Afta Thoughts on NAFTA

By J. Bradford DeLong

Photo by AP Wide World.

Anti-NAFTA protestors at a 1993 rally.

The Mexican Revolution of the early 20th century created a Mexico where peasants had nearly inalienable control over their land; where large-scale industry was heavily regulated; and where the country was ruled by a single, corrupt, patronage-based party — the Institutional Revolutionary Party (PRI). By the late 1980s, it was clear that this was not a very successful politico-economic framework with which to support Mexican economic development. Urban and industrial productivity remained far below world standards with little sign of catch-up or convergence. Rural agriculture remained backward. Successful development fueled by the transfer of labor from the countryside to the cities had come to an end in the late-1970s with the general slowdown of growth in the industrial core, even though oil-rich Mexico benefited enormously from the OPEC-driven tripling of world oil prices in that decade.

After stealing the presidency of Mexico from the true choice of the voters — Cuauhtémoc Cárdenas — Carlos Salinas de Gortari decided at the start of the 1990s to pursue policies of "neoliberal reform." He worked to open up the economy to trade; encourage rather than punish foreign investment; dismantle regulations and special privileges; and generally to rely on the market in the hope that any market failures that emerged to slow development would be less destructive and dangerous than the government failures — stagnation, corruption, entrenched interests — that many agreed were blocking Mexican prosperity.

So, in the early 1990s, Salinas de Gortari sought and won a free trade agreement with the United States and Canada: NAFTA — the

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North American Free Trade Agreement. NAFTA guaranteed Mexican producers tariff- and quota-free access to the U.S. market, the largest consumer market in the world. Once the United States was committed to allowing quota- and tariff-free imports from Mexico, the future twists and turns of U.S. politics would be unlikely to disrupt U.S.–Mexican trade. Industrialists could build their factories in Mexico to serve the American market without fearing the consequences of a political retreat from free trade by the United States.

More importantly, perhaps, NAFTA committed Mexico to following the rules of the international capitalist game in its domestic economic policies. Overregulation, nationalization, confiscation — all the ways that governments can take wealth, especially wealth invested by foreigners, and redistribute it — were to be ruled out, or at least made more difficult, as a result of NAFTA.

The hope was that this two-fold binding of national governments — the U.S. government committing not to let a wave of protectionism affect imports from Mexico and the Mexican government committing not to let a wave of populism affect the wealth that foreign investors would place in Mexico — would set off a giant investment and export-industrialization boom in Mexico and so perhaps cut a generation off the time it would take for full Mexican economic development.

Indeed, six years ago I was ready to conclude that NAFTA had been a major success. It looked as if NAFTA had been the most, or at least a very promising, road for Mexico. Given that the United States has both a neighborly duty and a selfish interest to do whatever it can to raise the chances for Mexico to become democratic and prosperous, it appeared that the pushing-forward of NAFTA by the George H.W. Bush and Bill Clinton administrations had been one of the lamentably few good calls by the U.S. government in its management of relations with Mexico.

Six years ago I would have said that NAFTA was a success because I would have looked at Mexico's exports and seen that they had boomed. Indeed, they have continued to boom. Mexico's exports have gone from 10 percent of GDP in 1990 to 17 percent in 1999 to 28 percent today. In 2007, Mexico's real exports — overwhelmingly to the United States — will be fully five times as great as they were at the beginning of the 1990s. Here, in the rapid development of export industries and the dramatic rise in export volumes, it is clear that NAFTA has made a big difference.

Without the dual guarantees of free imports into the United States and respect for foreigners' property in Mexico, fewer investments would have been made in Mexico in capacity to satisfy American demand. And to those of us advocating NAFTA in the early 1990s, such an expansion of exports as we have in fact seen would have been confidently predicted to generate enormous dividends for Mexico as a whole. Increasing trade between the United States and Mexico moves both countries toward a greater degree of specialization and a finer division of labor. Mexico and the United States can both raise productivity in important sectors like autos, where labor-intensive portions are increasingly accomplished in Mexico, and textiles, where high-tech spinning and weaving is increasingly done in the United States, while Mexico carries out lower-tech cutting and sewing.

Such efficiency gains from increasing the extent of the market and promoting specialization should have produced rapid growth in Mexican productivity. Likewise, greater efficiency should have been reinforced by a boom in capital formation, which should have accompanied the guarantee that no future wave of protectionism in the United States would close factories in Mexico. This is the gospel of free trade and the division of labor that we economists have preached since Adam Smith. And we have powerful evidence around the world and across the past three centuries that this gospel is a true one.

The key words here are "should have."

Photo by Jacqueline Sullivan.

Brad DeLong speaks at UC Berkeley.

Today's roughly 100 million Mexicans have real incomes, at purchasing power parity, of roughly \$10,000 per year, a quarter of the current U.S. level. They are investing perhaps a fifth of GDP in gross fixed capital formation — a healthy amount — and have greatly expanded their integration into the world economy, especially that of North America, since NAFTA.

Real GDP has grown at an average rate of 3.6 percent per year since the coming of NAFTA. But this rate of growth, when coupled with Mexico's 2.2 percent per year rate of population increase, means that Mexicans' mean market income from production in Mexico is barely 15 percent above that of pre-NAFTA days. That means that the gap between their mean income and that of the United States has widened. And there is worse news: Because of rising inequality the gap between mean and median incomes has risen. The overwhelming majority of Mexicans are no more productive in a domestic market income sense than their counterparts of 15 years ago, although some segments of the population have benefited. Exporters (but not necessarily workers in export industries) have gotten rich. The north of Mexico has done relatively well. And Mexican families with members in the United States are living better because of a greatly increased flow of remittances.

Intellectually, this is a great puzzle for us economists. We believe in market forces. We believe in the benefits of trade, specialization and the international division of labor. We see the enormous increase in Mexican exports to the United States over the past decade. We see great strengths in the Mexican economy: macroeconomic stability, balanced budgets and low inflation, low country risk, a flexible labor force, a strengthened and solvent banking system, successfully reformed poverty-reduction programs, high earnings from oil and so on.

Yet success at what neoliberal policymakers like me thought would be the key links for Mexican development has had disappointing results. Success at creating a stable, property-respecting domestic environment has not delivered the rapid increases in productivity and working-class wages that neoliberals like me would have confidently predicted when NAFTA was ratified. Had we been told back in 1995 that Mexican exports would multiply fivefold in the next 12 years we would have had no doubts that

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Photo by AP Wide World.

Corn flows from an Iowa combine.

NAFTA was going to be, and would be perceived as, an extraordinary success. We would have been convinced that Salinas de Gortari was right to focus his energies on free trade and NAFTA rather than on, say, education and infrastructure.

To be sure, economic deficiencies still abound in Mexico. According to the Organization for Economic Cooperation and Development (OECD), these include a very low average number of years of schooling, with young workers having almost no more formal education than their older counterparts; little on-the-job training; heavy bureaucratic burdens on firms; corrupt judges and police; high crime rates; and a large, low-productivity informal sector that narrows the tax base and raises tax rates on the rest of the economy. But these deficiencies should not be enough to neutralize Mexico's powerful geographic advantages and the potent benefits of neoliberal policies, should they?

Apparently they are. The demographic burden of a rapidly growing labor force appears to be greatly increased when that labor force is not very literate, especially when crime, official corruption and inadequate infrastructure also take their toll. Reinforcing these deficiencies is an important additional factor: the rise of China. The extraordinary expansion of exports from China over the past decade has meant that it has been the worst time since the 1930s to follow a strategy of export-led industrialization (unless, of course, you are China). Mexico has succeeded at exporting to the United States. But because of the rising economic weight of China, it has not succeeded in exporting at prices that generate enough surplus to boost Mexican development.

In addition, there is a great deal of anecdotal evidence that attempts by businesses to locate production for the U.S. market in Mexico are running into labor shortages. It is not that labor in Mexico is scarce, and it is not at all expensive. But labor with the skills needed to operate machines that could otherwise be located in Kuala Lumpur or Lisbon or, indeed, Cleveland, does seem to be hard to find. The logic of comparative advantage and the division of labor requires that the productive resources to divide the labor be present. The low level — and near stagnation over time — of education in Mexico may be a critical deficiency.

And there is the problem of Iowa, a gigantic and heavily subsidized corn and pork producing machine. The way NAFTA has worked out, the biggest single change in cross-border shipments has been that Iowa's agricultural produce is now sold in Mexico City. The impact on standards of living for Mexico's near-subsistence, rural

Photo by AP Wide World.

A Mexican farmer in his cornfield.

farmers is frightening to contemplate. Imports from Iowa have been an extraordinary boon to Mexico's urban poor and urban working class. But have they been a good thing for the country as a whole?

We neoliberals point out that NAFTA did not cause poor infrastructure, high crime and official corruption. We thus implicitly suggest that Mexicans would be far worse off today without NAFTA and its effects weighing in on the positive side of the scale. We neoliberals point out that we could not have predicted the rapid rise of China: from the perspective of 1991, China's future looked likely to be riddled with political turmoil, repression and perhaps economic stagnation as the Communist Party feared too-rapid change, rather than the greatest economic miracle we have ever seen.

That neoliberal story may be true, but, then again, it may not. Having witnessed Mexico's slow growth over the past 15 years, we can no longer repeat the old mantra that the neoliberal road of NAFTA and associated reforms is clearly and obviously the right one. Would some other, alternative, non-neoliberal development strategy have been better for Mexico in the late 1990s and early 2000s? Would it have been better to have urged President Carlos Salinas de Gortari to focus his efforts on investments in education and infrastructure and on trying to clean up corruption rather than on free trade? Perhaps.

The stakes are high. Our current systems of politics and economics, around the world, are legitimized not because they are just or optimal but because they deliver a modicum of peace coupled with rapid economic growth and increases in living standards. Mexico's development problems are not large when compared to those of many other countries. We as a species ought to be able to help Mexico to do much better than it has in the years since 1990.

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