth based on oil exports.
1982	Debt crisis triggered by external shocks and economic mismanagement.
1983–1985	Refusal to participate in a debtors' cartel. Adoption of strong stabilization policies to become the model "adjusting country."
1985	Major currency devaluation. Earthquakes in Mexico City, causing massive destruction of infrastructure. Mexico found to be out of compliance with IMF agreements.
1986–1987	Mexico becomes first "Baker Plan" country, and growth is to enable country to repay its external debts.
1987	Stock market crisis, another devaluation.
1988	Elections, in which strong claims are made that the official PRI party has been defeated for the first time in sixty years.
1988–1989	Successful heterodox stabilization.
1989–1994	"Impressive" trade liberalization and privatization.
1993	Slow growth and high external financing.
1994	Elections and high spending, with growth in the economy.

1994 (Dec.)	Abrupt devaluation.
1995	International Monetary Fund and World Bank claims of exchange rate mismanagement and insufficient structural adjustment.
1995–1996	Economic and political crisis.

Over the last fifteen years, the Mexican economy has been characterized by stagnation, with worsening poverty and an increasingly uneven distribution of income. Surprisingly, there was little evidence of social tensions or political turmoil throughout this period. However, in 1994 a series of events shocked the country—a revolt in Chiapas, political assassinations, and a sharp devaluation at year's end—and gave clear evidence that serious social and political problems were accumulating.

In less than twenty years, Mexico had moved from a relatively stable situation[1] to a major development crisis. The difference between the situation today and that faced by Mexico in the aftermath of the 1982 debt crisis is that it would be excessively difficult now to implement the same kind of policies adopted in the early 1980s—mainly because they require a high degree of credibility, something that has been undermined by the poor performance of the economy in the last fifteen years and today's level of social and political dissatisfaction. Clearly a new development strategy needs to be formulated, one that gives special emphasis to the basic needs of the population.

This chapter will first provide a brief historical background, a condensed review of Mexican history from colonial times to the land reform of President Cárdenas in the late 1930s. It then turns to the import-substitution-industrialization period, whose decline set in motion the search for alternative development strategies in the 1970s. It next addresses the 1982 debt crisis, the 1982–1988 period of stabilization, and the 1989–1994 neo-liberal experiment, underlining the latter's major successes and failures. The chapter ends with a description of the 1995 crisis and some thoughts about the problems of long-term economic development in Mexico.

[1] Even though this period saw challenges in the second half of the 1970s and encompassed the 1982 debt crisis.

From Colonization to Modernization

Soon after the discovery of America in 1492, Spaniards arrived on Mexico's Gulf Coast with plans to conquer native civilizations and establish a colonial power under the Spanish Crown. Tinted by strong feudal characteristics, dominance in the territories of New Spain depended on a complex web of local and regional groups that derived their power from ownership of extensive tracts of land (haciendas). The economic, social, and political system rested on a comprehensive set of detailed rules. The class hierarchy had Spaniards at the top, followed by Criollos (individuals descended from Spanish parents but born in New Spain), Mestizos (descendants of Spaniards and natives), and natives, Africans, and Zambos (descendants of natives and Africans). There was no judicial system; social order was based on the protection that the powerful granted to those at the bottom of the hierarchy who sought their support. Production was largely organized around meeting the needs of the haciendas and exporting natural resources (mainly gold and silver). There were no incentives for establishing industries since it was more difficult to produce than to trade for finished goods.

Early in the nineteenth century, Criollos, who far outnumbered Spaniards in the new territories, revolted against the Spanish Crown, winning independence in 1817. As Mexico's economic and political links with Spain loosened, new economic and social opportunities appeared, but most of the local and regional structure of power remained untouched. In the 1850s pressure was building to modernize the country along the lines of the then influential liberal ideology. Presidents Benito Juárez (1858–1872) and Lerdo de Tejada (1872–1876) clashed with powerful local and regional groups in an attempt to build a nation-state that would provide the framework for the development of a national economy. There were several attempts to lower interregional and international barriers to trade, though the latter was pursued with less enthusiasm than the former. Mexico's first rail line (thirty years in the making) was completed, and entrepreneurship and private investment were promoted during these administrations.

However, despite enormous efforts by the central government, little progress was made toward building a national economy. La Reforma, as this period was known, encountered many obstacles to modernization, including the 1862 French invasion and the temporary imposition of Maximiliano of Austria as emperor of Mexico. Although liberal ideology proclaimed the need to develop entrepreneurship within society, modernizing

Mexico also needed a strong state, something not in existence at the time. In addition, flawed agricultural policies weakened the system of communal property and further strengthened the power of owners of large landholdings known as latifundios.

The presidency of Porfirio Díaz (1876–1911) set the stage for the Mexican Revolution which began in 1910, but Díaz also created the conditions for Mexico's modernization. Relying on centralized dictatorial powers organized around privileges and political favors, Díaz garnered sufficient political strength to implement the reforms that Juárez and Lerdo de Tejada had so ineffectively initiated. For the first time in Mexican history, national economic development was a stated goal of government programs. Díaz's strategy was a simple one: attract as much foreign direct investment as possible, doing whatever was necessary to that end. Foreign investors received unlimited facilities, and Mexico was soon dependent on external capital to an extreme. Díaz and the group of intellectuals that supported him—"*los científicos*"—believed that foreign investors were better businessmen than Mexican entrepreneurs in most respects. Excluding agriculture and craft production, about two-thirds of Mexican production was given over to the control of foreign capital. During this period, called the "Porfiriato," the economy grew at unprecedented rates led by light manufactures, mainly for domestic consumption, and primary commodities, exclusively for export. Most resources were channeled to the construction of infrastructure, led by railroads. Although rail links were developed mainly to connect major cities to ports to facilitate exports, the construction of a national rail system also created the conditions for the integration of the domestic market. Large flows of foreign capital entered the country, mainly into the government securities that financed the construction of infrastructure.

Along with economic dominance comes political power, and foreign capital soon held leverage in Mexico's domestic politics. However, the political alliance that sustained Díaz was sufficiently strong that foreign interests remained second in terms of political importance. The real threat to the Porfiriato would come from within—in the form of growing social unrest and disputes among economic groups. The Porfiriato was a period of extensive social exclusion. In a still dominantly rural economy, about four-fifths of households owned no land, and about half the population lived in serf-like conditions in rural areas dominated by haciendas. When the Mexican Revolution (which ended the Porfiriato) began in 1910, under the leadership of a growing but politically excluded middle class and nationalistic intellectuals, large segments of the rural population joined the movement, organizing around their own rural leaders. Thus it was that land redistribution and democratization of political life in Mexico became the two central demands of the revolution.

The armed phase of the revolution ended in 1917, although political turmoil continued, including armed revolts in several regions. During the revolution, political power was fragmented among a number of local and regional forces under the leadership of different "caudillos." These leaders vied for position in the postrevolutionary period, making for a national government that was fragile and unable to articulate a national development program. In 1929, a new political party (the PNR, Revolutionary National Party) was created in order to unify what came to be known as the "revolutionary family"—the multiplicity of leaders who had played key roles in the revolution, and their followers. The PNR provided a forum for the internal resolution of disputes among the regional groups, and it succeeded in ending the series of political assassinations of the 1920s.

Trapped in attempts to resolve their own political conflicts, postrevolutionary governments postponed addressing one of the core demands of the revolution: land reform. During the 1920s and early 1930s the promise of land redistribution was used as a political tool to quiet discontent in the countryside, but the government did not modify the structure of property ownership in any substantial way. Land remained in the hands of large *latifundistas,* and this situation remained a persisting source of conflict.

Backed by a strong coalition of grassroots organizations and defying the most powerful groups within the party, Lázaro Cárdenas won the presidential nomination of the PNR in the mid-1930s. Based on his experience as governor of Michoacán, one of the poorest states in Mexico, President Cárdenas encouraged the organization of poor peasants in groups of "petitioners," which in turn pressed the federal government to redistribute land. Within four years, Cárdenas had radically modified Mexico's structure of land ownership. In order to avoid future reconcentration, land was not allocated as private property. Rather, peasants—transformed into *ejidatarios*—were given the right to cultivate *ejido* land, but they could not sell it.

The Cardenista land reform was more than a means to quiet social unrest in rural areas. It was conceived as part of a comprehensive development strategy. Reallocating land into smaller units would supposedly increase agricultural production—by bringing formerly idle land under cultivation and by intensifying cultivation on all land as peasants applied their intensive cultivation practices. An increase in agricultural production, in turn, would support the industrialization process in a number of ways: (1) it would increase the supply of foodstuffs for the growing urban population; (2) it would provide raw inputs for industrialization; and (3) by increasing exports of primary commodities, it would provide foreign currency to support the import of intermediate and capital goods required by the industrial sector.

The land reform of the 1930s was not limited to land redistribution. Because the agricultural sector was to play a central role in Mexico's development strategy, Cárdenas created new institutions to provide *ejidos* with credit, technical assistance, and infrastructure. Results were impressive. Agricultural production increased at a rapid rate.

President Cárdenas introduced other reforms as well. He nationalized Mexico's oil industry in 1938, previously in the hands of foreign firms. This nationalization proved to be a key step in the country's industrialization. In addition, land reform and the mobilization of petroleum-sector workers facilitated workers' and peasants' organization and incorporation into the official party. When the PNR became the PRM (Party of the Mexican Revolution) at the end of Cárdenas's presidency, the terms were set for Mexico's rapid industrialization: social and political stability was guaranteed through the incorporation of all sectors of Mexican society within the official party; a strong national state had emerged, with control over key national resources; and the agricultural sector was showing impressive growth rates.

During the 1940s the Mexican government was in a strong position to take advantage of favorable international conditions to support rapid industrialization and accelerated growth. With Mexico's access to manufactured imports cut off (as most world economic powers became involved in World War II), local producers were poised to benefit from a captive domestic market and from an increasing demand for raw materials and basic manufactures for export. Favorable domestic and international conditions brought about a period of rapid growth and economic prosperity, but they also determined the strategy of industrialization that the Mexican government would pursue in the following years: the substitution of domestically produced goods for imported manufactures, or import-substitution industrialization (ISI).

Industrialization and Import Substitution

ISI has been criticized from a number of theoretical perspectives. One of the strongest criticisms is that ISI introduces major distortions in the allocation of resources throughout an economy, promoting the growth of an inefficient industrial sector. Although there may be elements of truth in this observation, in order to understand ISI's virtues and its flaws one must also consider the historical context in which this strategy has been implemented by developing countries.

The Mexican economy represents a successful case of import-substitution industrialization. During the 1950s and 1960s, ISI spurred high economic growth and rapid industrialization. However, in the 1970s accumulating problems signaled that import substitution had reached its limit as a useful development strategy.

The Success of Import Substitution

In the early ISI period in Mexico, vigorous industrialization provided the foundation for strong economic growth. Between 1950 and 1970, manufacturing output grew at an average 8 percent per year, leading rapid economic expansion. GDP grew at an average rate of 6 percent a year, and GDP per capita rose at an average of 3 to 4 percent annually.

Not only was the economy growing, but profound structural changes were taking place as well. Industrial and manufacturing activities increased in importance relative to total output and employment. Manufacturing's share in GDP increased from 17 to 23 percent between 1950 and 1970, while primary activities decreased from 19 to 9 percent of GDP in the same period. The distribution of employment shifted from primary (agricultural) activities toward industry and services. Mexico was clearly becoming an industrializing country.

INSERT BOX 1 [MEXICO'S ECONOMIC GROWTH] ABOUT HERE

Another distinctive feature of Mexico's economic performance in these years was the macroeconomic stability that accompanied industrialization, particularly during the 1960s. In 1954 and 1958 the country, facing a crisis in its balance of payments, had devalued the peso sharply. Since then, a more conservative approach to fiscal and monetary policies had led the way to several years of relative price stability. Price increases measured about 3 percent a year, a remarkable achievement by Latin American standards and one that gave this period its name: the period of stabilizing development.

Industrialization Policy

Industrialization was supported by a wide range of policies designed to promote industry and transfer resources to industrial activities, particularly manufacturing. Industrial policy targeted specific sectors to benefit from strong incentives and protection. The Ministry of Trade issued a list of products that qualified for government support programs; selected industries benefited from tax reductions, credit allocations, preferential interest rates, rebates on import duties, and access to import quotas.

Mexico's trade policy was characterized by high levels of protection for industrial activities. Import licenses were required for more than two-thirds of total imports. And import duties ran as high as 100 percent, with the higher rates imposed on final products and the relatively lower rates imposed on selected intermediate and capital goods. In general, import duties were higher for consumer durables and lower for intermediate and nondurable consumer goods. This taxation structure translated into high levels of protection for domestic producers of consumer durables, who enjoyed high profit rates based on import restrictions on competing products.

The ISI strategy relied on private investment in most activities. However, the state played an important role in promoting industrialization, not only through indirect regulation of the economy but also through direct investment in selected sectors. In those activities where national private investors were hesitant and foreign direct investment was not desirable—for national security reasons—the state intervened directly in the ownership, organization, and management of industrial and manufacturing enterprises. In the early stages of industrialization in the 1940s, public investment accounted for as much as half of total capital formation, although its importance declined to about one-third in the 1950s and 1960s.

Examples of the role of the government in promoting development in Mexico include the provision of basic utilities such as water, gas, electricity, and telephone services. The government also provided physical infrastructure such as roads, railroads, ports, and transportation, as well as managing the extraction, refining, and marketing of petroleum. The state operated important companies in sectors like transportation equipment and steel. Direct management of key enterprises was an integral part of a strategy aimed at promoting industrialization. By setting prices low for key inputs, the government was actually subsidizing industrial production and the process of urbanization.

The government provided particularly strong industrialization support to the automobile sector. High duties on imported cars—along with fiscal incentives to transnational corporations from the United States, Germany, Japan, and France to produce in Mexico—nurtured the development of a fast-growing auto sector in Mexico that soon accounted for a large share of employment and of manufacturing value added. Given the automobile firms' high level of protection, their output was oriented almost exclusively to the domestic market. Large inefficiencies accumulated in the sector's structure of production, ultimately undermining its ability to develop into an international competitor.

Industrial development was also supported by a policy of wage restraint. Government control over the largest labor unions helped to keep real wages below productivity growth. Wage policy was implemented through two main mechanisms. First, there was a centralized process of wage bargaining that set regional and job-specific minimum wages. Minimum wages, in turn, served as the reference point for individual firms and sectoral wage negotiations. Second, the ability of workers to organize and demand wage increases was, and still is, severely curtailed by the existence of tripartite organizations comprising representatives of workers, employers, and government officials, which limit union actions. As a result, wages increased very slowly in real terms, below the rate of productivity growth. There were a few exceptions; in such fast-growing sectors as automobiles and steel, real wages were relatively higher and wage increases were closely tied to productivity gains.

Regarding resource allocation, there were explicit mechanisms for transferring resources to the manufacturing sector. First, price increases for primary products—especially agricultural commodities—lagged behind prices for industrial products. In addition, manufacturing producers were the main beneficiaries of the cheap electricity, fuel, and railroad transportation provided by state-owned enterprises. Second, the government channeled resources directly into the development of urban areas through public investment in infrastructure and the allocation of preferential credit to manufacturing activities. Third, to the extent that Mexico's exports were dominated by primary products and the country's imports consisted mainly of intermediate and capital goods, exchange rate management, which led to overvaluation of the peso, amounted to a tax on primary products and a subsidy to manufacturing activities. Thus exchange rate policies also contributed to the transfer of resources from primary activities to manufacturing and industrial activities.

Macroeconomic Policy

Macroeconomic stability was achieved through a mix of conservative fiscal and monetary policies. Public deficits were kept below 1.5 percent of GDP, and the government maintained tight control over the money supply. The most important tool of monetary policy was the high level of reserves that commercial banks were required to deposit with the Central Bank. Thus interest rates were also determined by policy design. Every year, government officials would set the desired level of public expenditures and the mix of deficit financing from domestic banks and external borrowing. The private sector would then borrow remaining funds from domestic banks and obtain any additional funds from external sources.

The Exhaustion of ISI

The strategy of import substitution was very successful in promoting rapid economic growth led by an unprecedented expansion of the industrial sector. Eventually, however, ISI succumbed to its own internal contradictions. Toward the end of the 1960s the momentum for industrialization was slowing. Once the relatively easy stage of import substitution—the production of nondurable consumer goods for the domestic market—was completed, it was difficult to advance into the production of more complex industrial products, including capital goods.

INSERT BOX 2 [AGRARIAN REFORM] ABOUT HERE

The high priority given to industrialization and the systematic transfer of resources from primary activities and rural areas toward industry distorted development in both rural and urban sectors. Huge disparities between expected income in the cities and average income in rural areas caused massive rural-to-urban migration, reinforcing the urban bias of development. The rapidly growing urban areas absorbed increasing amounts of resources for productive and social infrastructure. The incentives to the industrial sector—low interest rates, subsidies, high rates of protection—were very successful in accelerating industrialization, but they discriminated against primary activities and precluded the possibility of a more balanced pattern of growth. These incentives to the industrial sector also resulted in an artificially low price of capital, with perverse consequences for employment and the distribution of income—for two reasons: First, they created a highly concentrated structure of industrial production with correspondingly large profit margins, which contributed to widening income inequality. Second, they generated a very capital-intensive structure of production, with low capacity to create employment.

Balance-of-payments problems became increasingly severe. The level of protectionism that characterized industrial development in Mexico created an industrial sector that was unable to compete in international markets. Moreover, fixed exchange rates eventually led to overvaluation, further discouraging export growth. Although protectionist measures prevented a massive influx of imports, the structure of production was highly dependent on imported capital. Thus any increase in the pace of economic activity led unerringly to a corresponding increase in imports. In 1970, for example, more than 90 percent of total imports were intermediate and capital goods. On the other hand, years of policy neglect of agriculture and primary activities decreased the exporting capacity of those sectors. By the late 1960s, historical surpluses of primary products gave way to shortfalls. The rural sector was no longer able to provide adequate supplies of agricultural products for domestic consumption, and living conditions in rural areas deteriorated, not only in relation to urban residents but also in absolute terms.

Two problems were slowly eroding the foundations of macroeconomic stability in Mexico. The first was the reluctance to adjust the exchange rate, which eventually led to overvaluation. Rooted in the political and economic turmoil generated by devaluations in the 1950s, political leaders were hesitant to adjust the exchange rate to hold inflation in check, fearing that any devaluation would be interpreted as a sign that their policy choices were flawed. Although a 3 percent annual inflation rate was low by Latin American standards, it was higher than the rate prevailing in the United States, Mexico's major trading partner. Toward the late 1960s the exchange rate became slightly overvalued, and it was clearly out of line by mid-1970s.

The second problem was an unsustainably narrow tax base for public revenue. The proportion that taxes represented in GDP was low in Mexico compared to developed countries, but it was also low in relation to other developing countries at similar levels of industrialization. If the government was to continue playing an active role in development, additional sources of domestic funds had to be found.

Thus the country's development strategy was facing increasing difficulties in several domains: (1) the sources of foreign exchange that had supported import-substitution industrialization were drying up; (2) the easy stage of import substitution was over, making it more difficult to sustain fast rates of industrialization and economic growth; (3) macroeconomic stability was under strain; and (4) social problems were arising due to persistent inequalities in the distribution of income, as well as inequalities in the access to opportunities for social advancement.

The 1970s: Coping with the Legacy of ISI

During the 1970s and up to 1981, the goal of economic policy was to try to resolve some of the most severe problems generated by ISI policies. Traditional policies to support industrialization were supplemented by programs designed to promote manufactured exports. Several programs were designed to boost agricultural production. Policies of wage restraint were modified to allow some improvement in real wages. And specific policies were formulated to alleviate rural poverty as well as marginalization among the urban population.

Although some aspects of economic policy represented important departures from traditional import-substitution policies, it is safe to say that the main thrust of fundamental policy decisions remained the same. Protection of the domestic market was kept high through the imposition of import taxes and an extensive use of quotas. The structure of protection remained unchanged—i.e., higher duties for manufactured products in relation to primary goods, and higher duties for consumer durables among manufactured products. Overvaluation of the exchange rate increased throughout most of the period. And to a large extent, the urban bias of economic policy did not waver: the structure of relative prices, the allocation of credit, and the deployment of infrastructure continued to favor industrial and urban activities over agricultural and rural development.

Emphasis in particular policies varied over time and especially between the two presidential administrations of this period—those of Luis Echeverría (1970–1976) and José López Portillo (1976–1982). More important, however, was the change in Mexico's macroeconomic framework toward the end of the 1970s. A sharp rise in Mexico's oil exports increased the availability of foreign exchange. Up to the mid-1970s, the government had followed a policy of self-sufficiency with respect to natural resources, deeply rooted in the historical events that led to the nationalization of the oil industry in 1938. Oil extraction was basically limited to domestic consumption. Indeed, during years of peak demand or supply shortages, Mexico had imported oil. But in the late 1970s, after the U.S. government publicly announced the existence of large and long-known oil reserves in Mexican territory, that policy was reversed. Taking advantage of high prices in international oil markets, the Mexican government designed a strategy to increase petroleum extraction and oil exports in a very short period, and the oil industry became a central piece in the design of economic policy.

At this point Mexico also left behind the policies that had marked its period of "stabilizing development." Public deficits of more than 3 percent of GDP—after inflation—became common, and in some years they exceeded 5 percent. This new level of expenditures, coupled with rising international prices, pushed domestic inflation to average rates of 12 percent a year between 1971 and 1975 and 22 percent on average from 1976 to 1981.

The 1971–1976 Period

Policies implemented in the early 1970s were a first attempt to tackle some of the challenges posed by the decline of import substitution and the contradictions that surfaced in the late 1960s. Industrialization proceeded very much along the same lines as before. Unlike Southeast Asian countries once their easy stages of import substitution were completed, Mexico did not attempt to transform domestic manufacturers into successful exporters. Nor did Mexico pursue more aggressive programs of import substitution that would have carried it toward the second stage of import-substitution industrialization—nurturing the development of a strong capital goods sector—as did Brazil.

Mexico adopted a more moderate approach to promoting manufactured exports. In a few industries, the government granted special tariff exemptions for the import of intermediate and capital goods tied to specific export targets. A public agency (the Mexican Foreign Trade Institute, or IMCE) was created to facilitate export activities. Drawback provisions for import duties on exported goods were also designed to stimulate exports. Following the example of some Asian countries, Mexico facilitated the establishment of export-processing zones (EPZs) along its border with the United States. However, industries that flourished under these programs were isolated from the rest of the economy, and there was no clear medium-term strategy to integrate them with the domestic industrial sector. EPZ *maquiladoras* import up to 98 percent of their inputs, purchasing only 2 percent from domestic producers. These industries, located under the export-processing umbrella, were basically conceived as a means to obtain foreign exchange and create employment on a regional basis, rather than as a component of an overall strategy of industrialization.

To the extent that the industrialization approach to development remained unchanged, the nature of social policy did not differ substantially from previous years. Nevertheless, there was some effort to improve social conditions among large segments of the population. Indeed, public expenditures on social programs increased relative to GDP and resulted in a substantial improvement in socioeconomic indicators—most noticeably in literacy, infant mortality, and life expectancy. Some analysts have also found a more egalitarian distribution of income toward the late 1970s, when several programs were implemented to reduce the concentration of resources in Mexico City, mainly by decentralizing federal offices and a few industries. However, the system of relative prices continued to favor urban areas. And although substantial gains in real wages improved the distribution of income in urban areas, the gap between urban and rural areas widened.

One of the weakest areas in overall economic performance during these years was the external sector. The manufacturing sector did respond to export incentives by doubling foreign sales between 1971 and 1976. But although exports were increasing at an average rate of 19 percent annually, most industries remained basically oriented toward the domestic market, with exports representing only a small fraction of their total sales. On the other hand, the industrial sector's dependency on imported intermediate and capital goods did not improve, and an increasing import bill was the cost of moving ahead with the process of industrialization. As a result, and despite the rapid rise of manufactured exports, the external trade balance continued to deteriorate. Mexico's trade deficit increased from 2.3 percent of GDP in 1971 to 4.6 percent in 1974, to fall slightly to 4.1 percent in 1975.

Growing trade deficits must either be resolved through a devaluation, be financed with external resources, or be halted through contractionary policies. Taking advantage of international conditions, Mexico chose the option of financing its growing deficit with foreign debt. Since the mid-1960s Mexico had enjoyed relatively easy access to international capital markets. In the 1970s the government was able to borrow from the large pool of international loan funds made available due to international financial innovation, liability management, and the recycling of OPEC oil surpluses. A substantial proportion of Mexico's public and trade deficits were financed in this way, although debt ratios started to show some warning signs as debt grew faster than GDP and interest payments came to represent a large proportion of export revenues.

A substantial slowing of private investment became one of the most critical problems in these years. In the context of increasing imbalances generated by the industrialization process and of political actions taken by the government to lessen social tensions, harsh recriminations surfaced between government officials and segments of the private sector, and this contributed to a major retrenchment of private investment. Not only did new investments hold off, but the private sector also "lost" underinvested plants to the government. Private businesses took the back seat, and the state was forced to take up the slack. One way the government averted economic recession, growing unemployment, and greater social tensions was by taking over bankrupt businesses and undertaking major investment projects in such diverse industries as steel, electricity, automobiles, and even tourism. Although representatives of the business community blamed the government for the slowing of private investment, these years clearly represent a foreshadowing of what would later come to be recognized as a major economic problem: the chronic risk-averse behavior of Mexican entrepreneurs. It is of note that, despite its increasing role, the government did not seriously challenge the dominant position of the private sector in the economy. In fact, the government protected the private sector's short-term interests through major concessions in key decisions. At one point, for example, the government abandoned a fully designed fiscal reform that would have caused the private sector to experience a shortfall in revenue. The interest of private national investors were further protected by the adoption of restrictive legislation on foreign investment.

Mexico's overall economic performance continued to deteriorate. Economic growth slowed from an average annual increase in GDP of 7 percent between 1960 and 1970 to 6.5 percent a year from 1971 to 1976. Manufacturing output, which had been increasing by 8 percent a year between 1960 and 1970, rose by only about 4 percent during the later period. A fundamental cause of concern was the slowdown in productivity experienced during this period. Given the reluctance of private investors to expand production, economic growth was financed largely by a substantial increase in public investment, which contributed to drive up public investment as a portion of GDP by several percentage points. This public investment was not always guided by economic efficiency, but rather by multiple—often contradictory—criteria: to save jobs, bail out private companies, develop certain sectors of the economy, etc. This governmental approach, together with a retrenchment of private investment at a time when import-substitution industrialization had entered its critical phase and there was no apparent reorientation of production toward exports, explain the period's sharp slowdown in productivity.

President Echeverría's first attempt to reestablish conditions for strong growth, based on the old principles of import-substitution industrialization, terminated in a severe balance-of-payments crisis, a major devaluation, and economic recession. Heavy public-sector investment, combined with meager tax revenues, increased fiscal deficits. These deficits, when coupled with high rates of inflation in the world economy, fueled double-digit inflation in Mexico. Rising prices, in the context of a fixed exchange rate regime, led to real appreciation of the peso, which added pressure to the already high deficits in the country's trade and current accounts. External borrowing to finance those deficits would only work for a limited time, and in 1976 the government was forced to implement a recessionary economic policy—including a major devaluation—in an effort to improve its trade and public deficits. By then, an adjustment in the exchange rate was long overdue.

The economic and political situation had become so volatile that the government's efforts to stabilize the economy sent panic through exchange markets and ultimately provoked a drastic devaluation of the peso by approximately 100 percent. The government's intention in undertaking a devaluation was to correct macroeconomic imbalances, revitalize the economy, reduce external borrowing, and improve export performance. But the announcement of major oil reserves at about this time, in a context of rising international petroleum prices, took the economy in a very different direction.

The Oil-Export-Platform Experiment

The 1976 devaluation and a strict policy of stabilization implemented in 1977 reestablished basic macroeconomic equilibrium by reducing inflation and decreasing trade deficits as imports contracted. These policies carried a high cost: no economic growth.

Soon, however, Mexico changed tack and undertook a rapid increase in its oil exports. Oil revenues soon substituted for foreign borrowing. Since the country was no longer dependent on foreign debt, this also removed all foreign constraints on Mexico's growth. The country repaid its IMF loans and, using public investment, set the pace for rapid economic expansion. Between 1978 and 1981, GDP increased at an average rate of 9.2 percent a year, and inflation held to a relatively moderate 25–30 percent. Massive public investment was funded primarily through heavy taxes levied on petroleum-related activities, so deficits remained small. Mexico's ambitious oil-exporting program required large amounts of investment, beyond the capacity of either public resources or domestic savings. As had happened in earlier eras, international funds began to pour into the country to meet this need. Given the high price of oil in international markets, foreign borrowing did not appear to be a risky policy; borrowing would finance a large increase in oil exports, and the oil revenues would provide the resources to service the debt. In strictly financial terms, this strategy was perceived as sound, especially since real interest rates in international financial markets were negative. The expected rate of return on the investment financed with foreign debt easily exceeded the rates of interest on external credits.

The trade regime that prevailed in Mexico during this period was basically a holdover from before. More attention was given to programs to stimulate exports, and the structure of protection was made somewhat more efficient by replacing quotas with tariffs. From 1977 to 1980, manufactured exports more than doubled, but the rapid acceleration of economic activity, partial trade liberalization, and real exchange rate appreciation increased the value of imports three times over. By 1979–1980, Mexico's trade deficits, excluding oil exports, had reached a historic peak.

Oil revenues made it possible to allocate more resources for social programs. But, while President Echeverría had used a policy of real wage increases to check social unrest, President López Portillo did not support such a policy. Real minimum wages, including the wages of low-skilled government employees, fell below their 1976 level. It was only within the industrial sector that real wages increased.

Although the economy was booming in the late 1970s, this did not translate into strong industrialization efforts. Nor did it reverse the downward trend in productivity. The capital goods sector remained small, even when compared with other import-substituting countries, and Mexico's production of intermediate goods was also lagging. In spite of a rapid increase in manufactured exports, export volumes were an insignificant share of total production for most firms. Aggregate rates of investment reached levels that exceeded even those of the 1971–1976 period. But, again, productivity did not show any signs of improvement. Lacking specific policies to deepen the process of industrialization, and facing an increasingly overvalued currency and a persisting high level of protectionism, Mexico allocated its resources to finance marginal investment projects with low rates of return.

The argument can be made that, since investments mature over a long period, any investments undertaken in the late 1970s would not show results until much later. Thus any assessment of productivity performance during these years would have to be qualified to take into account the period over which investment projects mature. Moreover, one could argue that the investments made in the late 1970s sustained the economy during the stagnation of the 1980s. However, even if we adopt this longer-term perspective, there is no evidence that investments made during the oil boom were actually profitable. And, in fact, the economy became increasingly unstable.

A Debt-Ridden Economy

The rapid expansion of the Mexican economy in the late 1970s weakened its financial resilience against external shocks. The high rates of investment of the period were largely financed by oil exports: at the end of the 1970s oil exports represented about two-thirds of total exports and one-third of all federal government revenue. The remaining revenue came from foreign loans. Thus the economy was exceedingly vulnerable to changes in oil prices and in international lending rates. Complicating things further, toward the end of the decade, dollarization and capital flight began to plague the economy. High inflation in Mexico fed the expectation of a sudden devaluation of the peso, and wary domestic investors began converting their savings from peso-denominated to dollar-denominated assets. By 1981, dollar-denominated assets accounted for about one-third of domestic institutions' financial assets. Capital flight also ran high as Mexicans moved their deposits to foreign banks.

INSERT BOX 3 [EXTERNAL DEBT] ABOUT HERE

The Debt Crisis

Two external shocks hit Mexico in the early 1980s. First, rising international interest rates more than doubled the cost of servicing Mexico's debt. Second, international oil prices plummeted, causing a drastic reduction in Mexico's revenues from exports. The dominant perception at the time was that these events were temporary, and so the Mexican government decided to continue current policies of economic expansion, for which additional borrowing was needed. International banks agreed with Mexico's prognosis, and in 1981 alone, they advanced Mexico an additional $20 billion in loans. But interest rates did not drop, and oil prices remained low. Not only did Mexico's oil-export strategy become unsustainable, but the government's strategies for managing the two external shocks had actually made the situation worse, prompting a severe financial crisis.

In March 1982, under strong political pressure from organized workers, the Mexican government approved a wage increase beyond that negotiated in the stabilization package that Mexico had signed with the International Monetary Fund. In reprisal, angered financial institutions reportedly decided not to roll over (extend the term on) Mexico's foreign debt. By August of that year, the Mexican government announced that it was unable to meet its international financial obligations. The peso was devalued again, by nearly 200 percent in the government-controlled market and by even more in the free market. Seeking a resolution to this latest crisis, the government reduced public expenditures to a minimum and initiated negotiations with private international banks and the International Monetary Fund.

Turning Stabilization into a Development Strategy

Mexico's announced inability to service its external debt in August 1982 signaled the beginning of an international debt crisis that put the burden of adjustment almost entirely on developing countries. International financial institutions canceled all new loans to developing countries, and debt forgiveness was not even on the negotiating agenda. Even though its economy was not growing, Mexico (along with other heavily indebted countries) had to take on additional external debt just to service past borrowing. This strategy had severe repercussions. Between March and December 1982, the peso devalued by more than 200 percent. In 1982 GDP decreased by 0.6 percent; in 1983 it measured -4.2 percent. This contraction of the economy translated into a decrease in imports of about 60 percent from 1982 to 1983, which produced a large surplus in the trade account. In one year, the Mexican government's strategy for debt management engineered a major reversal of financial flows. From a net inflow of resources that represented as much as 6 percent of GDP before 1982, Mexico started to transfer net resources abroad that were equivalent to 6 percent of GDP.

Implicit at the center of this strategy was the need to preserve the integrity of the international banking and financial systems. The debt crisis was considered to be one of *illiquidity*, not *insolvency*, so debtor countries were supposed to pursue policies to reestablish their basic macroeconomic stability, and this would allow them to return to international capital markets. Although not so openly publicized, capital repatriation was also an important target. Between 1979 and 1982, estimates of capital flight from Mexico ranged from \$20 billion to \$70 billion. According to this general approach, capital repatriation and reestablishing voluntary lending to Mexico would ensure the country's return to economic growth. But these two objectives were highly dependent on private investors' confidence in the policies of stabilization, and these depended, in turn, on how closely Mexico followed the orthodox policy advice of the IMF. Operating under these constraints, the government emphasized scrupulous compliance with its international financial obligations. This policy effectively eliminated any possibility for collective action with other debtor countries, which reduced Mexico's potential for political initiative and leadership in international negotiations.

The stabilization policies hinged on drastically cutting demand by reducing public expenditures, credit, and real wages. However, so severe were these adjustment policies that the Mexican government resorted to other, less "orthodox" policies to reduce the deficit in the current account, such as imposing quotas on all imports and increasing import tariffs. This completely reversed the trade liberalization that Mexican had initiated in 1978, and exchange rate policies went well beyond restoring a balanced exchange rate—by 1983 the peso was clearly *undervalued* by as much as 30 percent.

By 1983 Mexico had cut its budget deficit to 8 percent of GDP (down from 16 percent in 1982). Once the rate of inflation is taken into account, adjustment policies produced a major reduction in the government's operating budget.[2] From 8.8 percent of GDP in 1981 and 5.2 percent in 1982, this was reduced to 1.9 percent of GDP in 1983. Real wages were drastically reduced, cut by 50 percent from their 1982 level. And credit collapsed relative to its level in 1982. Although Mexico met and maintained its stabilization goals according to schedule, and the international banking and financial systems escaped breakdown, Mexico (along with many other debtor countries) did not return to international voluntary capital markets.

Short-term stabilization had become Mexico's de facto development strategy. Budget deficits, wages, and credit remained under strict control for most of the 1980s, to ensure that there would be no demand pressures that could threaten prices or the trade balance. Inflation remained high, and there was no economic growth. One can hardly expect a country to regain credibility and return to international voluntary markets when inflation systematically outruns projections, investment is halted, and the economy stagnates.

Indeed, the rationale behind imposing stabilization policies under conditions of severe debt burden precluded the possibility of success. By 1983 the net transfer of

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[2] Inflation distorts budget accounts in several ways. Nominal deficits tend to be higher because interest payments on public debt increase nominally to compensate for inflation. Similarly, as tax collections accrue to the government with delays, the real value of revenue is lower at the effective time of collection. In the opposite direction, governments benefit from issuing money when prices rise, collecting the so-called inflation tax. Taking account of some of these effects leads to estimates of what the budget deficit would be if inflation were zero. One of these estimates is the operational deficit.

resources abroad was equivalent to 6 percent of GDP. The debt-stabilization strategy required a large surplus in the balance of trade. And although Mexico's manufacturing exports increased, import coefficients remained high so that the needed trade surpluses could only be sustained if the economy was repressed. Servicing the public debt—and, to a lesser extent, the private debt—also created conditions of recession and a drastic reduction in overall investment rates.

In order to service its external public debt, the Mexican government turned to domestic borrowing. Increasing government borrowing in the domestic market in a context of persistent inflation and financial vulnerability had the effect of driving up domestic interest rates, which further aggravated the economic situation. Not surprisingly, inflation continued to afflict the economy. But more important than the persistence of inflationary pressures was the high cost associated with this set of policies: consumption, investment, and overall economic activity were drastically curtailed.

The most notable exception in the recession-prone Mexican economy was the financial sector. The stock market boomed in 1984–1985 and again in 1987. Revenue from the holding of financial assets increased as a share of total income in the wealthiest households. Exporting sectors were also performing well. Intra-firm trade with the United States rose rapidly in the automobile and machinery sectors. Helped by an undervalued exchange rate, a few other manufacturing sectors, including cement and beer producers, also increased their exports. And *maquiladora* plants mushroomed along Mexico's northern border. By 1995 they employed about 700,000 workers (approximately 20 percent of the labor force in manufacturing) in more than 2,000 plants.

Managing and negotiating Mexico's external debt, together with a series of external shocks (including the 1985 earthquakes in Mexico City), set the pace for economic performance in these years. Most notably, in 1986 there was a combination of external shocks and negotiation entanglements: the price of oil collapsed, and it took the entire year to renegotiate and implement a package of debt restructuring. Economic activity was severely depressed. GDP decreased by 3.6 percent in relation to 1985. In September 1987—when what was defined as a "historical" debt agreement was finally in place, and economic policy was geared for stabilization—a worldwide stock market crisis hit the vulnerable Mexican market. The price index for traded shares plummeted, dragging the peso to a 240 percent devaluation in the exchange market.

Following the 1982 debt crisis, economic policy had been continuously reformulated under conditions of instability, external shocks, program inconsistencies, and debt burden. Although international organizations made every effort to label the strategy a success, as a stabilization strategy it was clearly a failure. It increased the vulnerability of the Mexican economy to external shocks, and it could not provide the framework for a more sustainable restructuring of the economy. The "lost decade," as this period has come to be known, was clearly *policy induced*, and its social and political costs remained to be paid.

The social costs of stabilization were high. Real wages were below their 1976 level, employment was stagnant, informal activities proliferated but income from these activities decreased, and social programs were curtailed precisely when they were most needed. Poverty increased in absolute and relative terms, and inequality in income distribution worsened. Clearly development had been postponed, probably forgotten in the whirlpool of debt negotiations.

A new external debt agreement was needed, but it would be months before negotiations could begin. Something had to be done. Elections were scheduled in eight months, and the economy was again in recession, with rising inflationary pressures. As elections got closer, the popularity of the government faded.

The Neo-Liberal Experiment

By the end of 1987 the Mexican government abandoned the most orthodox principles of stabilization and adopted a heterodox program, which, again, included an important reduction in government expenditures in order to decrease the budget deficit. This time, however, prices were not allowed to move freely. They were frozen for a few months at a time, and any subsequent changes were negotiated and closely supervised by an institutional tripartite body led by the government and including representatives of the business sector and labor. Through this mechanism, economic policy determined key prices: for energy, basic foodstuff, and, more importantly, the exchange rate. After the peso had suffered years of instability in the foreign exchange market, the government's economic advisers concluded that a fixed exchange rate was a key tool for regaining macroeconomic stability. The exchange rate was frozen for a few months and gradually adjusted thereafter according to target inflation rates.

INSERT BOX 4 [MEXICO'S INFLATION RECORD] ABOUT HERE

This time around, stabilization policies were accompanied by more comprehensive structural adjustments in an attempt to reestablish the conditions for long-term economic growth. Almost one thousand public corporations were sold to private businesses; others were simply closed. The government withdrew from the steel, automobile, and sugar sectors, among others. Most notably, the government sold the highly profitable telephone company, and it returned the recently nationalized banks to private hands.[3] The government unilaterally implemented a comprehensive policy of trade liberalization. Import licenses were lifted for almost all goods, and import tariffs were simplified and reduced. With these changes, the average rate of protection in Mexico was lower than that in the United States. Breaking away from a long nationalistic tradition of keeping a certain distance from the U.S. government—a tradition based on fears of political and economic domination—the Mexican government sought a regional trade agreement with the United States. In January 1994, the North American Free Trade Agreement went into effect, with complete trade liberalization among Mexico, Canada, and the United States scheduled to take place over a span of ten to fifteen years.

The Mexican government also sought a substantial reduction in its debt burden, with mixed results. Its objective was to stem the outflow of financial transfers abroad, which at that time represented 6 percent of GDP. In 1989, under the auspices of the Brady Plan, a three-item menu was offered to Mexico's creditor banks: (1) they could lend fresh money to indebted countries to allow them to reestablish regular debt service; (2) they could reduce outstanding debt; or (3) they could decrease interest rates on outstanding loans. Most banks opted for the third alternative, which translated into net financial transfers from Mexico equivalent to about 2 to 3 percent of GDP. Even so, the plan was presented officially as a successful negotiation to reduce Mexico's external debt, and domestic markets reacted favorably by cutting interest rates. Attracted by more favorable expectations, portfolio investment started pouring into the country.

[3] Banks had been nationalized in 1982.

Popular discontent with the economic situation, and underlying social and political tensions, turned Mexico's 1988 elections into a clear message for the government and for the dominant PRI party. Many observers believe that Carlos Salinas de Gortari actually lost the election to nationalist and socially sensitive Cuauhtémoc Cárdenas and assumed the presidency through fraud; in the best of cases, Salinas won by a hair. Entering office under a cloud, the Salinas administration understood that social policies had to be rebuilt. Public expenditures on social programs soon rose as a proportion of GDP, and a coordinating unit (Solidarity, or PRONASOL) directly linked to the president was created. Solidarity's stated objective was to alleviate poverty by implementing a nationwide program of public expenditures in various areas. Solidarity's supporters claimed to have initiated a new age of social policies guided by the principle of maximum efficiency in the alleviation of poverty. Programs sought better targeting in order to reach the poorest sectors of the population in a way that would avoid encouraging unproductive behavior.

Integrating to North America and Development

Rooted in old suspicious about U.S. expansionist intentions, Mexico's relations with the United States have always been controversial, and Mexico has placed high value on asserting its independence based on noninterventionist principles. As long as Mexico pursued an inwardly oriented development strategy, international economic integration was not an issue (although, for diplomatic reasons more than anything else, Mexico did participate in several initiatives to integrate markets in Latin America).

Yet, despite its independent diplomatic stance on international issues, Mexico's economic relations with the United States were close. Most foreign investment in Mexico originated in the United States. Mexican trade with other Latin American countries was small compared to Mexico's trade flow with the United States. Businesses in Mexico and the United States built a complex web of economic relations. And U.S. banks had been key lenders to Mexico since the mid-1960s. This is the process that has been referred to as Mexico's silent integration with the United States.

INSERT BOX 5 [ECONOMIC INTEGRATION] ABOUT HERE

Events in the 1980s modified Mexico's diplomatic stance on international issues. As its economic activity became increasingly dependent on external forces, Mexico's separation between diplomacy and economic relations tended toward a reconciliation with the United States and a greater distancing from other Latin American countries. For example, after Mexico had decided not to join the GATT in 1981 (Mexico's adherence had long been a goal of U.S. diplomacy in Mexico), the country reversed itself in 1985, three years after the eruption of the debt crisis, and joined the GATT. In Latin America, Mexico lost the directorship of SELA, a clear sign of its rapidly failing leadership position in the region.

An important ingredient in Mexico's 1988–1994 neo-liberal strategy was the reversal of the country's traditional foreign policy, historically defined along nationalistic lines. Mexico abandoned its efforts to gain treatment as a developing country in international organizations. One clear example can be found in a policy decision made after Mexico joined the GATT in 1986: Mexico cut its tariffs much further and much faster than it had agreed to do, the general idea being to put in place a structure of market incentives similar to that of a developed country (using the United States as a model). Another example is Mexico's request to join the Organisation for Economic Co-operation and Development, which includes most of the world's industrial countries. Even more puzzling than its request was Mexico's acceptance into the OECD in 1994.

By far the most significant initiative in this regard was Mexico's economic integration with the U.S. and Canadian economies through the NAFTA. Many analysts saw this trade agreement as healthy recognition of the deeply rooted tendencies shaping the silent integration of the Mexican and U.S. economies over decades. Importantly, neither the NAFTA negotiations nor the actual text of the agreement include any consideration of the obvious differences in development level and economic structures between the United States and Canada, on the one hand, and Mexico, on the other. Basically the reference point for redefining trade and investment relations was the U.S. code, and to a much lesser extent, Canada's. Once again, we find that the strategy is to emulate the industrial countries' ways and means.

The Twenty-first Century: The Lessons of Crisis

Since 1989 Mexico has once again become a showcase—of the International Monetary Fund and World Bank, the U.S. government, and international investors. Mexico's access to international capital markets has been reestablished, money is flowing into the country, and exports are increasing rapidly. The foreign exchange constraint that inhibited economic growth for almost ten years has been relaxed. And yet a number of yellow, very nearly red, lights have begun flashing. Despite the fast growth in exports, Mexico's trade deficit has continued to widen since imports increase at an even faster pace. The availability of international finance and the alleged efficiency gains from privatization and liberalization have all been overshadowed by a suspicious lack of growth in the economy. The carefully nurtured popularity of Solidarity has not been sufficient to alleviate social tensions in a number of regions. Indeed, serious questions about the effectiveness of this program were raised in January 1994 after an indigenous rebellion in Chiapas (one of the regions most favored by Solidarity) exposed the area's lacerating poverty and oppression and the inefficacy of Solidarity as a poverty-alleviation program.

By December 1994 the tensions building in the economy led to turmoil in the exchange market, and a 100 percent devaluation of the peso ensued. The trade deficit had skyrocketed to levels similar to the oil-financed imbalances of 1980 and 1981. Amidst a climate of political assassinations and incessant cries for democracy, capital became nervous, either exiting the country or seeking refuge in dollar-denominated government bonds. With its economic policy hinging on its credibility, the government refused to adjust the exchange rate. A devaluation was equivalent to admitting the complete failure of the administration's strategy of economic restructuring, since neither economic growth nor the trade deficit could make the record look any better. Probably most importantly, strategic interests of the group in power were at stake, including the signing of the NAFTA, forthcoming national elections, and President Carlos Salinas's campaign for the directorship of the World Trade Organization. Risking a speculative attack on the peso, the administration allowed the exchange rate to become overvalued. The inept management of exchange rate policy by the new administration of President Ernesto Zedillo (1994–2000), which precipitated a major exchange rate crisis in December 1994, was just the trigger in an unavoidable devaluation.

The 1994 devaluation was like opening Pandora's box. In the six months following the devaluation, the government had to negotiate an emergency financial package for $50 billion, with unpalatable conditions attached. Although there is no record of a similar deal having been negotiated previously, no one dared to called this one "historical" in the way governments had referred to prior large debt negotiations. The package's restrictive policies and exorbitantly high interest rates halted economic activity in Mexico. GDP growth was negative in 1995, and open unemployment increased from 5 to 8 percent. A very worrisome sign of the severity of the recession was the fact that the traditional mechanism used to cope with unemployment—the informal sector—was not sufficient to absorb the large number of newly unemployed workers. Medium-sized and small businesses were crushed by recession and debts incurred during the 1994 "easy-money" electoral run-up. A serious banking crisis became a real possibility.

The 1994 devaluation and subsequent crisis clearly revealed that Mexico's recent economic achievements had been exaggerated and that deep economic, social, and political problems were building. Trade liberalization was too fast and too broad. Many businesses failed, and employment did not increase sufficiently despite the fast increase in exports. Privatization and deregulation did not follow a careful plan and were plagued by favoritism and anomalies. Important businesses were turned over without due attention being given to the previous experience of the new owners. One exception, again, was the domestic banking sector, whose recently privatized banks received ample protection from foreign competition. The result in the banking sector was inefficiency, high cost, lack of financing, and an increase in foreign private indebtedness.

INSERT BOX 6 [INCOME DISTRIBUTION] ABOUT HERE

Although opinions differ about whether or not poverty decreased between 1988 and 1992, Solidarity did little to improve living conditions among the poorest of the poor. Most often, Solidarity funds were used to gain political support, diverting funds away from sectors that were most in need of aid. In addition, the published figures on the program's funding were misleading: it is not difficult to demonstrate that monies from the regular government budget found a place under the PRONASOL rubric.

While the social programs of the 1970s and 1980s had the structural limitation of having been designed within the ISI development approach and were skewed to the urban, industrial sectors, the social programs of the 1990s suffered from the assumption that it was just a matter a time before marginal sectors of the population would be incorporated into the market and thereby improve their living standards through their participation in an expanding market economy. There was no effort whatsoever to integrate a vision of economic performance with social improvement in a country where nearly half of the population lives in poverty, and one-quarter in extreme poverty.

During the Salinas presidency, the priority was economic reform, with political reform postponed indefinitely. But the December 1994 crisis shook the foundations of Salinas's neo-liberal strategy of development. It uncovered the severe inefficiencies, misconceptions, technical incapacity, authoritarianism, and corruption that prevailed in the high spheres of the Mexican government. The lesson left by the devastating experiment of reforming the economy along crude and unrealistic market principles, principles that do not correspond to the realities of a developing country like Mexico, is that balanced and sustainable economic growth can only be achieved if it comes accompanied by parallel social improvement, democracy, and rational economic policy that serve the interests of the majority of the population, not just the few in power.

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.BOX 1

MEXICO'S ECONOMIC GROWTH

The accompanying graph shows the wide fluctuations characteristic of Mexico's economic growth over the last four decades. Despite such marked fluctuations, one can clearly identify two distinct periods. The 30 years between 1951 and 1981 were times of rapid economic expansion. For all but three of these years (1953, 1976, and 1977) GNP grew at more than (and usually much more than) 3.5 percent a year. But beginning in 1982 the Mexican economy has been unable to achieve grow rates above 3.5 percent a year (except in 1990 and 1991).

Within these two periods we can also identify several sub-periods. From 1951 to 1970 the average growth rate was 6.6 percent a year. This is the same average growth rate for the 1971;nd81 decade, but the annual rate soared at 44.8 percent between 1971 and 1977 and then dropped to 8.4 percent from 1978 to 1981. Within the second period of slow economic growth, we find very low rates in 1982;nd1986 (-0.5 percent a year) and more moderate though low rates in 1987;nd1994, averaging 2.7 percent a year. The peso devaluation in December 1994 triggered the worst economic recession in modern Mexican history. GDP declined by about 7 percent in 1995. Although the economy improved in 1996, because of the extensive contraction of the economy during 1995, the Mexican economy is still far from fully recovering its pre-crisis production level.

Insert figure 6.1 about here

BOX 2

THE AGRARIAN REFORM

Although the demand for land was the central issue that mobilized peasants during the Mexican Revolution, postrevolutionary governments did little to modify the structure of land tenure. In fourteen years (1920 to 1934) land redistribution proceeded at a very slow pace; under pressure from local communities, about seven million hectares had been distributed, mainly as a way to quiet social unrest. The presidency of Lázaro Cárdenas (1934–40) brought a different orientation to the rural question. Cárdenas radically modified the structure of land tenure with the redistribution of almost eighteen million hectares among 800,000 peasants.

President Cárdenas perceived land redistribution not only as a legitimate demand of poor peasants but as an effective way to expand agricultural production by increasing the cultivated area and improving its productivity. Within this context, land reform was expected to play a central role in Mexico's economic development. The growth in agricultural production was very dynamic in the years that followed the land reform. The table below shows that average growth rates in agriculture between 1940 and 1960 nearly matched the rapid growth rate of the economy overall in that period. And the growth of production in agriculture actually exceeded GDP growth in 1945–1955.

Table 6.1
Agrarian Reform

Year	Number of Hectares Distributed	Number of Beneficiaries
1920-1934	7,534,241	738,521
1934-1940	17,889,792	810,473
1940-1946	5,518,970	152,220
1946-1952	3,501,835	72,901
1952-1958	3,188,778	65,337
1958-1962	4,318,528	61,899
1964-1969	8,030	73,338

Rates of Growth of GDP and Output in Agriculture

(Percentages)

	GDP	Agriculture and Livestock
1940-45	7.6	3.6
1945-50	6.3	9.1
1950-55	6.9	8.1
1955-60	4.7	2.7
Avg. 1940-60	6.4	5.9

Sources: Salomón Eckstein, *El ejido colectivo en México* (Mexico: Fondo de Cultural Económica); Raymond Vernon, *El dilema del desarrollo económico en México* (Editorial Diana); Moisés de la Peña, *El pueblo y su tierra, mito y realidad.*

BOX 3

EXTERNAL DEBT

Mexico is one of the few developing countries that has enjoyed relatively easy access to international capital markets—a privilege that has brought consequences both good and bad.

After international capital markets were reestablished following World War II, Mexico began borrowing heavily, and it continued to do so until the 1970s, primarily to foster national development. Between 1946 and 1955 the value of Mexico's international loans increased at an average annual rate of 27 percent; and from 1955 to the early 1970s, although foreign public borrowing slowed, it remained an important source of funds to finance the country's fast economic growth.

Importantly, Mexico's external debt was well under control up to the early 1970s. Then Mexico's stable pattern of foreign borrowing gave way to a spurt in international borrowing that began in 1973. Taking advantage of highly liquid international markets and very low, often negative, real rates of interest, the Mexican government accelerated its foreign borrowing from 1973 to 1976 in order to finance large public investment programs. Total external debt nearly tripled between 1972 and 1976.

The 1976 peso devaluation and Mexico's agreement to abide by an IMF stabilization package put a temporary cap on the country's foreign borrowing, but when Mexico announced the discovery of huge oil reserves, the cap was quickly forgotten. Expectations of sizable earnings from oil extraction and a developing petroleum industry led to an important increase in foreign public borrowing, with external debt rising from U.S.$23 billion in 1977 to about $34 billion in 1980. Government officials justified such high levels of indebtedness by pointing to the country's rising earnings through expanding exports and overall economic growth. The external debt situation still appeared to be quite manageable.

Then in 1981–82, the international oil price collapsed. Both Mexican government officials and commercial bankers believed that the price drop was temporary and attempted to cover the revenue shortfall with even more debt. Their failure to correctly interpret the situation did much to undercut Mexico's economic strength. In just one year (1981) the country's external debt increased by more than U.S.$20 billion. By March

1982, when foreign banks refused to continue lending to Mexico, the country's public external liabilities exceeded U.S.$50 billion.

Moreover, Mexican businessmen, caught up in the euphoria of the oil boom years, had also accumulated large foreign liabilities. Total external private debt (from financial and nonfinancial borrowers) had risen from $7 billion in 1977 to $17 billion in 1980. By 1982, without new loans to refinance existing ones, Mexico was bankrupt.

Throughout the 1980s the Mexican government pursued a debt management strategy that resulted in the bulking of foreign debt. Between 1983 and 1988 Mexico added some $20 billion to its foreign liabilities. Meanwhile, Mexico, along with other Latin American countries, was sunk in a deep economic recession, with negative per-capita GDP growth rates and rapidly deteriorating social conditions. It was not until the end of the decade, under the Brady Plan, that Mexico was finally able to reduce its foreign debt. By 1994 foreign debt had been brought down to less than 30 percent of GDP, from more than 70 percent in 1986 and 1987. Once the drag of debt payments had been eased, growth mildly recovered.

Insert figure 6.2 about here

BOX 4
MEXICO'S RECORD ON INFLATION

Compared to other countries in Latin America, Mexico has been relatively successful in keeping inflationary pressures down. A number of factors have been suggested to explain this behavior: a more orthodox approach to monetary policy, relatively easy access to international financing, and the fact that Mexico is a diversified economy and well endowed with natural resources. From the late 1950s to early 1970s Mexico enjoyed rapid economic growth accompanied by price stability. In 1973, however, prices started to move in an upward direction: from 1973 to 1982 annual inflation rates increased to around 20 percent a year. Inflation accelerated even further in 1983 in response to the heavy burden imposed by the external debt, inertial inflation, and a succession of external shocks. Then in 1989 inflation started to ease, falling below 20 percent a year. This declining trend was interrupted by large price hikes in 1995 and 1996 as a result of the sharp devaluation of the peso in December 1994.

Insert figure 6.3 about here

BOX 5

ECONOMIC INTEGRATION

Mexico's economic relations with the rest of the world traditionally have been dominated by its close ties with the United States. Export figures by country show that during the 1940s about 80 percent of Mexico's exports were sold to the United States. During the 1950s and 1960s that proportion decreased, but it oscillated around a still high 60 percent level. Since then the share of trade with the United States has further increased, to represent about 75 percent of total exports in the 1990s.

The picture is very similar if one looks at the origin of foreign direct investment in Mexico. Historically, investments by U.S. corporations account for the bulk of foreign investment in Mexico. Looking at the table below, which presents the annual flow of monies into Mexico from investors in other countries, we find that investments from the United States historically represented about two-thirds or more of the total value. Other important sources, though on a much lower scale, are the United Kingdom, Canada, Germany, and Japan.The large proportion of foreign investment flows represented by the United States in the first half of the century became even larger during the years of high growth, to represent about four-fifths in the 1960s, but this decreased somewhat in the troubled decade of the 1970s.

As Mexico's economic strategy switched toward a more open stand in the mid–1980s, the importance of U.S. foreign direct investment recovered ground. Between 1989 and 1994 the United States accounted for 63.2 percent of the total accumulated flow of foreign direct investment (excluding reinvested earnings) in Mexico, which compares favorably with a historial share of 60.2 percent.[4]

[4]SECOFI, *Inversón extranjera en México 1989-1994* (Mexico, 1995).

Table 6.2

Annual Flow of Foreign Direct Investment in Mexico,

Selected Years

TOTAL	U.S.	U.K.	GERMANY	CANADA	JAPAN	OTHER
1940	61.4	8.1	0.0	24.5	0.0	6.0
1950	68.9	5.3	0.0	15.2	0.0	10.7
1960	83.2	5.1	0.6	2.3	0.5	8.4
1970	79.4	3.3	3.4	1.6	0.8	11.5
1979	68.0	6.7	5.2	3.0	2.6	14.5

Source: Authors' calculations based on Banco de México, *Inversión Extranjera Directa*, Cuaderno 1938-1979, Vol. II, Subdirección de Investigación Económica, Mexico, p. 397.

BOX 6

INCOME DISTRIBUTION[5]

Comparatively high levels of income inequality have characterized economic development in Mexico. Although the information about household income and expenditures is limited and what data exist were collected with varying methodologies, making comparison difficult, several authors have attempted to trace the evolution of income distribution in Mexico. Using only the income/expenditure surveys that are methodologically comparable, Hernández and Córdoba[6] found that income distribution became more unequal between 1958 and 1970. The Gini coefficient (which ranges from zero to one and takes a higher value as inequality worsens) increased from 0.45 in 1958 to 0.496 in 1970, suggesting that there was a tendency toward a greater concentration of income during Mexico's years of rapid industrialization. Especially relevant was the impact on the poorest 10 percent of households; their share of income fell dramatically from 2.3 percent of total income in 1958 to a mere 1.4 percent in 1970.

During the 1970s, explicit efforts were made to reverse the increase in income inequality engendered by the industrialization process, with an emphasis on improving real wages, especially among unionized workers. Wages as a share of GDP increased from 35.8 percent in 1971 to its peak value of 40.5 percent in 1976. Some analysts have identified a more egalitarian distribution of income toward the late 1970s. However, social programs and the resulting improvement in living conditions were generally restricted to urban areas and mainly benefited the most organized sectors of workers, leaving the income gap between urban and rural areas to widen further. While the share of wages in national income increased and the share of the richest households appeared to decline, the share accruing to the poorest families (where rural households predominate) continued to deteriorate. By 1977 the share of income of the poorest 10 percent of households was down to 1.08 percent. Thus the 1970–1976 efforts to redistribute income increased the income share of middle-income families relative to the

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[5] This box draws on Diana Alarcón, *Changes in the Distribution of Income in Mexico and Trade Liberalization* (Tijuana: El Colegio de la Frontera Norte, 1994).

[6] Hernández Laos, E., and Jorge Córdoba, *La distribución del ingreso en México* (Mexico: Centro de Investigación para la Integración de la Sociedad, 1982).

top and bottom deciles of the distribution, but they did little to prevent the deterioration of living conditions for the lowest income households or to close the urban-rural gap.

Since the 1980s attempts to restructure the economy have been accompanied by increased inequality in income distribution. Gini coefficients reveal a systematic tendency toward a greater concentration of income among the wealthiest decile, whose share of total income rose from 32.8 percent in 1984 to 38.4 percent in 1994, while the remaining 90 percent of households saw their share of total income decline throughout the decade.

Table 6.3
Income Distribution 1984–1994

Deciles	1984	1989	1992	1994
I-III	9.0	8.1	8.0	8.0
IV-VI	19.6	17.9	17.5	17.4
VII-IX	38.6	36.0	36.3	36.2
X	32.8	37.9	38.2	38.4
Gini	0.429	0.469	0.475	0.477

Source: INEGI. *Encuesta Nacional de Ingresos y Gastos de los Hogares, 1984–1994.*

 Figure 6.1

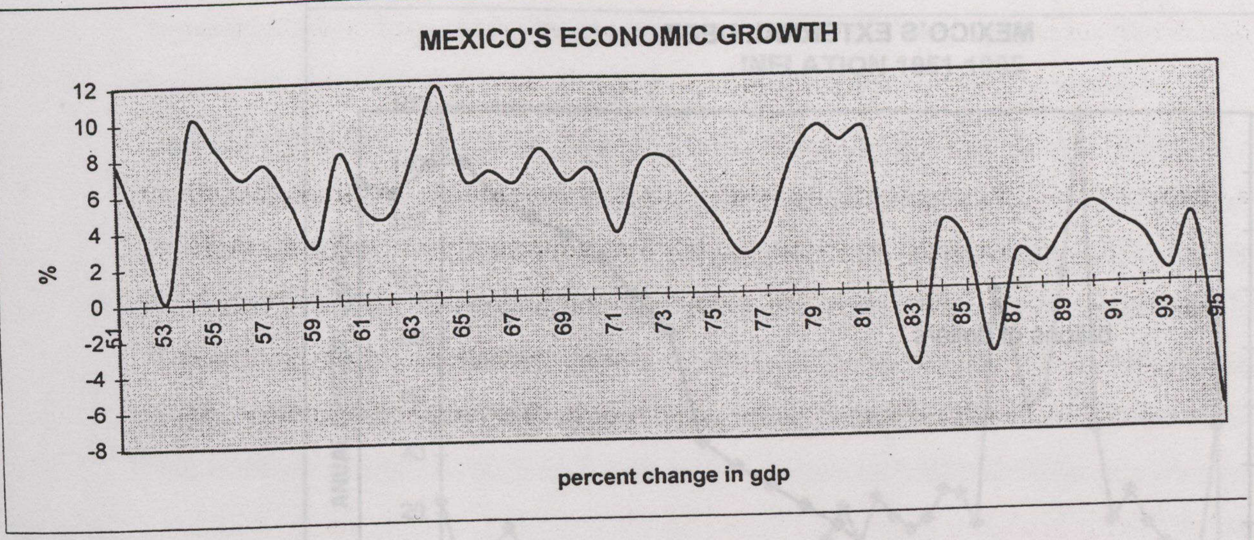
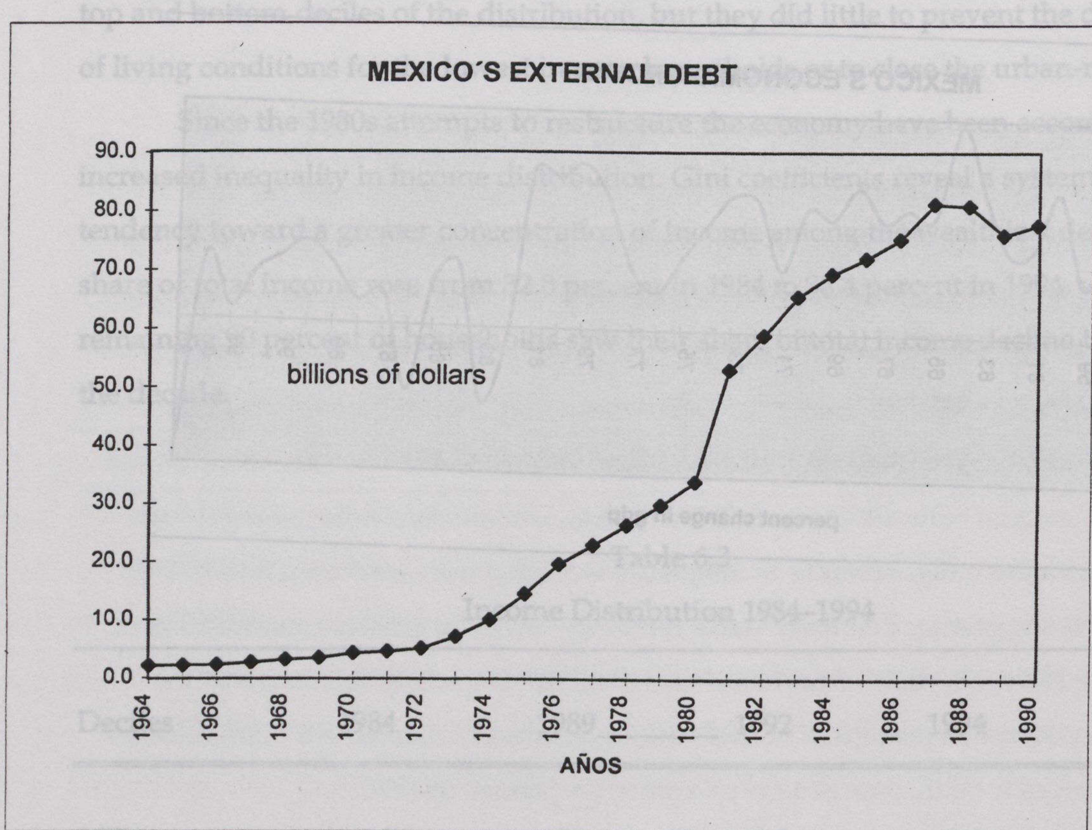

MEXICO'S ECONOMIC GROWTH
12
10
8
6
4
2
0
-2
-4
-6
-8
%
51
53
55
57
59
61
63
65
67
69
71
73
75
77
79
81
83
85
87
89
91
93
95
percent change in gdp

Figure 6.2


MEXICO´S EXTERNAL DEBT
billions of dollars
90.0
80.0
70.0
60.0
50.0
40.0
30.0
20.0
10.0
0.0
1964
1966
1968
1970
1972
1974
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1978
1980
1982
1984
1986
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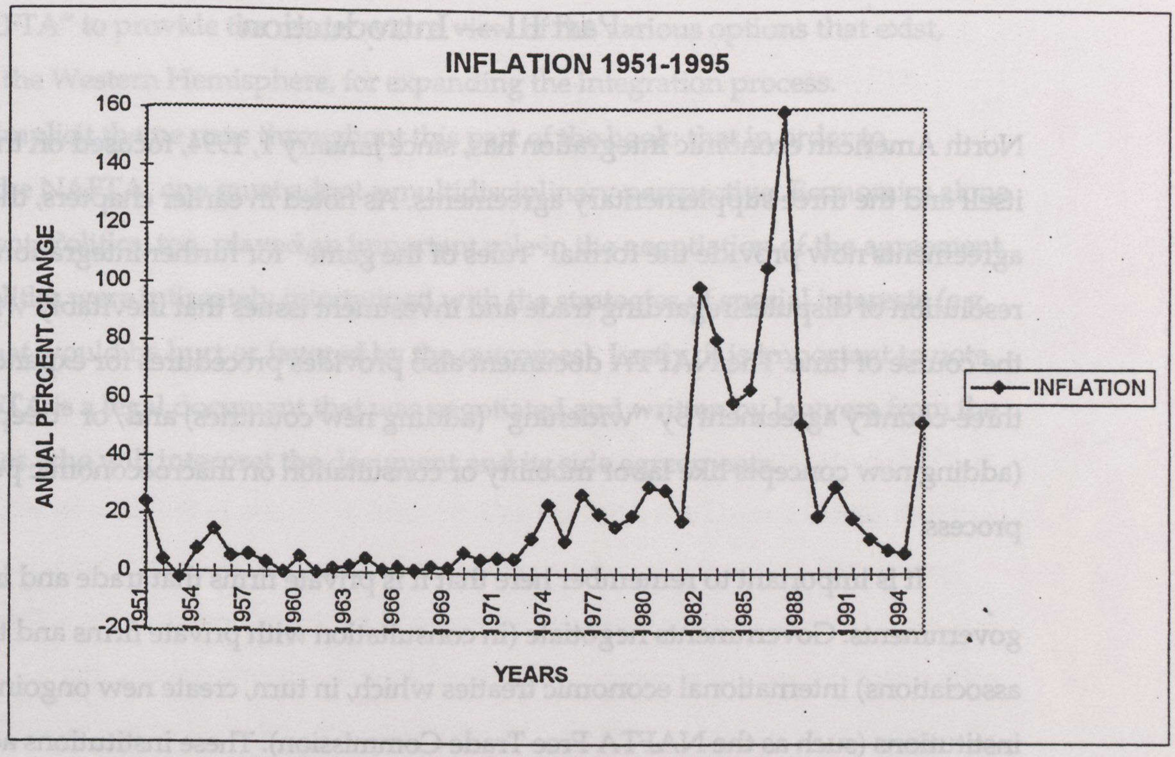
1990
AÑOS

Figure 6.3



SOURCES: Data Take From INEGI, *Estadísticas Históricas de México.* and Banco de México, *Indicadores Económicos.*

Part III — Introduction

North American economic integration has, since January 1, 1994, focused on the NAFTA itself and the three supplementary agreements. As noted in earlier chapters, these agreements now provide the formal "rules of the game" for further integration and for the resolution of disputes regarding trade and investment issues that inevitably will arise over the course of time. The NAFTA document also provides procedures for expanding the three-country agreement by "widening" (adding new countries) and/or "deepening" (adding new concepts like labor mobility or consultation on macroeconomic policies) the process.

It is important to remember here that it is private firms that trade and invest, not governments. Governments negotiate (in consultation with private firms and their trade associations) international economic treaties which, in turn, create new ongoing institutions (such as the NAFTA Free Trade Commission). These institutions administer the implementation and operation of the (transnational) treaty under which firms must operate as they buy from, sell to, and invest in other countries. Additionally, it must be remembered that in the case of the NAFTA, each of the three countries embraced the principles of the multilateral GATT/WTO, which implies that their (trilateral) institutions and actions grew out of and must be consistent with those of a larger framework. Finally, implementation of an international economic treaty such as NAFTA requires a higher-level "harmonization" of a myriad of customs procedures, along with business and legal practices, as the economic borders between countries are gradually dismantled—a practical, nuts-and-bolts process that requires a great deal of energy, patience, and goodwill on the part of representatives from business, government, and academia.

In this third and final part of the book we first examine (in chapter 7) the international environment that led to NAFTA's birth. Then we turn to the content of the agreement itself, NAFTA's main provisions for freeing up trade and investment relations between the three countries within specified time periods. In chapter 8, we examine the major deficiencies of the NAFTA, which mainly revolve around Mexico's asymmetric level of development in comparison with the United States and Canada. Then we present the main aspects of NAFTA's implementation during the first few years, focusing on the institutional structure that will be responsible for its ongoing operations. Finally, we look "beyond NAFTA" to provide the reader with a view of the various options that exist, especially in the Western Hemisphere, for expanding the integration process.

One implicit theme runs throughout this part of the book: that in order to understand the NAFTA, one must adopt a multidisciplinary perspective. Economics alone is not sufficient. Politics, too, played an important role in the negotiation of the agreement, and those politics were intimately intertwined with the strategies of special interests (e.g., businesses that would be hurt or favored by the outcomes). Lastly, it is important to note that the NAFTA is a legal document that was negotiated and written by lawyers from the three countries who will interpret the document and its side agreements.

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CHAPTER 7

The Political Economy of the NAFTA

Gustavo del Castillo V.

When the North American Free Trade Agreement went into effect on January 1, 1994, it raised the hopes of millions of people in Mexico, Canada, and the United States that the agreement would enhance production efficiency, create jobs, and increase investment within the North American continent. Its chances for success—for a successful conclusion to the negotiating process, for ratification by the respective legislative bodies of the three signatory countries, and for achieving its objectives—had been enhanced by the global economic context, by economic opening already well under way in Mexico, and by the demonstration effects of a prior bilateral trade agreement between Canada and the United States, the CUSFTA.

However, despite high expectations for a wide range of benefits to accrue through North American economic integration, the NAFTA was flawed. Its imperfections did not go unnoticed, but for a variety of reasons they were allowed to remain as part of the final document. These weaknesses will plague North America in the future and hinder the operation of institutional instruments as the region attempts to integrate vastly asymmetrical economic systems. In this respect, the NAFTA is predestined to undergo a difficult implementation process—and ultimately to emerge as a working agreement born, not out of cool mediation, but by trial by fire.

Preceding chapters have dealt with the processes of economic integration in North America: exchanges of exports and imports, trade in services, and so on. There were also chapters on the individual economies of the three countries of North America, outlining in detail their developmental histories and the problems that these histories imply for the process of continental integration.

This chapter's objective is to place the North American Free Trade Agreement in context. While a point-by-point examination of the NAFTA might suggest that it is a purely economic agreement, its evolution was guided as much by political considerations as by economic ones. Thus any review of the NAFTA's origins and early implementation will necessarily lead us into both the economic and the political realms of analysis.

Regarding the economic dimension: in the early days of the NAFTA negotiations, many observers suggested that the high degree of economic interdependence (that is, the mutual trade in goods and services) already established between the United States, Mexico, and Canada made it "natural" and "inevitable" for these countries to pursue additional instruments of economic integration.[1] This argument is only half right; it forgets the dynamic aspects of *asymmetry*, and the relations in North America were nothing if not asymmetric. Asymmetric interdependence had introduced aberrations into what otherwise would be the everyday exchange of goods and services (Emmanuel 1972; Sau 1978). One of the most worrisome of these aberrations in North America was a situation of unequal *terms of trade*, a disequilibrium that has led many developing countries to run up large trade deficits as they import more than they export, and the resulting currency exchange and payments problems. Before the 1980s, Mexico was largely an exporter of primary products, relying on oil exports to bring in hard currency; and it was dependent on technological and restricted manufactured imports to make headway against underdevelopment. There was added concern because of Mexico's prior history of *protectionism*, which made much of the country's productive plant noncompetitive (see Zepeda and Alarcón, this volume). These factors suggest that the NAFTA was far from a "natural" developmental stage within the North American trading regime.

The second dimension, the political one, is related to the internal and external relations among domestic political actors, and between them and international actors—that is, country-to-country relations. This dimension is just as influential as the economic one. Indeed, the politics of the NAFTA were of key importance in Canada, the United States, and Mexico (del Castillo and Vega 1996). The NAFTA's structure and the

[1] Bilateral trade between Canada and the United States and between Mexico and the United States is extensive. That between Mexico and Canada still lags far behind, although it is growing at a very rapid rate. Besides being extensive, trade in North America is also highly concentrated, involving very few goods and a great deal of intra-firm trade. Up-to-date figures on bilateral or North American trade are available from the U.S. Census Bureau via the Internet or on-line services such as CompuServe (look for Reference icon).

process that produced a signable agreement were the result of how the different political actors related to one another. For example, if Mexico had insisted on including the mobility of labor in North America as part of the NAFTA negotiating agenda, there would be no agreement today. If Mexico had rejected the side (complementary) agreements on labor, the environment, and import surges, there would be no NAFTA. And if there had been no Canada–U.S. Free Trade Agreement to serve as a model for the NAFTA, it is unlikely that negotiators from the three countries would have been able to come to an agreement within the strict timetable imposed by the *fast track* negotiating authority granted to the U.S. president by Congress. All of these factors combined to produce a trade agreement that is workable but less than perfect.

Because the NAFTA was not a "natural" or "inevitable" trade policy development, if we want to understand how it came into being we must look to factors in the international arena that facilitated the NAFTA's emergence. The following section discusses five key political and economic considerations that largely defined the context within which the NAFTA developed.

A later section examines the major components of the NAFTA. What is included in this agreement is of particular importance because the accord represents these three countries' attempt to organize under a set of rules designed to govern the trade that already existed between them, as well as to promote trade in other areas where the potential for exchange was just becoming apparent. The NAFTA is also especially important because of what it does *not* include; it is illuminating to explore why some topics were deliberately excluded from consideration.

The concluding section returns to the NAFTA's shortcomings. It considers why flaws were allowed to remain in the final document and what their likely effects will be on future trade within North America.

The International Environment on the Eve of the NAFTA

The NAFTA was the product of forces in the global economic environment interacting with the foreign economic policies of the countries of North America. It is important in this regard that there was general concordance in the NAFTA member countries' interpretations of the international economic environment. This "conjuncture" among the countries' analyses was not coincidental; it resulted from a common set of ideas, held by economic and political elites, about the place and future of their respective domestic economies in a changing world of production.

There are three key factors that, in combination, enabled the countries of North America to integrate their trade relations:

- The United States' frustration with the slow progress of multilateral negotiations in the Uruguay Round of the General Agreement on Tariffs and Trade (GATT), together with its freedom to choose the bilateral/trilateral route to advance its foreign economic policies. From 1982 through 1987, the United States had negotiated a series of advantageous trade-related agreements with Mexico, including Mexico's entry into the GATT, which resulted in Mexico's unilateral establishment of a 20 percent tariff level on its imports (30 points lower than the tariff reductions negotiated in the GATT). If the United States entered into negotiations of a North American free trade agreement, it could begin, not from the 50 percent tariff rates of the GATT, but from the 20 percent level that Mexico had implemented at the time of its GATT entry.
- Mexico's move toward an open economy. This shift was prompted by the weak state of the Mexican economy in the early 1990s, after a decade of economic downturn that began with the debt crisis of 1982.
- The Canada–U.S. Free Trade Agreement. The CUSFTA had produced significant economic gains for sectors participating in bilateral trade. This agreement could serve as a model for bringing Mexico into the North American economic region.

There are many other contributing factors in the formation of the NAFTA. At least two of these are sufficiently significant to deserve mention: the trade-diverting impacts that the CUSFTA had on Mexico, and the fall of the Berlin Wall. Together, these five factors can reveal much about the complex process involved in the NAFTA negotiations, but they are also useful in determining why certain issues are covered by the NAFTA and why they are treated as they are.

The United States and the Uruguay Round

Because the United States is a world superpower, the world's foremost trading nation, and the world's largest market, this country has long been in a position to strongly influence, if not determine, the world's trading agenda. The United States has played a leading role throughout the eight rounds of GATT negotiations (see Schott 1990), the last of which (the Uruguay Round) began in 1986 and concluded in the fall of 1993. U.S. dominance of trade negotiations generally, and the specific trajectory of the Uruguay Round, catalyzed the push for North American integration and strongly determined the eventual form of the NAFTA.

The Uruguay Round was the most prolonged round of GATT trade negotiations. Its slow pace was due to the complexity of the issues under discussion, and also to the vast number of countries taking part. From the end of World War II until the Uruguay Round, trade negotiations had had a very short agenda: how to reduce the protectionist barriers that had been erected with tariff and nontariff instruments, and how to broaden the number of goods covered by tariff reductions. But the growing complexity of global production over the past forty years has introduced new trade issues that demand multilateral solutions.

It was in this context that the United States began to promote a *New Agenda*. This agenda went far beyond questions of tariff reductions to include topics such as services, investment, textiles, government procurement, agriculture, and intellectual property protection (Schott 1994). Because these were long-standing U.S. concerns which had been at the root of bilateral conflicts between the United States and Canada and between the United States and Mexico since the late 1970s/early 1980s, this was the agenda that was ultimately incorporated into the CUSFTA and the NAFTA.

In explaining why the United States opted to pursue the NAFTA, many analysts have argued that the United States was increasingly frustrated with the lack of progress in the Uruguay Round and determined to develop a strategy that would give faster results. The United States appeared to abandon the multilateral GATT forum and positioned itself to switch to the bilateral route as the basis of its trade policy. (Ironically, both the CUSFTA and the NAFTA originated, not from U.S. overtures, but from requests from the Canadian and Mexican governments, respectively.) The relative ease of negotiating a bilateral or trilateral agreement was obvious. The CUSFTA negotiations had begun in 1986, the same year as the Uruguay Round, but were completed by 1989. And the NAFTA, initiated in 1991, was also brought to conclusion in advance of the close of the Uruguay Round. There is little doubt that the swift completion of these agreements had an impact on the GATT deliberations, forcing this multilateral forum to act expeditiously for fear that the United States would continue to favor bilateral over multilateral actions.

As the United States continued to promote its New Agenda within the GATT, U.S. policy makers saw that much was to be gained if a developing country such as Mexico would demonstrate its willingness to adhere to the agenda, with all the new regulations that this implied. If Mexico gave the lead, then other developing countries would have fewer grounds for refusing to following this path. In this sense, the NAFTA was critical for the United States, because it would set Mexico up as an example to the rest of the developing world.

Mexico's New Economic Model

When Mexico entered the NAFTA, its domestic and foreign economic policy was markedly different from earlier periods in the country's history. Mexico's new policy orientation was the outcome of a decade of evolution toward new foundations for economic and political understanding between Mexico and the United States. It marked a dramatic reversal from Mexico's earlier perception of its neighbor to the north—ever since Mexico had lost half of its territory to the United States in 1848. At that point Mexico had decided that the only way to survive U.S. expansionism was to isolate itself behind a wall just as formidable as any built in China or Berlin but constructed of prejudice about the United States as an alien (Anglo-Saxon, Protestant, greedy) world. (These prejudices paralleled those developing in the United States about the "lazy Mexican." See del Castillo 1995.)

Mexico's evolution from an inward to an outward orientation is linked with the changes taking place in the country's foreign economic policy (see Zepeda and Alarcón, this volume). Mexico's "lost decade," beginning with the debt crisis of 1982, had demonstrated that Mexico's hopes for independent development through import-substitution industrialization (ISI) had failed. A new model was needed to spur economic growth and generate the one million new jobs per year that the economy demanded (del Castillo 1993). Thus Mexico determined to shift strategies; it opted for an open economy beginning in 1982. Economic opening reached its zenith with the implementation of the NAFTA in 1994.

Mexico's reorientation toward the outside was not solely of its own making. When Mexico refused to join the GATT in 1979, the United States retaliated by revoking Mexico's right to the *injury test*, a protective measure granted to all countries that have most favored nation (MFN) status. This meant that from 1980 forward, U.S. producers could claim that Mexican imports were hurting their efforts to market their own U.S. products, without having to substantiate their claims with evidence. Any claim of injury would automatically close the U.S. market to that particular Mexican import, and Mexican producers were denied any recourse. This state of affairs compelled Mexico to sign a bilateral Agreement on Subsides and Countervailing Duties with the United States in 1985 in order to protect its exports.

Ultimately Mexico joined the GATT (in 1986), further liberalizing its economy. It shifted away from official pricing and import permits as instruments of protection, choosing instead to adopt import duties. Although the latter were negotiated at 50 percent under the GATT, Mexico unilaterally reduced its tariff level to 20 percent, as noted earlier. And in an effort to improve its trading relations with the United States, its principal trading partner, Mexico signed the Framework Agreement with the United States in 1987, setting up a host of working groups to liberalize trade under the New Agenda.

Mexico took further steps at liberalization in May 1989, when it overhauled its regulations on foreign investment, opening many economic sectors to foreign investors and allowing 100 percent foreign ownership in some cases. To attract foreign direct investment, Mexico also adopted stringent new measures for intellectual property protection; and in 1991 it strengthened protection for process and product patents and also boosted its enforcement of trademarks and trade secrets. While Mexico was pursuing this process of liberalization, Canada and the United States signed and implemented the bilateral CUSFTA, in 1989.

CUSFTA, Trade Diversion, and the Berlin Wall

In its pursuit of economic development during the 1980s, Mexico turned away from protection of domestic industry as an instrument of growth and placed a much heavier emphasis on the country's export potential. Therefore, the CUSFTA posed a danger for Mexican economic growth: it had the potential to divert Mexican exports, replacing them within U.S. markets with Canadian goods. That is, Canadian industries' preferential access to the U.S. market meant that Canadian suppliers would replace Mexican suppliers, seriously affecting key sectors of the Mexican economy. As the various provisions of the CUSFTA were phased in, Mexico found itself at a disadvantage in areas where it had already gained a market share in the United States, including the machinery, textile, automotive, and petrochemical industries. These trade diversion effects were estimated to total about U.S.$662 million in 1988 (del Castillo and Vega 1996: chap. 4).

This impact was not lost on Mexican decision makers. Further, there was the danger that these negative consequences would be compounded if U.S. investments started flowing northward instead of toward Mexico. This was particularly critical because Mexico was already struggling to hold its own as an attractive site for new foreign direct investment after the dismantling of the Berlin Wall and the collapse of the Soviet Union—a time when Europe was redirecting much of its capital resources toward the countries of Eastern Europe.

With its economy open and its economic growth faltering, Mexico saw two principal roles for foreign investment, especially foreign investment from the United States (historically the primary source): first, as a job-creating instrument, and second, as the means to maintain a balanced current account. If foreign investors abandoned their pivotal role in Mexico, the liberalizing trends in the economy would be put at risk, and the job-creating and technology-transfer effects of foreign investment would be lost to the national economy.

When Mexico considered the likelihood that the CUSFTA would accelerate growth in both Canada and the United States, it found further evidence that economic liberalization offered a sure road to increased economic payoffs. Hard economic data on the effects of the CUSFTA were hard to come by at the time, but a landmark study by Schwanen (1993) demonstrated that, in the first five years of the CUSFTA:

- Canadian exports to the United States grew faster than those to any other market, despite the fact that the U.S. economy experienced much slower growth than other markets importing from Canada;
- in sectors liberalized by the CUSFTA, Canadian exports to the United States increased by 33 percent, compared to 2 percent with the rest of the world;
- imports from the United States increased 28 percent in value, compared to 10 percent with the rest of the world;
- Canada made significant gains in the export of services to the United States;
- the evidence did not signal a decline in Canadian economic output; rather it seemed to document growth in industries in which Canada has a comparative advantage; and
- the jobs created and preserved by the CUSFTA did not compensate in number for the jobs lost; however, the jobs created were in higher-paying sectors.

Moreover, although the CUSFTA had been in operation for only two years before the NAFTA negotiations began in 1991, the earlier agreement demonstrated that—independent of its economic results, which were in dispute—the conflict-resolution mechanisms incorporated into the CUSFTA (Chapters 18 and 19) were working as intended. These two chapters—designed to control the political-administrative interpretation of U.S. trade law and practice—were crucial from a Canadian, and later from a Mexican, perspective. By instituting bilateral panels to resolve trade disputes, the CUSFTA curbed the authority of U.S. decision makers in such controversies. Bilateral panels replaced the domestic judicial review of government regulatory bodies' findings concerning anti-dumping and countervailing determinations. The new panels are considered superior to the GATT instruments: they return their decisions more quickly; because they are bilateral, their decision-making process is open to close scrutiny; and their findings are binding.

The NAFTA: Provisions

When negotiators from Canada, Mexico, and the United States convened in 1991, they had, as noted previously, several factors in their favor:

- the United States' willingness to adopt a bilateral strategy within North America while simultaneously pursuing multilateral efforts on other fronts;
- Mexico's new development model, which favored on open economy, and Mexico's new focus on North America; and
- the demonstration effects (both political and economic) of the CUSFTA.

In hammering out the new accord, the negotiators agreed that the NAFTA should focus on seven substantive areas: market access (through tariff liberalization and new rules of origin), foreign investment, financial and other services, intellectual property, dispute settlement, and government procurement.

Further, the NAFTA would incorporate one very significant new element absent in all preceding trade accords: the NAFTA introduces "social aspects" into the trade agenda. These are reflected in the *complementary* or *side agreements* dealing with workers' rights and environmental issues, to be discussed in a later section.

Market Access

TARIFF LIBERALIZATION—A key focus of the NAFTA was the elimination of all tariffs on imports among the three countries, with tariffs to be phased out over fifteen years according to four stages of liberalization. These tariff reductions would take place independent of the trade liberalization measures that Mexico had implemented during the 1980s, independent of the terms of the CUSFTA, and independent of commitments made in the Uruguay Round related to trade in the global arena.

In the first phase, immediately following ratification of the NAFTA by the three member countries, Mexico eliminated tariffs on 41 percent of Canadian export product categories and 43 percent of U.S. product categories. Canada, meanwhile, removed tariffs from 79 percent of Mexican export products, and the United States dropped to zero its import tariffs on 84 percent of product categories exported from Mexico.

In phase 2, to end by year five of the agreement, Mexico will drop tariffs on an additional 19 percent of Canadian and 18 percent of U.S. export product categories, respectively.

In phase 3, to be completed by year ten of the agreement, Mexico will reduce tariff barriers to zero on 38 percent of U.S. and Canadian products, while Canada and the United States will drop import tariffs on 7 percent and 12 percent, respectively, of Mexican exports.

During phase 4, to end by the fifteenth year of the phase-in period, all three countries will eliminate any tariffs remaining on imports from their North American partners. Thus, by the year 2009, there will be no tariffs on goods traded among the three countries of North America.

While Mexico would appear to be the prime beneficiary of tariff elimination in the first phase, significantly, some of Mexico's most competitive export products were not included in this initial stage of tariff reduction. These products include glass tableware, ceramic and refractory bricks, specialty steel pipe, live plants, cut roses, tuna, and shrimp.

Also, although eliminating tariff barriers is a principal component in the NAFTA, this is not to say that the member countries have forfeited all mechanisms for controlling the entry of goods exported by their partners. The three countries can still apply *quantitative restrictions* on imports from some sectors, such as from other members' agricultural, auto, textile, and energy industries. In the agricultural sector, for example, *nontariff barriers* (NTBs, such as restrictions based on claims of pest infestations) and *tariff-rate quotas* (TRQs, which impose higher tariffs on a product once imports have exceeded a certain threshold) can still be put into effect. NTBs and TRQs are commonly applied to Mexican sugar, orange juice concentrate, peanuts, corn, beans, and winter vegetables.

Thus we find additional evidence that the NAFTA is, indeed, driven by both political and economic considerations. It liberalizes in many areas; but where protection is still thought to be politically or economically necessary, member countries can skirt around adherence to full-fledged free trade practices.

RULES OF ORIGIN—While market access under the NAFTA is fostered largely through the phased-in tariff reductions described above, market access is also addressed in the agreement's *rules of origin*. These rules are designed to keep the benefits and preferential treatment of the free trade area within North America. These rules apply especially to automobiles and auto parts, computers, and textiles.

Regarding trade in automobiles, for example, the NAFTA's rules of origin increase the amount of North American components a car must contain in order to be considered "North American" in origin, and thus be allowed to move free of tariffs within the North American market. The percent of North American components required for a car to be designated "North American–made" is now 50 percent; this will increase to 62.5 percent within ten years. Raising the percent of parts that must be manufactured in North America will discourage U.S. car makers (such as Chrysler and Ford) from sourcing their components from countries outside of North America, such as Korea.

The NAFTA members also agreed to eliminate all quotas and tariffs on textiles and applied two distinct rules of origin in this sector. The "yarn forward" provision requires North American producers to use North American yarns. The "fiber forward" provision requires them to use only North American fibers. (The "textile" industry encompasses both the producers of fibers and the manufacturers of textiles and clothing.)

Foreign Investment

When market access improves as tariffs are eliminated, other components of trade, the factors that make trade possible, begin to emerge as important issues for negotiation. One such key factor is foreign investment: how foreign investment will be received and treated in the host country, and how investment services can be handled in a transborder fashion. The NAFTA addresses both of these concerns.

Prior to the NAFTA negotiations, both Mexican and Canadian law contained provisions that the United States saw as injurious to U.S. investors wanting to invest in those countries. Mexico's history of nationalizations (it nationalized U.S. oil companies in 1938, and it nationalized its banking system in 1982, with the result that many foreign investors lost their dollar accounts) had made U.S. investors very mistrustful of the Mexican investment climate. Moreover, under Mexican law, foreigners could only invest in certain sectors and, within these limited sectors, could hold only up to 49 percent ownership, effectively guaranteeing that control would remain in the hands of the Mexican partners. Canada's investment climate was less hostile to foreign investment. However, in the 1980s, during the administration of Pierre Trudeau, Canada had instituted a review process on foreign investment under the New Economic Policy, which could potentially disallow new U.S. investments in Canada. The goal of the NAFTA's investment provisions was to treat foreign investment in a nondiscriminatory fashion. That is, under the NAFTA, foreign investors would have the same rights as national investors in the three countries. In other words, foreign investment would now receive *national treatment*.

Regarding the treatment of foreign investment, the NAFTA represents an improvement over previous accords, including the bilateral agreement between Canada and the United States. In fact, the NAFTA investment provisions represent an entirely new and different approach to the subject. These differences begin with how the NAFTA defines "investment." Prior accords addressed only *foreign direct investment* (FDI). The NAFTA incorporates a much enhanced definition—expanded to include all financial aspects related to investment in an enterprise: loans to the business, profits, interest, business real estate, equity, any debt the enterprise holds, and so on.

Because the NAFTA expanded the definition of investment, it also incorporated a new approach to how such investments were to be "protected." If there is a dispute over investment issues within the NAFTA region, the companies or individuals involved can take their dispute to binding international arbitration. (This protection provision was aimed primarily at Mexico, since Canada and the United States felt that the highly politicized judicial system in Mexico would put them at a disadvantage in any dispute if it were subject to resolution in Mexico.) The NAFTA's protection of investment also extends to third parties (Japan, for example) if the third party has substantial interests in more than one NAFTA member country.

Investment protection is also covered in the NAFTA's provision on "minimum standards of treatment." This article of the agreement contains very specific language on how foreign investment is to be treated (especially in Mexico), reducing the risk that countries will attempt to "interpret" the NAFTA's investment protections arbitrarily.

Even so, the NAFTA countries can exempt some foreign investments from full protection. That is, while still receiving "national treatment," some foreign investment can be subject to slightly different, somewhat less advantageous treatment, usually in sectors that are considered less competitive internationally. Therefore, the extent of protection in a given country can be quantified by looking at how many "reservations" each country claims in the annexes to the NAFTA.

Financial Services

Another key issue covered under the New Agenda and picked up in the NAFTA is financial services. Over several decades, production has been in a process of reorganization, moving from domestic to global manufacturing; and investments have gone international, hand-in-hand with transnational manufacturing, over the same period. Paralleling this transformation in manufacturing and investment, the nature and uses of capital also have changed, and financial services must now be able to operate across borders. This issue is addressed in a NAFTA chapter on activities such as the securities industry, banking, lending services, retail deposits, and so on.

Any attempt to incorporate financial services within a free trade regime raises two important questions: How many and which financial services can non-nationals provide? And what domestic structure will regulate those financial services that are allowed to be provided by non-nationals? When dealing with financial services, the right of establishment (that is, when a foreign company is already established in the host country and is offering a service) will generally give a company preference over cross-border trade in services (a foreign company not established in the country but offering to provide services there).

Liberalizing financial services has been complicated by the fact that each NAFTA country already has a well-developed regulatory system in place, and the systems operating in the respective countries are sufficiently different from one another to make them difficult to harmonize. However, the CUSFTA provided guidelines in this area and served to break the ground for the liberalization of financial services under the NAFTA.

As finally written, the NAFTA gives each country the right to regulate financial services as it sees fit. However, it lays out the conditions under which financial institutions can operate in another country, how financial services are to be supplied from outside a country, and how disputes within this sector are to be handled (that is, the NAFTA sets up a dispute settlement mechanism).

The NAFTA also address services such as telecommunications, professional services, and land transportation, generally providing for cross-border provision of services between the three NAFTA member countries under national treatment protection.

Intellectual Property

Under NAFTA, each member country agrees to protect the intellectual property rights (patents, copyrights, trademarks, trade secrets, sound recordings, films, and so on) of the other members within its own national territory—at the same level as that provided to its own nationals. Further, the NAFTA dictates that efforts to protect intellectual property rights must not be used as barriers to trade between the three countries.

Dispute Settlement under the NAFTA

The Canada–United States Free Trade Agreement was highly innovative, and many of its innovations served as blueprints for the design of the NAFTA agreement. The CUSFTA incorporated dispute settlement mechanisms which, although not altogether new, did allow the two countries to settle conflicts in a fair and expeditious manner. These same mechanisms were included in the NAFTA.[2]

The trade dispute instruments in the NAFTA are directed toward some of the most critical areas of international trade conflicts—specifically anti-dumping measures and countervailing duties. NAFTA provisions allow international (in this case, bilateral) judicial review of actions taken in these areas by domestic agencies.

[2] The idea for the creation of bilateral panels to solve bilateral trade disputes is credited to Representative Sam Gibbons of Florida, a member of the Ways and Means Trade Subcommittee and a specialist in trade matters. Gibbons apparently became involved in the last-minute negotiations in Washington between Canada and the United States when the CUSFTA was in danger of collapsing because Canada could not persuade the United States to exempt Canada from its "unfair trade" laws. See Doern and Tomlin 1991: 178–204.

Under the provisions of NAFTA, each member country has the right to retain its current laws for implementing countervailing duties and anti-dumping measures. However, if a member country wishes to modify its laws in these two areas, it must notify and consult with its trade partners. Finally, if a partner is about to modify these laws, that country can request a review of the proposed changes by a binational advisory panel to determine whether the changes meet the requirements of the NAFTA and other international trade law.

The most innovative and functional part of the chapters on dispute settlement is the creation of binational panels that review whether a given country's agencies have administered that country's trade law according to legal procedure and without political intervention. These panels look at the case record and determine whether the final judgment delivered by the country's adjudicative system is supported by the evidence and is in accordance with that country's domestic law.[3] The panel issues an "initial declaratory opinion," which is open to challenge by the affected party for fourteen days, after which the panel writes its final opinion. Final opinions are subject only to an "extraordinary challenge," which forwards the case to a panel of three members selected from a fifteen-member roster. After an extraordinary challenge has been raised, the new panel, once instituted, has ninety days to render a decision. Its decision is binding and not subject to challenge. Similar procedures exist to review cases relating to the interpretation of the NAFTA itself.

Government Procurement

Governments are major purchasers of goods for both military and civilian applications. Most such purchases have traditionally been reserved for domestic providers and contractors. The NAFTA opens up government purchases to providers in all NAFTA member countries, specifying threshold levels for different kinds of goods and services. For example, a NAFTA country can contract for up to U.S.$6.5 million in construction

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[3] Each country is required to maintain a 75-member roster (favoring lawyers) of available panelists. When a case comes up for settlement, each country will choose 25 from this list. Within 30 days of a request for a panel, each country will nominate two panelists, who may be challenged by the other country. Within 55 days, both countries must agree on a fifth panelist drawn from the rosters. Decisions within a panel are taken by a majority vote, with all five panelists voting.

services from another NAFTA country. Suppliers and producers compete for government contracts under the "national treatment" clause.

Although NAFTA-country government contracts can no longer be designed or structured to exclude foreign competition, significant levels of protection persist. For instance, all three member countries award research and development contracts to domestic firms only. And each country specifies additional areas where it will use only national suppliers. Because some liberalization in government procurement had already taken place between Canada and the United States under the CUSFTA, Mexico lags behind on this front; for this reason the NAFTA agreement specifies that Mexico must establish a specialized publication to announce notices of procurement.

The Side Agreements

A key innovation in the NAFTA is the incorporation of the "social aspects" of trade, referred to earlier. Two of the three side agreements to the NAFTA deal specifically with such social concerns. These two agreements (the North American Agreement on Environmental Cooperation and the North American Agreement on Labor Cooperation) reflect popular concerns about the environment and labor rights—especially about how the latter are understood in Mexico—and how these two dimensions could affect trade in North America.

Efforts to integrate these concerns into the trade agreement arose in Washington, when President George Bush asked Congress for authorization to pursue the NAFTA under "fast track" negotiating authority. (Under fast track, the Congress would be able to vote the accord up or down—that is, to pass it or not—but not to modify it in any way.) Had Bush not agreed to incorporate environmental and labor issues into the accord, Congress would have refused to give him fast track authority.

The side agreements turned the NAFTA into more than a trade agreement. They set general objectives and require treaty members to carry out continued consultations to assure that these objectives are met. The agreements also define a grievance procedure for resolving any conflict that may arise.

The environmental agreement states that the NAFTA countries will work jointly to enhance human, plant, and animal life and health, and the environment, and that no country can lower its environmental, health, or safety standards to attract investment. It prohibits "environmental dumping"—the production of goods in sites where environmental controls are less stringent. And it requires the United States and Mexico to cooperate in improving the border environment through the Border Environmental Commission (BEC). It also establishes the North American Development Bank (NAD Bank, funded by the three countries) to finance environmental cleanup and enhancement projects.

The side agreement on labor outlines eleven sets of labor rights, ranging from the right to organize to the prohibition of child and forced labor. It calls for equal pay for men and women, injury and illness compensation, and the protection of migrant workers. These rights are to be protected through a process of consultation and cooperation, especially through the Commission for Labor Cooperation. This side agreement was included to assure that no party or industry could gain competitive advantage through the exploitation of its labor force.

NAFTA'S Shortcomings: Implications for the Future

The North American Free Trade Agreement was always posited as being "a trade agreement, nothing more." It required no social charter or transfer of economic resources in the form of structural funds, elements that the European Economic Community, and then the European Union, had developed as part of their integration efforts in order to lessen the effects of economic asymmetry between member countries and regions and mitigate the social effects of rapid social change prompted by the integration process. Mexican President Carlos Salinas de Gortari proclaimed in San Antonio, Texas, at the signing of the NAFTA in 1993, that what Mexico wanted was "trade, not aid," justifying the limited scope of the agreement.

One of the obvious features of the accord is that it contains no remnants of the "special and differential treatment" that Mexico had enjoyed within the GATT. Under the NAFTA, Mexico would be a co-equal partner with Canada and the United States, and it would receive no special treatment just because it was by far the smallest of the three economies.

However, the Mexican economic crisis of December 1994, when the peso lost approximately half of its value within a matter of days, demonstrated the problems that can arise when trade agreements lack the flexibility (in import and monetary policy) to deal with sudden economic reversals—eventually leading to enormous trade deficits, current account imbalances, and intense and immediate pressures on weak currencies.

Both the NAFTA and the GATT allow member countries some measure of protection from import surges under emergency action procedures and safeguard measures. However, these protective measures are largely temporary in nature and require some form of restitution to be made to the country being closed out by protection.

Moreover, these protective measures are "traditional" in the sense that they are oriented toward restricting the flow of goods or services. They offer little protection against speculative activities that are global in nature but have, for one reason or another, more profound impacts on some countries than others.[4] These activities affect currency values and, in so doing, also affect trade flows and the very nature of free trade, since stable currencies are the basis of international trade. The end result of these speculative activities is that they lead, as they have done in Mexico since December 1994, to currency devaluations, inflationary spirals, tight fiscal and monetary policies—all of which also put in peril the possibilities for free trade in the future.

The NAFTA and the recently concluded Uruguay Round are inadequate instruments to deal with economic "near calamities" caused by speculative activities such as those plaguing Mexico today. These calamities are the direct result of capital's incessant search for the highest rates of returns in the most secure environments.

Problems arise for a number of reasons. The first is related to the composition of investment capital. Here one must differentiate between short-term, speculative capital, which was dominant in the new capital flows to Mexico between 1990 and 1994, and long-term foreign direct investment in productive assets. The former can add volatility in periods of economic instability, while the latter type of investment supports steady, productive growth. The second problem relates to capital mobility, which has been greatly accelerated by modern computational technologies. These factors interact as follows: when there is a high risk, whether real or imagined, speculative capital can flow out of a country just as quickly as it flowed in, deeply aggravating the initial

[4] Mexican policy makers attributed much of the December peso crisis to the uncertainty created over the presumed political instability in Chiapas and the murders of the PRI's presidential candidate, Donaldo Colosio, in early 1994 and the later assassination of the PRI's executive secretary, José Francisco Ruiz Massieu.

conditions of risk. As the affected country loses monetary stability, the prices of goods produced by that country will fluctuate, and price fluctuations will determine the country's ability to import and export goods.

Investment measures (regulatory and administrative procedures, legislation, and so on) can work to mitigate the impacts that currency speculation and other "destabilizing" activities have on trade. These measures are well known to trade negotiators; they were the subject of discussions in a North-South context during the Kennedy and Tokyo Rounds of the GATT.[5] However, they were not incorporated into the GATT or the NAFTA (Stewart 1993). The negotiators of these two accords were concerned with attracting foreign investment, not with holding capital, and therefore they failed to draw on the examples offered by earlier trade agreements. One such measure, discussed in the Uruguay Round negotiations—and included in the 1991 Dunkel Draft of the Uruguay Round—were the TRIMs (*trade related investment measures*), designed to forestall the exodus of investment capital at critical moments of economic crisis. In the Dunkel Draft, TRIMs would have been tailored to an individual country's level of development (i.e., developed, developing, or least developed). The negotiators ultimately decided that the issue of whether a government could use investment measures to direct or restrict investments was outside the purview of the GATT, and the Uruguay Round Final Act leaves adoption of the TRIMs up to the individual participant countries.

Another aspect of the NAFTA that is open to criticism is its incomplete treatment of trade in financial services. Various articles in the agreement are designed to protect countries' rights in the trade of financial services: the NAFTA protects a country's right to regulate financial services; accords national treatment to the providers of these services; discusses the issue of supply of financial services; and specifies consultation and resolution procedures for financial services disputes. However, it does not address the issue of how regulated financial institutions may, either on their own or through government action, control the flow of capital on a transborder basis.

[5] Both of these multilateral trade negotiations build on previous series of negotiations leading toward liberalized worldwide trade and incorporating ever-widening areas of trade, ranging from tariff reductions to trade rules on services, investment, agriculture, and government procurement—as occurred in the Uruguay Round. For a detailed explanation of both of these multilateral negotiations, see Curtis and Vastine 1991; Winham 1986.

The NAFTA negotiators were aware of the possible problems associated with market-driven flows of cross-border capital. Their awareness is reflected in the provision that outlines a country's right to ensure the integrity and stability of its financial system, as long as the measures are not discriminatory. Furthermore, the NAFTA specifies that nothing in the chapter on financial services "applies to nondiscriminatory measures of general application by any public entity in pursuit of monetary and related credit policies or exchange rate policies."

In other words, because the NAFTA allows member countries to design their own stabilization policies, if rules could be developed on a continental or multilateral basis (under the new World Trade Organization, WTO) to regulate capital mobility and its destabilizing effects, particularly on developing countries such as Mexico, this would go a long way toward underpinning economic stability. At a minimum, these rules might cover the composition of investments in a country's national accounts, specifying optimal ratios of short (or hot) investments versus the direct productive investments that ensure macroeconomic stability. A related issue, which ties back into the Dunkel Draft of the Uruguay Round, is that countries at different stages of development could be made subject to differential investment ratios (referring to the difference in proportions between direct foreign investment and short-term speculative investments). Just as most economic integration efforts permit the parties' exchange rates to fluctuate within certain band limits (15 percent in the European Union), the same principle (of controlled fluctuations) could be applied to the stock markets of developing nations in order to control widely swinging negative trends. For instance, automatic "slow-down" procedures could be activated for paper transactions if the aggregate stock began to deteriorate, as happened in the United States on Black Monday (October 19, 1987). In other words, when a situation develops where "speculative investments" (S_i) within the stock market diverge from a prescribed ratio in relation to foreign direct investment (D_i) or $S_i > D_i$, any undue speculation in stocks will cause financial instability, leading to events similar to those that occurred in Mexico in November and December 1994.

Finally, the public sector's sale of bonds (*tesobonos*) should be analyzed carefully and regulated to fall within certain ratios (pegged to GNP growth or productivity gains, or as a proportion of the budget deficit). This would ensure that the public-sector debt would not add to the natural pressures on a country's currency, forestalling the need for emergency actions.

These measures are clearly needed as countries throughout the world decide to liberalize their economies, opening them up to the pressures of market forces. Such measures would appear to be essential under integrationist schemes like the NAFTA, where countries with very different levels of development are brought together and their economic asymmetries put enormous pressures on the least developed partner.

The North American Free Trade Agreement was an incomplete and flawed instrument. It must now be deepened in order to take account of these additional dimensions. If steps are not taken, the economic and political pressures to nullify the agreement will increase as further distortions emerge (such as the Clinton emergency rescue package for Mexico in the wake of the December 1994 crisis). Such a situation would augment the costs that any partner withdrawing from the accord would have to pay in a now hostile North America.

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CHAPTER 8

NAFTA and Beyond

Norris C. Clement and Gustavo del Castillo V.

In previous chapters we developed the theory and history underlying NAFTA's creation. Then we examined the content of the agreement itself and its three side agreements. Now we turn to the question of how the NAFTA is working in practice since its implementation in January 1994 and speculate on where it might go in the future. Given the complexity of the agreement and its many economic, social, and environmental implications, we will limit our discussion to those topics which we believe have most relevance to the readers.

In the first part of the chapter we look at the "Mexican dilemma"—the special issues presented by Mexico's status as a still underdeveloped country (and its consequent macroeconomic instability) and how this status affects the NAFTA. Next we look at NAFTA's evolution during the first three years, as a tool for managing the de facto integration occurring in the region. In the third section we look "beyond NAFTA" at the possibility for reforming and/or deepening and widening the current agreement.

The Mexican Dilemma

We have argued that economic integration in North America was well under way before the signing of the NAFTA, as indicated by the flows of goods, services, and investments. Given these substantial flows, there was no obvious reason why two developed economies—the United States and Canada—would choose to form a trade alliance with an underdeveloped economy like Mexico. Not only was size a problem (the Canadian and U.S. economies in combination are about twenty times larger than the Mexican economy), but there are other problems as well: Mexico's autocratic political system, frequently associated with political violence and disrespect for human rights, and significant differences in legal practices between Canada and the United States, on the one hand, and Mexico, on the other.[1]

Thus the NAFTA agreement was far from inevitable. In fact, it represents a major accomplishment, a process of successful trade negotiation linking two advanced industrialized nations with a developing economy. Apparently the three member countries were not overly concerned about the asymmetries in the relationship, since they never seriously discussed anything like the transfer of "structural funds" from developed partners to underdeveloped partner, as was done in the European Union. This apparent lack of concern over the implications of asymmetry could well be the source of problems well into the future.

According to economic theory, there are potential "gains from trade," and it is in this light that we have to evaluate the NAFTA. Does it (or will it) remove obstacles, make trade more efficient, and therefore increase the likelihood for higher living standards in its member countries? Theory also tells us that specialization and competition will produce some winners and some losers. Some industries and firms may not be able to compete under economic liberalization. They may lose market share or even disappear from the economy completely, with clear implications for their workers. But losers need not stay losers forever. If this were the case, no government whose firms were likely to be losers would engage in trade negotiations because their political constituencies would be hurt more than helped.

Nevertheless, there is substantial evidence that trade liberalization has produced some very negative effects in Mexico: production and wages have become more concentrated, and income distribution has become increasingly unequal (see Unger and Saldaña 1989; Zepeda and Alarcón, this volume). Given that these outcomes clash with accepted notions of equity and economic growth, why did Mexico choose to enter into a trade agreement with two of the most highly developed countries in the world?

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[1] The differences in legal systems posed problems for Canadian and U.S. trade officials, who were unsure about how Mexico's legal system would treat legal suits related to trade issues. Further, it was unclear what the relationship would be between legal systems and the trade bureaucracy or, worse, a politicized trade bureaucracy.

The NAFTA as Mexico's Salvation

The following discussion lays out some possible explanations for Mexico's entry into the NAFTA and for the dilemma that Mexico's membership presents for this accord. First, from Mexico's perspective the economic opportunities presented by the NAFTA seemed to offer the best chance for a "great leap forward," allowing that country to jump from developing country status to developed country status in a very short time.[2]

Second (and related to the previous point), the corps of new technocrats in the Mexican government, who had just taken over from the corrupt political elites of the old PRI regime, were supremely frustrated with the low economic growth rates that had characterized the Mexican economy since the debt crisis of 1982, despite the technocrats' commendable success in achieving macroeconomic stabilization. Their frustration predisposed them to grasp at the hope for a great leap forward.

Third, the new technocrats saw neoliberal economic theory as Mexico's salvation. Mexico could be saved if it could take its place in the international economy by exporting manufactured goods and services, and by increasing foreign investment in Mexico. This salvation was based, in turn, on two important assumptions: (1) that domestic savings and investment alone were insufficient to grow the economy enough to create an adequate number of jobs for the rapidly growing population, and (2) that exports could be kept internationally competitive thanks to Mexico's low wages and to the acquisition of new technology that would occur when foreign firms began to transfer technological inputs into the Mexican economy. Basically, Mexico was placing its hopes for economic growth on its external sector, and to grow its external sector, it needed mechanisms like the NAFTA that would promote the foreign investments Mexico so critically needed.

To publicize its new outlook, the Mexican government initiated a worldwide public relations effort, directed especially toward the United States and toward international organizations like the World Bank, the International Monetary Fund, and the Organisation for Economic Co-operation and Development (OECD). The message was as follows:

[2] In effect, the idea was for Mexico to skip the different processes leading to economic development as put forward in Rostow 1960.

- Mexico's new politico-economic elites were on par with their counterparts in any developed nation.
- After a decade of economic adjustment and self-control, Mexico was stable, politically and economically, and foreign investment there was safe.
- Mexico could guarantee this stability if it were admitted into the NAFTA and the OECD.
- Mexico's stability was the result of national pacts among key political and economic groups that guaranteed continued peace—even though profits were rising for entrepreneurs and investors even as wages were held low for a subservient working class.
- This new economic stability was demonstrated by the relatively minor fluctuations in the value of the Mexican peso.

Although President Carlos Salinas, the architect of this new structure of prosperity, received strong support from the Bush administration, his lofty hopes for Mexico (and for himself, since he was believed to be a front-runner for the directorship of the newly created World Trade Organization) were dashed on the very day that the NAFTA went into effect. Mexico's political peace was shattered when, on January 1, 1994, a band of peasants (the Zapatista National Liberation Army) emerged from the forests of Chiapas to protest with arms Mexico's involvement in the trade accord. The appearance of the EZLN was followed by the assassination of PRI presidential candidate Luis Donaldo Colosio and the murder of the party's executive secretary, José Francisco Ruiz Massieu, completely destroying any remaining belief in Mexico's political tranquillity. The myth of economic stability went by the wayside as well when newly installed President Ernesto Zedillo devalued the peso by half in December 1994.

One victim of this political and economic turmoil was the popular belief that the country could achieve a great leap forward and reap the desired results, now that macroeconomic stability, the prerequisite for any free trade agreement, had been obliterated.[3]

[3] The peso devaluation made Mexican exports competitive in price but it reduced the population's ability to purchase imports. The consequent rise in inflation destabilized the pricing structure for goods and services, making economic transactions (at a domestic and foreign level), harder to arrive at because of the uncertainty

Mexico's Macroeconomic Situation

The political and economic events of 1994 had two principal outcomes. First, the actors to whom the "marketing of Mexico" had been directed—the U.S. government and Wall Street financiers—felt that they had been misled by Mexico's new technocrats. Even so, through the efforts of President Clinton and against widespread popular opposition, Mexico received a pledge of support from the U.S. Treasury Department, the International Monetary Fund, and the Bank for International Settlements in the amount of U.S.$47 billion to help stave off financial collapse. In exchange, Mexico was forced into an austere recovery program with IMF-imposed performance requirements, which ended up triggering a severe recession.

Even though Mexico recorded a surplus in its current account (total trade in goods and services) for 1995, the country was in its deepest recession since the Great Depression of the 1930s, with GDP rates in the minus numbers through all four quarters of the year and continuing into the first quarter of 1996. It had become painfully clear that Mexico's pre–1995 pattern of running a current account deficit was not a "self-financing" strategy, as the country's technocrats had argued to the international community.

Foreign investments in Mexico, whether direct or financial, are highly susceptible to political winds, and this was certainly true in 1994 and 1995. Not only did financial flows react to events within Mexico, but the volatility of capital flows became an important reflection of the instability of economic life in the country. Perhaps more importantly, capital flows themselves became primary determinants of economic events in Mexico (see del Castillo and Vega 1995; del Castillo 1996).

NAFTA's Shortcomings vis-à-vis the Mexican Dilemma

The economic chaos in Mexico in 1994 and 1995 was not the direct result of the NAFTA. However, it may have been an *indirect* result: pressures on the Mexican peso after the country embarked on a NAFTA– stimulated import binge in 1994 created the conditions

related to costs of production, transport, etc. Adding to this uncertainty were soaring interest rates, which surpassed 100 percent, cutting off access to capital for any type of industrial enterprise.

for a severe economic contraction, a crisis from which the country began a slow recovery in 1996. Mexico's cyclic pattern of sudden contraction and slow recovery, price instabilities, extremely high interest and inflation rates, and a currency of questionable stability does not bode well for the success of trade agreements, for which macro-economic stability is a precondition. Yet the issue is not so much that stability is lacking in Mexico, but that the NAFTA—since it is "only" a trade agreement—lacks provisions that would allow country members to intervene in order to lessen the effects of instability.

Perhaps the absence of such provisions is attributable to Mexico's success in "selling" itself. The NAFTA negotiators moved ahead in the belief that problems in Mexico's economic history of cyclic instability would not reappear. And even if instability did reappear, it could potentially affect the volume of trade and services between NAFTA countries but not the underlying rules that governed trade.[4] Nevertheless, as the Clinton administration's rescue package clearly demonstrated, intervention by Mexico's trading partners was essential in guaranteeing the economic viability of Mexico and of the NAFTA agreement itself.

Perhaps the unwillingness to face the possibility of economic instability in Mexico within the NAFTA context reflected the negotiators' refusal to contemplate the possibility that North-South transfers might be needed in order to avoid such instability and avert its effects on trade. What is clear is that foreign investors in Mexico never fulfilled the (perhaps unrealistic) expectations that Mexican technocrats had of them as the source of job-creating investments and technology transfers that would make Mexican manufacturing competitive in global (and especially in North American) markets. Instead, foreign direct investment, small at about one-fifth the total size of portfolio investments, has failed to reduce unemployment and underemployment rates; nor can portfolio investments, which are apt to take flight at the smallest sign of political or economic instability, serve as the basis on which to build a job supply.

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[4] For information on trade negotiators' prior discussions of instability-engendering factors in the Mexican economy, such as capital flight, see del Castillo and Vega 1995: 286. According to the Trade Related Investment Measures (TRIMS) working group of the Uruguay Round: "Following an examination of the operation of GATT articles related to the trade restrictive and distorting effects of investment measures, negotiators should elaborate, as appropriate, further provisions that may be necessary to avoid such adverse effects on trade" (quoted in del Castillo and Vega 1995: 286).

NAFTA: The First Three Years

Despite the enormous challenges posed by Mexico's economic asymmetry, the NAFTA is functioning. Any attempt to assess its effectiveness at this early date must be regarded as highly preliminary given that the NAFTA's main effects will appear, not in years, but in decades.[5] Moreover, so many influences operate on each member country's economic situation and on the trilateral relationship itself that it is difficult to determine with any degree of certainty how much impact each factor exerts on the complex sequence of events. Thus, in this section we will limit our assessment to the progress made in setting up the NAFTA institutions, initial impacts on trade and investment flows, and other issues emerging during this initial period.

NAFTA Institutions and Procedures

The trilateral agreement as a management tool for continued integration provides for an organizational structure to administer its mandates. At the top of the structure is the NAFTA Commission, comprised of cabinet-level representatives from each of the three countries. [The main activities of the Commission are to supervise the work of NAFTA committees and working groups, as well as to make interpretive rulings on the content of the agreement relating to dispute resolution. The NAFTA Secretariat, located in Mexico City, basically supports the NAFTA Commission's work, as well as other bodies related to NAFTA (see Appleton 1994: 146).]

As noted in previous chapters, three supplemental accords (side agreements) were appended to the agreement prior to its approval by the legislatures of the three member countries. These side agreements covered labor standards, the environment, and "import surges." The inclusion of labor and environmental concerns in the NAFTA is widely considered to be one of the trade accord's most innovative aspects. The supplemental agreements convey the authority to monitor the enforcement of laws already on the books in the member countries and provide mechanisms for consultation and cooperation on labor and environmental issues.

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[5]The U.S. Congress requires that a major review be conducted of the NAFTA and its impacts on the U.S. economy in mid–1997. At that time, much more data will become available.

The labor side agreement (the North American Agreement on Labor Cooperation) established a trinational Commission for Labor Cooperation, which includes, in turn, a Ministerial Council and a Secretariat. The Commission compiles and publishes data on the labor-related issues submitted to it, and also plans and coordinates cooperative activities. The Commission may examine disputes and apply compensatory mechanisms (such as fines and/or trade sanctions) in three areas: threats to health and security, the employment of minors, and violations of minimum-wage laws. Additional matters, such as labor union activities, may be referred to the Commission but recourse in these areas is limited to consultation with the respective governments (see Pérez-López 1996). There are national Commission offices in each member country, and the full Commission comes together to meet annually. The Secretariat (located in Dallas, Texas) provides technical and administrative support.

The environmental side agreement (the North American Agreement on Environmental Cooperation) created the Commission on Environmental Cooperation, which, like the Labor Commission, consists of a tripartite, cabinet-level council of ministers, assisted by a Secretariat (located in Montreal, Quebec). There is also a Joint Public Advisory Committee, with representatives from each member's National Public Advisory Committee. The Ministerial Council oversees the implementation of the agreement, conducts discussions and cooperative projects, and settles disputes. The Commission has no enforcement power, but it is obliged to monitor the environmental impacts of the expanded trade and investment flows that are expected to result from the NAFTA. However, environmental conditions on the U.S.–Canadian and U.S.–Mexican borders are still dealt with primarily with the framework of existing bilateral mechanisms between the United States and Mexico and between the United States and Canada. In the case of the former, bilateral negotiators are addressing primarily the issues of acid rain and water quality in the Great Lakes (see Schwartz 1994).

In the second (U.S.–Mexico border) case, key environmental issues relate to the rapidly expanding population and booming *maquiladora* (twin-plant) industry, both of which have aggravated transborder contamination of air, water, and soil. These issues, which have become increasingly contentious in recent years, were not systematically addressed prior to the NAFTA. Since the NAFTA's implementation, two organizations have been set up to deal with environmental issues: the Border Environmental

Cooperation Commission (BECC), which supports research and action projects to clean up the border environment; and the North American Development Bank (NADBank), which provides financial support for large environmental infrastructure projects. Because the NADBank was established through a separate agreement, it does not include Canada, and its financing operations are limited to the U.S.–Mexico border region (defined as stretching 100 kilometers north and south of the international boundary). NADBank capital (now equaling $224 million) has come from the U.S. and Mexican governments; it is expected that these funds will be used to leverage private-sector funding in future to total $1.5 billion in lending capital. As of August 1996, after eighteen months in operation, NADBank had yet to extend its first loan.[6]

Perhaps procedural problems such as those affecting the NADBank reflect the newness of the NAFTA. However, they may also reflect a lack of attention on the part of the member countries. In this regard, it may be significant that the first official version of the NAFTA, as published by the Office of the U.S. Trade Negotiator, had omitted the North American Agreement on Environmental Cooperation, the North American Agreement on Labor Cooperation, and all of the U.S. restrictions on Mexican agricultural exports. In a second published version, the two side agreements were appended as attachments but looked to have been produced hurriedly on a low-end printer. These omissions may be indicative of the slight importance that the U.S. and Mexican governments attached to these issues, despite the fact that they were items of heated interest and debate in the Canadian and U.S. legislatures (see Cameron and Grinspun 1993).

Trade Growth

Obviously one key criterion for evaluating a free trade agreement should be its success in expanding trade. Table 8.1 presents export data for the NAFTA region from 1992 to 1996, covering the two years prior to the NAFTA and the three years since its implementation.

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[6] The U.S. General Accounting Office has identified at least three major problems with the NADBank: (1) a requirement that NADBank's loans be made at or above market rates makes alternative sources of financing more attractive; (2) the small communities on both sides of the U.S.–Mexico border which most need NADBank's help do not know how to deal with the many intricacies of governmental bureaucracies; and (3) constitutional prohibitions do not allow border communities in Mexico to borrow from foreign lenders, making it necessary to channel NADBank's resources through Mexico's Federal Treasury.

Table 8.1

NAFTA EXPORT PERFORMANCE

(percentage growth, 1992–1995)

	1992	1993	1994	1995	1996
Total NAFTA exports	8	5	12	15	7
Intra-NAFTA exports	14	11	19	10	10
Intra-NAFTA exports as percent of total	43	45	48	46	47.3

Source: Inter-American Development Bank, *Integration and Trade in the Americas: Periodic Notes*, August and December 1996.

When looking at the data in table 8.1, it is important to remember, first, that the Canadian–U.S. free trade agreement had already been in force since 1989, and intra-NAFTA exports were already expanding rapidly as a consequence of that agreement; and, second, that the Mexican economy entered a severe recession in December 1994, with a dramatic devaluation of its currency and a sharp decline in total output and imports.

From the perspective of growth of all the variables included table 8.1, 1994 stands out as an exceptional year. Total NAFTA exports grew by 12 percent during 1994, while intra-NAFTA exports (exports among the three countries) grew by a startling 19 percent and intra-NAFTA exports as a percentage of total exports rose to 48 percent. This growth ended with the economic crisis, as the 1995 figures show. Even so, trade between the United States and Canada and between the United States and Mexico continued to grow despite Mexico's economic woes.

Foreign Investment

Given that the promotion of investment flows is a key component of the NAFTA, and that attracting increased foreign direct investment (FDI) was perhaps Mexico's primary motivation in seeking to join Canada and the United States in this trilateral trade agreement, this aspect must also be assessed when evaluating the NAFTA's performance during its initial phase. Although the data are limited, and what information exists is often buried in aggregate data, we can discern some surprising trends in investment flows among NAFTA countries during 1994, the first year of the agreement's operation.

First, U.S. FDI in Mexico during 1994 actually registered a *drop* of 23.5 percent over the preceding year (JETRO online: http://www:jetro.go.jp/). However, this almost surely represents investor unease over political and economic events in Mexico during that year—including assassinations of high-profile public figures, the appearance of the Zapatista National Liberation Army, and suspicions that an overvalued peso could soon be ratcheted downward—and not a failure to respond to NAFTA incentives. Indeed, Mexico's Ministry of Commerce and Industrial Development has noted that in both 1994 and 1995, FDI to Mexico from the United States and Canada flowed most heavily into the very sectors that had been liberalized under the NAFTA: in order of importance, financial services, transportation and communications, and industrial production (SECOFI online: http://www:secofi.gob.mx/). This suggests that investors are incentivized by the NAFTA provisions and that investment flows toward Mexico will increase on par with that country's ability to reassert macroeconomic and political stability.

And despite the drop in U.S. investment levels, Mexico was still able to increase the total flow of FDI into the country during 1994, largely through investments from non–NAFTA countries hoping to establish manufacturing platforms there in order to compete in the North American market under the "rules of origin" provisions of the NAFTA.

A second finding is that FDI flowing from the United States to Canada in 1994 rose by 350 percent (to U.S.$72.8 billion) over the preceding year (JETRO online) This also is surprising in light of the fact that investment flows between these two countries had already enjoyed several years of preferential treatment under the bilateral CUSFTA agreement.

The United States attracted high levels of FDI during 1994 (U.S.$504 billion, an 8.7 percent increase over 1993), but most of this came from non–NAFTA countries, particularly the United Kingdom and Japan. Even so, the United States enjoyed a significant increase in investment from its NAFTA partners. Canada, with U.S.$43.2 billion, was the fourth largest source of FDI to the United States in 1994, and this level of investment reflected an increase of 33.9 percent over 1993. Investment from Mexico, which in 1993 had registered a net outflow of U.S.$7.5 million, rose sharply in 1994, to reach a net inflow of U.S.$970 million as Mexican investors responded to the same economic and political instability in their home country that had provoked the reduction in U.S. FDI to Mexico (JETRO online).

NAFTA's Impact on Infrastructure

The NAFTA is just one more step toward making North America a region without economic borders. While the barriers to most labor mobility remain in place, the obstacles to trade and investment will largely disappear over the next fifteen years and firms will become free to export to, import from, and locate their operations anywhere in the region.

Economic integration generally increases trade flows between member countries.[7] And expanding trade flows, usually expressed in terms of their total monetary value, result in increasing flows of tangible goods (freight flows). This, in turn, heightens the pressures on all existing transportation infrastructure, including highways, railroads, and airport and seaport facilities. If the transportation infrastructure is already operating at or near capacity, this could delay the delivery of inputs and/or finished products, offsetting some of the competitive advantages (such as lower tariffs and reduced transaction costs) that economic integration is supposed to guarantee.

Resolving transportation bottlenecks as they appear will require close collaboration between private firms and government agencies in the NAFTA countries. Transportation planning must be done internationally in order to ensure fast and dependable access to the trinational market. For trade to flow easily, inspection facilities at international borders must be expanded and improved; although the NAFTA cuts tariffs and nontrade barriers, border inspections are still needed to enforce rules of origin and phytosanitary restrictions and to interdict smuggled drugs and undocumented border crossers. New inspection technology is being introduced at expanded border inspection stations on both the U.S.–Canada and U.S.–Mexico borders, but the expanded volume of freight stimulated by the NAFTA still threatens to overwhelm existing capabilities.

[7] Trade flows consist of traditional exports and imports as well as informal border transactions between neighboring communities on international borders. The latter may or may not increase, depending on many other factors, including exchange rates and limits on merchandise that consumers can bring directly into the country.

Harmonizing Trade Laws and Commercial Documents

The NAFTA is regarded by many observers as a monumental accomplishment, opening North America to new opportunities for market access and cross-border investment. However, important issues are still to be resolved, including the standardization of trade and investment documents and the harmonization of trade and investment laws among the three countries.[8]

The U.S. and Canadian legal systems are based on common law, which relies on judicial precedents, while Mexico's system is based on civil law, which focuses on written, constitutional codes and statutory provisions. Thus in some areas there are no parallel legal concepts, and new difficulties are introduced when legal vocabularies must be translated from one language to another. Litigation is also carried out differently in the two systems; what may be a civil case in one system may have criminal implications in another. Such a minor detail as assigning liability for merchandise damaged in transit—easily resolved when it occurs within one country—may not have resolution when merchandise moves from one country to another.

Ordinary business practices also vary significantly between the three countries. For example, in the United States and Canada, inventories and accounts receivable normally serve as collateral for bank loans to firms. In Mexico, loan collateral has traditionally been land. This difference is linked to the manner in which bankruptcy proceedings are conducted in the two legal systems.

Legal documents, including warehouse receipts and bills of lading, vary also, resulting in lost time and added transaction costs. The absence of uniform accounting standards is an area where differences are especially problematic: investors have difficulty comparing statements of earnings and profits between, say, U.S. and Mexican corporations.

Most of the differences between legal structures and business practices hold the potential to affect businesses on a practical, day-to-day basis. The differences in powers of

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[8] While there are many institutions involved in this task, one serves as the hub of such efforts: the National Law Center for Inter-American Free Trade, located at the University of Arizona in Tucson. The Center works with counterpart organizations in Canada and Mexico. This section draws heavily on materials obtained from the Center.

attorney, franchise agreements, and banking practices, among others, must be standardized if the NAFTA is to succeed it its goals.

There are other areas in which a lack of structural symmetry could impact the way that individuals and firms conduct cross-border business. Two areas that are of special importance are educational and professional standards (applying to medical doctors and lawyers, for example) and environmental regulations (including uniform monitoring standards for measuring air and water quality).

The Changing Business Environment

The NAFTA is creating an increasingly open economic environment which will determine where and how North America (and the world) does business. In this section we examine the changing business environment and the opportunities and challenges it presents.

The free-trade, market-oriented position of multilateral institutions created to manage the global economy (such as the GATT, IMF, and World Bank) have frequently been at odds with countries whose economic strategies stressed a strong role for government—and sometimes outright protectionism. The contradiction that emerges when countries design their own domestic industrial policies but participate in open markets at the international level was historically handled quite differently by Mexico, Canada, and the United States. In the post–World War II period Mexico was significantly more protectionist than Canada and the United States,[9] and the Mexican government was much more proactive than the other two. Despite the entry of large U.S., European, and Japanese multinational firms into Mexico after the war, these two differences (along with differences in language, culture, and legal system) served to keep small and medium-sized firms from the United States and especially Canada from participating in the Mexican economy. Now, under the NAFTA, increasing integration in North America through trade and investment has become a fact of life. The "domestic market" is becoming synonymous with "North America," with three (or four, if we count an independent Quebec) national economies grounded in three (four) different political, legal, and cultural systems, and two

[9] Significant differences remain. In 1994–95 average tariffs were 6.6, 6.7, and 14.2 percent, respectively, for the United States, Canada, and Mexico.

(three) main languages, with transactions across national boundaries using three (or four?) national currencies.

This new "domestic market" exists within a global economic system with its own dynamics and "rules of the game." As firms increasingly venture beyond the confines of their domestic economy into the North American domestic market and discover its advantages, pressures will build to expand this framework to include other, and perhaps most, of the nations of the Western Hemisphere. In order to succeed in these new markets, key actors in North American firms must acquire: (1) working knowledge of the dynamics of the global economic system (its history, institutions, and mechanisms), (2) familiarity with the history and socioeconomic structure of each potential trade partner, and (3) communication skills, including linguistic and cultural skills appropriate for the region. The need for such knowledge and skills holds important implications for designing business school curricula, foreign language programs, and internships (see Clement 1993).

There are, of course, many ways of doing business. A firm can enter a foreign market by buying goods from and/or selling goods to another country. Buying can be done by importing directly, by forming a joint venture with or acquiring an already established firm in another country, or by establishing a subsidiary in that country. Similarly, selling can be done by exporting directly through a distributor in another country or by licensing technology to a firm there, which will then produce the product. Joint ventures with another firm to produce a product in a foreign country is another possibility, as is establishing a subsidiary (Fraser 1992). Each option produces a different set of benefits and costs (less/more risk, less/more control, the promise of higher/lower long-term profits). The ultimate choice of how to do business is a function of both a firm's capabilities and the "comfort zone" of its management, employees, and board of directors.

The Mexican market, like many other Latin American markets, presents some unique opportunities that are currently not available in the United States or Canada. Mexican firms need technology and capital in order to modernize their operations, which have long stagnated under protectionism and high interest rates. Many Mexican firms are also in need of guidance on how to enter the Canada–U.S. market, already somewhat integrated through the CUSFTA.

Firms going into Mexico will also find some attractive attributes there. Mexican labor costs are low in comparison with those in the United States and Canada. Cheap labor, however, is not the whole story. High labor productivity is also essential in keeping unit labor costs low. Companies that have made sizable investments in training and equipment have generally found Mexico's labor force to be of high quality. The area in which Mexico remains deficient is transportation infrastructure, where a shortage of modern rail and port facilities can add time (and cost) to doing business.

One important mechanism by which outside firms have taken advantage of the incentives for doing business in Mexico is the border-based *maquiladora* industry.[10] The maquiladora functions as an export-processing zone, where Mexican or foreign firms can import inputs into Mexico free of duty and assemble them for export, paying duty only on the value added in Mexico. (Recent changes allow some of the products to be sold in Mexico, but only under certain conditions.) Most maquiladora plants are located along Mexico's northern border, for ease of access to the U.S. market and to circumvent the problems inherent in relying on the inadequate transportation infrastructure in the country's interior. Asian firms, especially electronics producers, began entering the maquiladora sector when the NAFTA negotiations began in order to gain preferred access to the entire North American market under the NAFTA's "rules of origin" requirements. They have become an important presence in Baja California, now the world's premiere producer of television sets.

NAFTA and the Location of Economic Activity

How will the NAFTA change the economic geography of North America? First, as intraregional trade expands, firms with high transportation costs will likely try to lower these costs by relocating their production and/or distribution facilities closer to the trade corridors that run from north to south through the three countries.[11] Other changes in the

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[10] The NAFTA will phase out the maquiladora program as it currently exists, but Mexico will remain an attractive export-processing platform and low-cost manufacturing site as long as firms are able to use inputs from NAFTA countries.

[11] Several trade corridors which have appeared in recent years serve as "gateways" for firms involved in cross-border transactions. Examples are the Red River Trade Corridor (connecting Manitoba, North Dakota, and Minnesota) and El Camino Real (running from Taos New Mexico, across the border at El Paso–Ciudad Juárez, and continuing through Chihuahua to Mexico City).

"location" of many economic activities[12] will reflect firms' efforts to maximize opportunities as they confront changing price structures, both within and outside of the NAFTA area.

In the years since the Canada–U.S. Free Trade Agreement went into effect, the easing of trade and investment barriers have allowed firms in the two countries to make location decisions without regard to borders. Some U.S. and Canadian firms have reorganized their operations, sometimes consolidating two plants, one in each country, into one plant in one or the other country. In other cases, firms expanded their operations into the other country. Their motivation was clearly profit maximization, mainly based on the economies realized through large-scale production (in the case of consolidation) or "economies of scope," in the case of expansion into another country.

Another factor that will trigger changes in the spatial location of economic activity is the increased competition that exists in a borderless environment. As inefficient producers in one country are outmatched by more efficient producers elsewhere, some firms, perhaps entire industries, will simply disappear as local markets begin to be supplied totally through imports.

The net effect of these changes is that, over time, economic activity will tend to move from regions that offer less to those that offer more in terms of attractive costs, labor skills, infrastructure, innovativeness, and quality of life. Border regions present some special characteristics in this regard. Traditionally border regions have tended to be relegated to the periphery of economic activity, primarily because access to their geographical markets—their natural hinterlands—was constrained by an international boundary. As economic borders recede and eventually disappear due to regional and/or global economic integration, new opportunities present themselves. Local trade and commerce becomes more "transborder," and firms on opposite sides of the border may find new bases for working together based on complementarities such as now exist on the U.S.–Mexican border (where low-wage Mexican workers are employed in research and development facilities in U.S. border cities, for example). Such opportunities may attract new firms and new industries and/or stimulate the expansion of existing ones, potentially driving new forms of economic development in border regions. Of course, these new

[12] Under the NAFTA, incentives to firms locating in Mexico's border regions will be phased out over time so that there will be a "level playing field" for firms on both sides of the international boundary.

conditions do not guarantee that economic development will surge in border regions. Economic development in the post–Cold War era may prove extremely elusive precisely because of the new, more competitive environment that now exists. Thus many border regions are likely to remain in the periphery, both geographically and economically.

What differentiates the cities or regions that will prosper in the new economy from those that will stagnate or decay? No single factor provides the complete answer. Clearly, location is important, as is having a diversified economic base, a well-trained work force, links with research institutions, modern telecommunications and transport facilities, a high quality of life, and "the institutional capacity to develop and implement future-oriented development strategies" (Commission of the European Communities 1992: 22). However, in the case of border regions, there is one more important factor: a well-developed system of transborder cooperation. In this regard, the NAFTA could have a decidedly positive effect. As Paul Ganster (1995) noted:

> NAFTA has been a catalyst, for it made border issues a high priority on the bilateral agenda and brought increased federal involvement and funding to border issues, particularly by the U.S. federal government. At the same time, the longstanding inclination of the U.S. government and the decentralization process in Mexican public administration have combined to facilitate greater transborder cooperation at the local level in the border region.

The NAFTA's Technical Deficiencies

There are technical details that will plague the NAFTA in future years, and they are the same ones that have been thorns in the side of the Uruguay Round of GATT negotiations. Three appear to be most important.

First, the NAFTA lacks a common regulatory framework on dumping, subsidies, and countervailing duties. These problems have been discussed exhaustively within the GATT, and they were a major reason why Canada sought a free trade agreement with the United States. Since early in the Reagan administration, Canada had become a frequent target of U.S. antidumping actions, and it hoped that a free trade agreement would lessen the pressures on Canadian exporters (see del Castillo and Vega 1995).

A second deficiency in the NAFTA is that it does not allow for "industrial policies." This focuses attention on subsidies, technical standards, and government procurement policies, which all countries in the region use to foster development through research and development and so on. The Uruguay Round and the new WTO are beginning to address these issues; for example, there is now a classificatory scheme for subsidies (defined as "an action by a national or sub-national government that bestows a financial benefit") that specifies how various kinds of subsidized export products should be treated (Morici 1996). Because many Uruguay Round and WTO rules and procedures like the subsidies classification are not incorporated within the NAFTA, in late 1995 the Canadian government asked that a working group be set up within the NAFTA to resolve subsidies issues, without which the principle of market access would be no more than a sham.

The third deficiency relates to the NAFTA's "newborn" status. Because the NAFTA is still embryonic, it is vulnerable. Perhaps the most significant danger is that the agreement could become the stepchild of special interest groups exercising pressure in Washington, Ottawa, or Mexico City. Because pressure tactics often are effective with weak or receptive governments, the danger is that whenever the interests of a special group are threatened by the process of free trade, that group will take action to prevent the implementation of the offending provision.

Some cases may serve to illustrate this point, including the Clinton administration's failure to implement (as of December 1996) the transport services provision of the NAFTA, which is to allow Mexican and U.S. truckers to handle cargo on a transborder fashion. This provision was not implemented in a timely fashion because of successful lobbying by the Teamsters' union, whose members objected to Mexican competition. The delay was, in effect, a reward for the Teamsters' support in Clinton's reelection campaign. In a similar vein, Southern California avocado growers objected to the import of Mexican avocados; the U.S. Department of Agriculture bowed to the pressure, citing a parasitic threat as its justification for forestalling avocado imports. It was not until the time of this writing (February 1997) that Mexican avocado growers finally gained access to limited sections of the U.S. market. In neither of these two cases did

Mexico take action under the NAFTA conflict resolution panel structure.[13] On the Mexican side, United Parcel Service (UPS) has not yet been granted national treatment, to the benefit of small Mexican delivery systems.

The question is, how far will such interest-group-driven actions go? Given the protectionist climate in the United States, there are strong indications that this type of political action can be rewarding, especially if lobbyists use the argument that a "distant international bureaucracy" is impinging on national sovereignty or that special "secret" panels are making decisions contrary to the U.S. Congress's intentions. The only protection against this tendency is to "deepen" the NAFTA agreement—that is, to carry it to higher levels of integration.

Beyond NAFTA

In the first three years of the NAFTA, trade and investment expanded despite Mexico's peso devaluation and economic recession. Moreover, an institutional structure has been put in operation, overcoming initial delays and funding shortfalls. The dispute resolution mechanism has reviewed approximately forty administrative decisions and, despite charges of bias, most of which originated in the United States, has gained the respect of many observers in the three countries (see *NAMINEWS*, various issues).

Looking toward the future, we see the NAFTA evolving in three ways. First, as it matures it could grow into the structure that is envisioned in the originating document; foreshadowings of this are already visible in the areas of dispute resolution and environmental and labor concerns.

Second, the NAFTA could be modified to correct the deficiencies present in the initial document. The areas most in need of reform and strengthening are antidumping, subsidies and countervailing duties; industrial policy; capital movements and investment; and dispute settlement. Another area is labor mobility; while the United States is not eager to admit more foreign nationals, a bilateral plan for managing crossborder labor flows

[13] Interestingly, immediately after implementation of the NAFTA, Mexican milk producers in Baja California objected to the importation of milk from the United States. The response from Mexico City was that they should face up to the new world of competition.

might be more efficient than the present unilateral one (see del Castillo and Vega 1995). Such reforms would result in a "deepening" of the trilateral relationship.

Finally, the NAFTA relationship could be "widened" by the "accession" (inclusion) of additional individual country members or by somehow merging with one or more regional trade blocs.

Widening and/or deepening is likely to be resisted, at least in the short term, because of the strong anti–free trade sentiment that has developed in the United States. During the NAFTA negotiations and approval process, most criticism of the agreement came from labor and environmental groups traditionally associated with the political left. However, in recent years, attributable in part to the instability and recession in Mexico, many conservative groups have joined organized labor and environmentalists in their objections to the NAFTA—and to the World Trade Organization as well—claiming that they threaten "America's sovereignty." Their opposition kept free trade initiatives off President Clinton's agenda throughout the 1996 election year and could delay action in the near term.

Even so, a number of proposals, both official and unofficial, have been advanced that would expand the integration process. These include:

- Repeated (unofficial) appeals to create a North Atlantic Free Trade Zone between NAFTA and the European Union (Nelson 1996) as a way of avoiding growing economic and political tensions between the two groups of nations.
- Building stronger free trade ties between the United States (and NAFTA) and the Asian Pacific Economic Cooperation group of seventeen Pacific Rim nations (Stout and Robbins 1996).
- Negotiating the accession of individual countries into the NAFTA; Chile has long been considered the strongest candidate for entry into an expanded NAFTA.
- Negotiating a hemisphere-wide free trade agreement (a Free Trade Agreement of the Americas, FTAA) by building on the Enterprise of the Americas Initiative originally introduced by President Bush in 1990 and confirmed by President Clinton at the Summit of the Americas meeting in Miami in 1994. Two follow-up meetings in 1995 (Denver) and 1996 (Cartagena) and the ongoing efforts of several working committees have kept this process very much alive but out of U.S. newspaper headlines.

- Extending the Group of 3 (G-3) free trade agreement between Mexico, Venezuela, and Colombia, signed in June 1994.

Any such negotiations would require President Clinton to seek congressional approval for fast-track authority,[14] which is not considered likely at this time in light of congressional sentiments.

At the same time that the United States is dragging its feet on trade issues, Canada and Mexico are expanding their free trade ties.[15] Additionally, Latin American countries are eager to open their economies to competition from other countries within the region at roughly the same level of development, and eventually with the United States and other developed countries as well.

In order to facilitate this process, the major Latin American economic and political organizations—including the Economic Commission for Latin America and the Caribbean (ECLAC), the Inter-American Development Bank (IDB), and the Organization of American State (OAS)—have mounted a collaborative effort to analyze the complex web of economic integration agreements in the region (IDB 1996). The four main trade blocs in the region are the Central American Common Market, the Caribbean Common Market, the Andean Community, and the Southern Cone Common Market (Mercosur). However, free trade agreements between individual countries and these common market groups are also growing. For example, Mercosur recently signed free trade agreements with Chile and Bolivia and is currently negotiating agreements with other Andean countries. Finally, a variety of relationships (such as nonreciprocal preferential agreements and free trade agreements) are being formed between Latin American groups and the European Union.

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[14] Fast-track authority was established in the Free Trade Act of 1974. Under this procedure, Congress can define the objectives for trade negotiations before they begin; periodic updates and consultations about the negotiations are held between the president's negotiators and certain members of Congress; Congress has a maximum of ninety days after an agreement has been signed to analyze and discuss it in congressional committees; and each house of Congress has fifteen days after receiving the committee reports to vote for or against the trade package (Heritage Foundation 1995).

[15] In addition to the G-3 agreement, Mexico has signed trade agreements with Chile and Costa Rica and is negotiating agreements with several other Central American countries. Canada recently began negotiating a free trade agreement with Chile.

Preliminary Conclusions

While it would be easy to conclude that the United States could be left out of the global movement toward free trade if it does not act quickly, we reject that position for three reasons. First, it is clear that the mere size of its market gives the United States options that few other nations can claim. Second, as noted above, there *are* serious problems with the NAFTA which should be addressed before its membership is expanded. Third, given the fact that any movement toward free trade creates both winners and losers, we see certain advantages to reopening the debate on North American free trade in the three countries before further changes are implemented. Such a debate, if properly focused on the various economic, social, environmental, and technical issues raised in this volume, might produce a better framework for managing the process of de facto integration that is taking place between the three countries.

Finally, any book on North American economic integration would be remiss were it not to mention, however briefly, the important and related topic of North American political integration. There are two broad issues here. The first revolves around the asymmetrical political systems of the three countries of North America. Although all three embrace a federalist form of government, there is great diversity with respect to degrees of centralization and the specific form of federalism utilized (e.g., Canada's parliamentary system versus the congressional systems of the United States and Mexico). The main questions here are: Will such political diversity inhibit or facilitate North America's economic integration? If so, how? These questions are of considerable importance in view of Mexico's current political reforms, Canada's constitutional crisis centered on Quebec, and the fiscal strains imposed by the New Federalism in all three countries.

The second issue relates to the future of overall North American integration. If North America goes the way of European integration, we can expect that some sort of "North American Trilaterism" might someday evolve that would bring the three countries together for increased integration in a variety of areas. Again there are two issues here. First, we might ask if the current NAFTA institutional structure is conducive to the growth of continental-trilateral integration in other areas. If so, how far are these institutions likely to take the three countries down the road of integration, given the economic, cultural, and political asymmetries between them?[16]

At this time it is difficult to imagine a "United States of North America" or something similar. However, just a decade ago few observers foresaw anything like a NAFTA. As circumstances change, new challenges and opportunities could arise that are difficult to predict from today's vantage point regarding the future of North American Trilateralism in the twenty-first century.

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[16] For more detailed discussion of these areas, see *NAMINEWS* 1996; Randall 1995; and the trilateral Project by Gibbins, Guillén, and Sparrow being carried out by researchers at San Diego State University, the University of Calgary, and El Colegio de la Frontera Norte.

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