
COMMENTARY 20170305

Mexico's Case for Free Trade

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Mexico is open to re-negotiating NAFTA in ways that lead to further integration of the North American economies, and which reflect the modern world of e-commerce. But there is no option to constrain the ability of firms to invest across borders by imposing tariffs or quotas. In the view of Mexico's Secretary of Economy, that will simply hamper the ability of U.S. firms to compete globally and ultimately lead to poor outcomes for workers across North America. The Secretary is correct. In our view, we cannot simultaneously treat labor market disruption from innovation as an achievement, but labor market disruption from trade as an argument for protectionism.

INTRODUCTION

Mexico's Secretary of Economy, Ildefonso Guajardo Villarreal, made two salient points regarding any re-negotiation of Mexico's free trade agreement with the United States, in a presentation to the Detroit Economic Club on Friday. The comments are timely, given that the President has the authority to withdraw the U.S. from the North American Free Trade Agreement (NAFTA) with six months' notice.¹

First, the Secretary accepted that the 23 year old agreement needs modernization. He is not averse to changes but stated that any discussion on amendments must start with a mutual understanding on deficiencies in the current agreement. He gave some signals as to what those deficiencies are, from Mexico's perspective. At the inception of the agreement, e-commerce did not exist, the telecom sector has undergone reform within Mexico², and trademarks and patents are now more important especially in the medical devices industry.

Second, he made it clear that the re-introduction of tariffs, quotas or other protectionist mechanisms cannot be part of any discussion. He stated that, as soon as tariffs enter into the debate, he will have an endless stream of industry lobbyists at his door arguing the case for protection of their particular industry. In the words of the Secretary, he just cannot open Pandora's box on protectionism.

¹ Villarreal and Ferguson (2017, p. 26) state that, "It appears that the President, then, can withdraw from the agreement as a matter of international law six months after providing written notice to the other parties pursuant to NAFTA Article 2205 above." – Villarreal, M.A., and I.F. Ferguson, 2017, "The North American Free Trade Agreement (NAFTA)," *Congressional Research Service*, R42965, February 22.

² In 2014, AT&T (U.S.), Eutelsat Communications (France) and Virgin Mobile (United Kingdom) made investments worth a combined \$5.1 billion, and regulatory reforms led to substantial price reductions (The Economist Intelligence Unit, *Telecoms reform begins to show results*, October 30, 2015).

Put these two points together and we can reach an important conclusion about Mexico's priorities for a refined free trade agreement. It is Mexico that is making the case for free and fair trade and sees no place for a return to protectionism of preferred industries.

In particular, the Secretary makes the case that the integrated economies of North America provide the best opportunity for U.S. companies to compete on a global basis by creating vertically integrated supply chains. In the Secretary's presentation, he made the point that U.S. imports from China contain only 4 per cent U.S. content.³ In contrast, imports from Mexico are estimated to contain 40 per cent U.S. content.⁴ His appeal to U.S. policy makers is that U.S. firms face intense competition from Chinese firms, that it is this competition that threatens the prosperity of U.S. workers, and that regional trade agreements enhance the ability of U.S. firms to compete globally.

The auto sector is the single best industry sector to illustrate the Secretary's point. The agreement phased out auto sector protectionism in Mexico, which included tariffs as high as 25 per cent, high domestic content provisions and prohibition on the import of finished vehicles.⁵ This led to the integrated production chains that are standard practice across the auto industry and which now mean that across automobiles and auto parts the U.S. imports \$96 billion of products and exports \$27 billion worth.⁶ It is difficult to see how U.S. auto makers can compete on a global basis if the efficiency gains from regional integration are removed.

LABOR MARKET DISRUPTION

Labor market disruption from science and technology is lauded as an achievement, but labor market disruption from trade is used to argue for protectionism

The problem faced by policy makers is that no-one has developed a policy prescription to effectively mitigate the impacts on low wage earners in trade-exposed industries. Specifically, workers develop industry-specific skills regardless of whether the worker is able to command a high or low wage. But when there is an employment shock, highly paid workers are more likely to transition out of the trade-exposed industry. Low wage earners are more likely to remain in the trade-exposed industry, and continue to be exposed to employment shocks.⁷ The adverse impacts of trade are not just industry-specific but region-specific. One conclusion of a recent research paper on disruption from China is that, "Labor-market adjustment to trade

³ This figure also appears in the paper by Villarreal and Ferguson (2017, p. 17) who cite Koopman, R., W. Powers, and Z. Wang, et al., 2010, "Give credit where credit is due: Tracing value added in global production chains," National Bureau of Economic Research, Working Paper 16426, Cambridge, MA, September.

⁴ Villarreal and Ferguson (2017, p. 17)

⁵ Villarreal and Ferguson (2017, p. 17)

⁶ Villarreal and Ferguson (2017, p. 18)

⁷ Autor, D.H., D. Dorn, and G.H. Hanson, 2016, "The China Shock: Learning from Labor-Market Adjustment to Large Changes in Trade," *Annual Review of Economics*, 8, 205 to 240, referring to pp. 232 to 234.

shocks is stunningly slow, with local labor-force participation rates remaining depressed and local unemployment rates remaining elevated for a full decade or more after a shock commences.”⁸

The labor market disruptions of free trade are real. But we readily accept labor market disruptions from technology and research without calls for protection. The goal of medical researchers is to displace doctors and the march towards autonomous vehicles is hailed as ground-breaking, despite the intended displacement of drivers. It is labor market disruptions from trade that are given special status in debate.

SUMMARY

In sum, the Secretary has given the clear signal that Mexico is open to re-negotiating NAFTA in ways that lead to further integration of the North American economies, and which reflect the modern world of e-commerce. But there is no option to constrain the ability of firms to invest across borders by imposing tariffs or quotas. In the view of the Secretary, that will simply hamper the ability of U.S. firms to compete globally and ultimately lead to poor outcomes for workers across North America. The Secretary is correct. In our view, we cannot simultaneously treat labor market disruption from innovation as an achievement, but labor market disruption from trade as an argument for protectionism.

⁸ Autor, Dorn and Hanson (2016, p. 235)