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# Trumping the NAFTA renegotiation: an alternative policy framework for Mexican-US cooperation and economic convergence

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**Abstract**
The effects of globalization and regional integration have not worked well for most Americans and Mexicans. Our objective here is to assess the proposals of the Trump administration for revising NAFTA, the responses of the Mexican government, and progressive alternatives to both. This article will address what kind of economic policies are needed to achieve more inclusive and sustainable growth in both Mexico and the United States, given their current degree of integration and the changing character of global production and technology.

**Key words** NAFTA, regional integration, convergence, inequality, development, minimum wages

## 1. Introduction

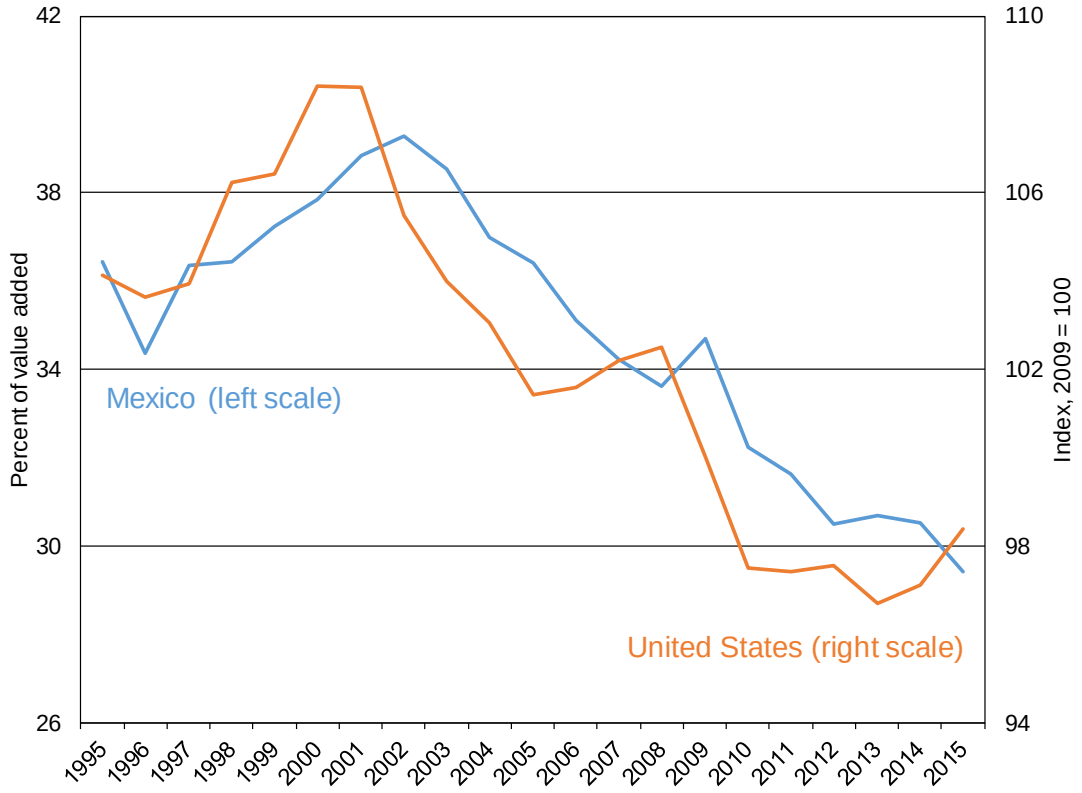
The election of Donald Trump as U.S. President has put the future of the North American Free Trade Agreement (NAFTA), as well as U.S.-Mexican relations generally, back onto the political agenda. The Trump administration has made it clear that if the renegotiation of NAFTA with Canada and Mexico does not lead to an outcome it finds acceptable, it will withdraw the United States from the agreement, and Trump has also threatened to impose a 35% tax on businesses that ship goods to the United States after relocating out of the country.

The political success of Trump's demagoguery (and faux populism) partly reflects the failures of the neo-liberal policy regime in place since the Reagan era (for example, adjustment costs that were not offset, industrial policies that were not adopted, inequality that grew out of control, and a dollar that was allowed to become overvalued). The aftermath of the 2007-2008 financial crisis has not produced a hopeful outlook for many Americans. Even though the rising inequality was not caused solely by the subprime crisis and the downturn that followed – it had been building up over the past three decades – the crisis made matters worse, to the point where it could no longer be ignored (Stiglitz, 2015).

Indeed, globalization and regional integration have not worked well for many Americans and Mexicans. Recent research shows that the United States has experienced significant localized job market effects (mostly depressed wages and dislocation of less educated workers) as a result of NAFTA's tariff reductions (Hakobyan and McLaren, 2016), as well as much larger job losses attributed to increased imports from China and worsened inequality attributed partly to trade and outsourcing more generally (see Autor, Dorn and Gordon, 2016; Bivens, 2017).

On the Mexican side, the consumer "gains from trade" due to all of Mexico's tariff reductions (not only those due to NAFTA) – while generally positive – have been highly concentrated in upper-income households and the northern regions of the country (Nicita, 2009), while wage inequality between more and less "skilled" workers (for example, workers with higher or lower levels of education) worsened after trade liberalization and the formation of NAFTA (Hanson, 2004). In both countries, real wages have failed to keep up with rising productivity of labor in key tradable goods industries, especially manufacturing, resulting in falling shares of labor in national income since the late 1990s (see figure 1; see also Mishel, Bernstein and Shierholz, 2012; Ibarra and Ros, 2017). And, as detailed in the next section, the Mexican economy has made no progress in convergence with the United States in per capita income or wages since NAFTA went into effect in 1994.

**Figure 1** Private business sector labor shares, Mexico and United States, 1995-2015




**Sources:** Ibarra and Ros (2017), data used with permission; U.S. Bureau of Labor Statistics (BLS), www.bls.gov; and authors' calculations.

Thus, our purpose in this paper is not to defend NAFTA. Nevertheless, we recognize that the economies of all three member countries have been transformed by the regional integration brought about by NAFTA and other liberalization policies, and therefore the efforts by the Trump administration to undermine or destroy NAFTA without putting any positive alternative policies in place could have many adverse consequences. As one critic of U.S. trade policy has written,

> "the U.S. and Mexican manufacturing sectors have become tightly integrated in recent decades. One need not like the new equilibrium to which this integration has led our economies to recognize that ripping this integration apart could well impose new costs on American workers. Undoing a treaty like NAFTA, even if done intelligently with a progressive focus, would be

> challenging. Undoing it rashly, with a simple-minded aim of declaring victory over Mexico, will most certainly provide no help to American workers" (Bivens, 2017, p. 14).

Our objective here is to assess the proposals of the Trump administration for revising NAFTA, the responses of the Mexican government, and progressive alternatives to both. In our view, what is needed to make the process of North American integration work more in the interest of workers and average ("middle class") citizens in both countries goes beyond mere tweaks to NAFTA, and would require significant reorientations of macroeconomic, industrial, and labor market policies in both Mexico and the United States. In contrast to the nationalistic approach adopted by the Trump administration, we believe that there are positive changes to NAFTA that could be adopted in the renegotiation, and there is much more that could be done in terms of U.S. and Mexican economic policies if there is a constructive vision that seeks to foster upward economic convergence between the NAFTA countries.

Therefore, this paper will address what kind of economic policies are needed to achieve more inclusive and sustainable growth in both Mexico and the United States, given their current degree of integration and the changing character of global production and technology. Most importantly, we will seek to identify policies that can move the two neighbors back onto a trajectory of upward convergence, defined as one in which Mexico raises its per capita income and real wages toward U.S. levels that are also rising (and in which real wages increase in line with productivity growth in both countries). At the same time, we will identify changes to NAFTA's provisions on trade, investment, property rights, and labor standards that could contribute to our policy objectives. But first, we turn in the next section to a brief evaluation of what NAFTA has and has not accomplished.

Before proceeding, two caveats are in order. First, although we recognize that Canada is an integral part of NAFTA, our focus is on Mexican-U.S. economic integration and convergence, so we will discuss Canada only as necessary in relation to the NAFTA renegotiation. Second, although geographers may consider that North America includes Central America and the Caribbean islands, we will use the term North America to refer only to the three NAFTA members.

## 2. Has NAFTA been successful?

NAFTA appears to have been successful in its immediate objectives of promoting greater volumes of trade and flows of foreign investment. Regional trade increased sharply over the agreement's first two decades, from roughly $290 billion dollars in 1993 to more than $1.1 trillion in 2016. Inflows of foreign direct investment (FDI) into Mexico have also increased since NAFTA went into effect in 1994, from averaging 1.2% of Mexico's gross domestic price (GDP) in 1980-1993 to an average of 2.7% of GDP in 1994-2016.[1] During the same period, the U.S. FDI stock in Mexico increased from $15 billion dollars to more than $100 billion dollars (McBride & Aly, 2017). NAFTA has given Mexico preferential access to the world's largest consumer market in the United States, which helps to attract investment from other countries outside North America, although the degree of such preference has

[1] Authors' calculations based on data from World Bank, World Development Indicators [online database] http://data.worldbank.org/data-catalog/world-development-indicators [date of consultation: 16 June 2017] updated to 2016 using INEGI data for FDI and IMF/WEO data for Mexican GDP in dollars [date of consultation: April 7, 2017].

been eroded by U.S. trade agreements with other nations and the reductions in most-favored nation tariffs under the WTO.

However, recent research finds that only part of the post-NAFTA increase in intra-regional trade can be attributed to the causal impact of the tariff reductions in this trade agreement. Romalis (2007) estimated that the tariff reductions in NAFTA increased bilateral U.S.-Mexican trade by only 23%, while Caliendo and Parro (2015) – using a model that emphasizes trade in intermediate goods – estimated that the impact was to slightly more than double U.S.-Mexican trade.[2] These are not negligible increases, but they suggest that U.S.-Mexican trade has grown for many reasons besides NAFTA. In any event, bilateral Mexican-U.S. trade has clearly become very important for both countries: as of 2016, the Mexican economy was the third largest supplier of goods imports into the United States, and the second most important destination (after Canada) for U.S. exports, while the United States was by far Mexico's largest trading partner accounting for about 80% of its exports and 50% of its imports.

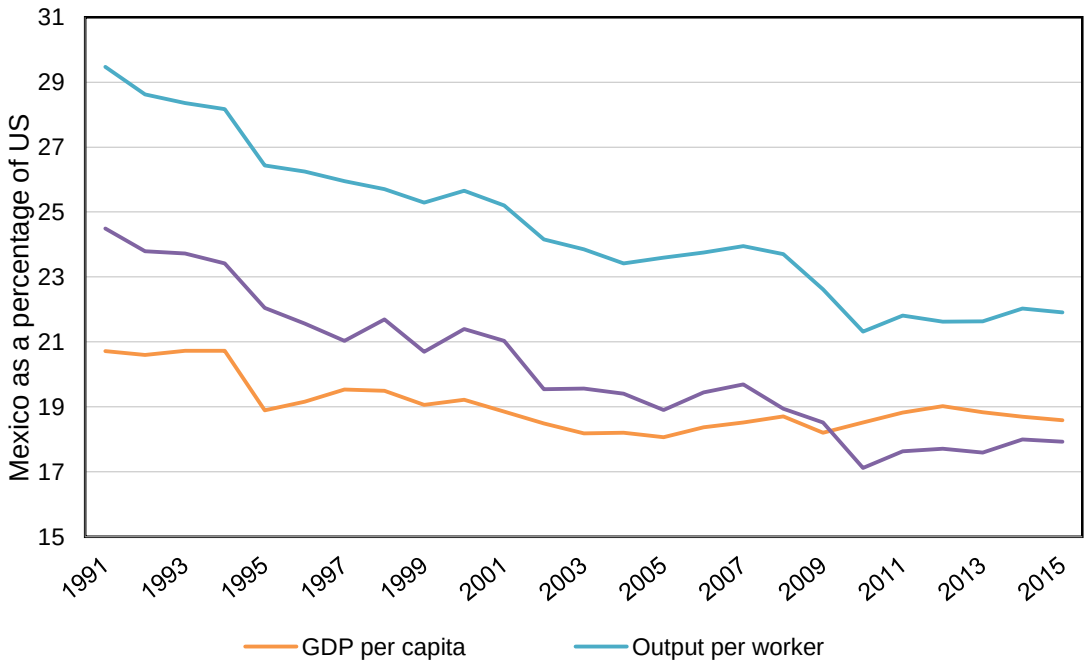
For Mexico, NAFTA represented the culminating phase of a process of neo-liberal reforms that began in the 1980s that led to trade and financial liberalization. NAFTA was an instrument designed to increase trade and FDI with North America. It was also seen as a legal constraint that would prevent any attempt by subsequent governments in Mexico to return to trade protectionism and excessive state intervention in the economy (the so-called "lock-in of reforms").

In spite of the increases in trade and FDI, however, the larger goals that the Mexican government proclaimed for NAFTA when it was adopted in 1994 have not been achieved. Contrary to the assertion by then-president Carlos Salinas de Gortari that NAFTA would transform Mexico into a "first-world country," there has been no convergence between Mexico and the United States in per capita income or labor productivity since NAFTA went into effect (see figure 2). Indeed, Mexico's NAFTA experience has suffered from a disconnect from the promises of some of its supporters that the pact would deliver rapid growth, raise wages, and reduce emigration. Between 1993 and 2013, Mexico's economy grew at an average rate of just 1.3% a year during a period when most of Latin America was undergoing a major expansion. In spite of the increase in FDI as a percentage of GDP, there is no evidence that the ratio of domestic investment to GDP has increased in Mexico in the post-NAFTA era.

Poverty in Mexico remains at about the same levels as in 1994. Also, the expected "wage convergence" between U.S. and Mexican wages never occurred. As figure 3 shows, as of 2016, real hourly compensation in Mexican manufacturing was still below its absolute level from 1994, while as of 2015 (the last year for which data are available) Mexican hourly compensation was also a lower percentage of the U.S. level than in 1994. Furthermore, Mexico's per capita income rose at an annual average rate of just 1.2% in the 1993-2013 period – far slower than in other Latin American countries such as Brazil, Chile, and Peru (McBride & Aly, 2017).

[2] Specifically, Caliendo and Parro (2015, Table 5, p. 23) report that NAFTA's tariff reductions increased Mexican imports from the United States by 118% and U.S imports from Mexico by 110%. Also, these academic studies refer to real increases in trade volumes (holding prices constant), while the raw data cited earlier are in current dollars and are not adjusted for price changes.

**Figure 2** GDP per capita and labor productivity in Mexico as a percentage of US, 1991-2015

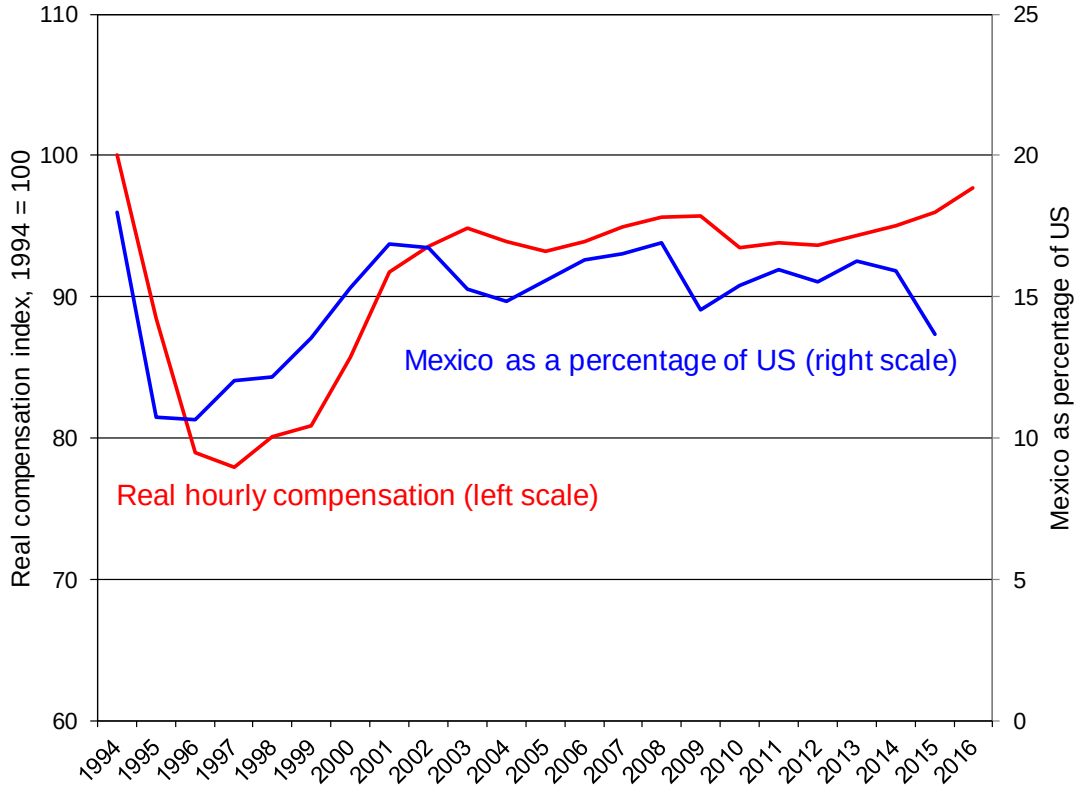



**Sources:** Data from World Bank, World Development Indicators, and OECD Statistics, accessed October 15, 2017, and authors' calculations.

This brings us to the great paradox about NAFTA and Mexico. On the one hand, NAFTA and related policies of trade liberalization and neo-liberal reforms adopted since the late 1980s have been an abject failure from a development standpoint: after three decades, these policies have never achieved the promised convergence to first-world (U.S.) levels of real wages or per capita incomes or any progress in that direction.

On the other hand, NAFTA (in combination with those same related policies) has locked Mexico onto a growth trajectory along which whatever growth does occur – however slow and inadequate – derives most of its momentum from the performance of exports, and hence is highly dependent on the growth of the U.S. market and other external factors (Blecker, 2009). As a result, any changes to NAFTA that would impede Mexican exports would undermine the chief dynamic factor in the Mexican economy, and a U.S. withdrawal from NAFTA or the imposition of higher tariffs and other trade barriers could be catastrophic in the short and medium term. Yet, the failure of the current development model implies that Mexico needs to re-think its economic strategy anyway, and ironically the threats from Trump could provide an opportunity to accelerate that re-thinking and shift Mexico's policy paradigm to a more development-oriented, less externally dependent, and more equitable and sustainable model.

**Figure 3** Hourly compensation of Mexican production workers, in real terms and as a percentage of the US, 1994–2016




**Sources:** Authors' calculations based on data from Banco de México, www.banxico.org.mx; INEGI, EMIM, www.inegi.org.mx/; BLS, International Labor Comparisons, www.bls.gov; accessed 26 June, 2017 and earlier; and Conference Board, https://www.conference-board.org/ilcprogram/, accessed 9 August, 2017.

## 3. Critical perspectives on the NAFTA renegotiation

Trump's attack on NAFTA as "the worst trade deal ever" (based on a zero-sum view of trade) poses a serious threat to the performance of the Mexican economy. In fact, his rhetoric alone has already wreaked havoc on the business climate in Mexico and reversed a number of foreign investment commitments there, even before he took office (for example, Ford cancelled plans for a new assembly plant in San Luis Potosí for $1.6 billion dollars, right after he threatened General Motors with a large border tax unless it moved production of the Chevy Cruze back to the United States). Indeed, a failed renegotiation and a U.S. withdrawal from NAFTA could push the Mexican economy into a recession. Mexican exports more than quadrupled since NAFTA went into effect; they accounted for 37.5% of Mexico's gross domestic product in 2015, and more than 80% of those exports go to the United States.

In its response to Trump's nationalistic posture on NAFTA, the main points presented by the Mexican government show a conciliatory posture in being willing to modernize NAFTA, while adopting a "win-win" vision of trade in the region, which considers the interests not just of one country but all three of them. The Mexican government has stated its willingness to update NAFTA by including economic activities that were not considered in the original negotiation (for example, electronic commerce and oil production, among others).

Also, the Mexican government wants to incorporate provisions to transform the energy sector, as long as they are consistent with the laws implemented by the energy reform of President Enrique Peña Nieto. Nevertheless, the Mexican government would be expected to defend Mexico's interests in the negotiation, as those are conceived by the Peña Nieto administration. In both Mexico and the United States, interest groups (above all the business sector or corporate lobbyists) are lining up to try to influence each administration's negotiating strategy, while critics (ranging from free traders to labor, environmental, and social activists) have issued varying opinions about what changes should or should not be adopted in a revised NAFTA.

Our objective here is not to immerse ourselves too deeply in the "weeds" of the NAFTA renegotiation, especially since we doubt in the likelihood of anything positive emerging from a renegotiation process spearheaded by Trump's trade officials (and it remains entirely possible that either Trump will scuttle the negotiations and withdraw the United States from NAFTA, or Mexico and Canada will find Trump's demands so unacceptable that they prefer not to reach a new agreement). Nevertheless, we believe that there are some changes to NAFTA that could truly help to promote upward convergence of living standards in Mexico and the United States, in combination with other types of policies discussed in later sections.

In order to assess the U.S. administration's approach, we will rely primarily on the "Summary of Objectives for the NAFTA Renegotiation" submitted by U.S. Trade Representative (USTR) Robert Lighthizer to the U.S. Congress, as required by law, on 17 July 2017. For the sake of brevity, this document will be referred to below as "the USTR Objectives". To address the Mexican government's position we will rely principally on the document sent by the Secretaría de Gobernación to the Mexican Congress on 26 July, 2017. In both cases, to analyze the Mexican and U.S. governments' positions on the renegotiation we will also rely on media reports about what is actually being discussed in the renegotiation process. Our purpose is not to give a comprehensive response to these objectives and discussions, but rather to analyze some key aspects of the proposed NAFTA revisions that relate to our own objectives for making North American integration work more in the interest of the majority of the population on both sides of the Río Grande (Río Bravo).

### *3.1 Rules of origin and national content requirements*

NAFTA's rules of origin (ROO) are the provisions that determine how much North American content a good has to contain in order to qualify for a NAFTA tariff preference (usually a zero tariff). The USTR Objectives call for the NAFTA renegotiation to "Update and strengthen the rules of origin, as necessary, to ensure that the benefits of NAFTA go to products genuinely made in the United States and North America", and to "Ensure the rules of origin incentivize the sourcing of goods and materials from the United States and North America". We will discuss strengthening the region-wide ROO first, followed by the proposal to enact new requirements for U.S. content within NAFTA.

In principle, strengthening the ROO for NAFTA as a bloc could potentially encourage the production of products with greater North American content, thereby supporting jobs in all three member countries. However, stronger ROO could also encourage "trade diversion" that can cause losses in consumer welfare by inducing regional production of goods that could be imported more cheaply from other countries. Nevertheless, carefully crafted ROO could be helpful in some industries, if formulated as part of a larger set of policies for promoting those

sectors. Indeed, the Mexican government has not rejected stronger ROO at the regional level, and private interests such as the Mexican textile, steel, automotive and auto parts, electronics and telecommunications sectors have also expressed support for tightening the ROO for North America as a whole in order to replace imports from Asia.

However, tougher ROO, even for North America as a whole, might not be effective. The potentially higher costs of compliance in combination with relatively small tariff preferences could drive producers to ignore NAFTA rules and import from other countries instead. This is what has occurred in the textile and apparel sector, which – in spite of very high ROO (triple transformation test) in NAFTA – has shrunk tremendously in all three member countries due cheaper imports from China and other lower-wage countries. The North American textile-and-apparel complex took a big hit in 2001, when China entered the WTO and obtained "permanent normal trade relations" status in the U.S. market, and again after 2005, when the Multifibre Arrangement (a system of global quotas) was abolished. This example illustrates that if the cost savings from producing outside North America are greater than the benefit of the tariff preference for producing within the region, the goods will not be produced in North America.

Furthermore, if stronger ROO lead to higher costs, they could make North American products less competitive on global markets, in which those products have to compete with goods from Asia, Europe, and other regions. For example, if the ROO are strengthened in the automotive sector, the auto companies would be likely to raise the prices of cars produced in the region as a result of being forced to source more of their parts and materials from Canada, Mexico, and the United States, thus reducing the competitiveness of North American cars (including U.S.-produced vehicles) in the global automotive market (or in relation to cars imported into North America from other countries, such as South Korea or Japan).

In addition – and this seems to be a major stumbling block in the current renegotiation process – the Trump administration is seeking U.S. content rules in addition to the regional ROO in NAFTA. Needless to say, such rules would be against the interests of Mexico (and Canada), since they could force some production to relocate (or return) to the United States, and indeed the Mexican negotiators (along with their Canadian counterparts) have rejected this demand. But what would be the effect of the U.S. content rules on U.S. producers?

To understand the likely consequences, it is useful to use the auto industry (one of the main sectors in which the USTR is proposing to tighten ROO and impose U.S. content rules) as an example. First, imposing U.S. content requirements would be hugely disruptive to the regional supply chains already established in the industry, including supply chains that furnish U.S. manufacturing plants with inputs. Second, such rules could make some inputs more expensive for the U.S. producers of finished cars, who would then have a harder time competing with imports from other countries (Japan, Korea, Germany). Third, such rules could lessen the economies of scale and scope achieved through the regional rationalization of the industry (currently, Mexico is specialized in small cars and labor-intensive auto parts, while the United States and Canada tend to produce luxury cars and larger vehicles such as SUVs and light trucks).

Fourth, any restored U.S. production of small cars and auto parts would likely involve much more automated technology than what similar production utilized in the past, so the jobs that would return would be far fewer in number than those that left. There would also be high fixed costs of relocating links in regional supply chains to domestic producers in each country, as

well as possibly significant variable costs of documenting national as well as regional content. Unless the United States were to revert to very high tariff levels for finished autos (which would be a WTO violation, but not inconceivable for the Trump administration), the intention to encourage greater U.S. content could well backfire as producers might choose to source more cars and auto parts from Asia or other global regions rather than try to produce them at higher cost in the United States merely in order to qualify for NAFTA tariff preferences. In the long run, a U.S. auto industry that has higher costs and less scale economies would be less competitive, thereby inviting imports from cheaper locations outside North America. In short, intra-NAFTA U.S. protectionism is not a recipe for success in the auto sector, and for similar reasons would not be in other industries as well. However, there are positive things the United States could do to make the United States economy more competitive, which will be discussed under industrial policies in section 5, below.

### *3.2 Labor provisions and minimum wages*

The USTR Objectives propose to "Bring the labor provisions into the core of the Agreement rather than in a side agreement," and "Require NAFTA countries to adopt and maintain in their laws and practices the internationally recognized core labor standards as recognized in the ILO Declaration..." The Mexican government has not objected to these stipulations, and indeed had agreed to similar provisions in the Trans-Pacific Partnership (TPP) before Trump withdrew the United States from that proposed agreement. However, the USTR Objectives also propose to "Require NAFTA countries to have laws governing acceptable conditions of work with respect to minimum wages, hours of work, and occupational safety and health," and Trump and other administration officials have spoken more bluntly about the need to increase wages in Mexico (and this is one of the few areas in which the Canadian government of Prime Minister Justin Trudeau has agreed with the Trump administration).

The Mexican government has rejected any negotiation over Mexican wages (minimum or otherwise) and labor laws as part of the NAFTA renegotiation – although it should be noted that Mexican governments since Salinas in the 1990s have accepted negotiations with the United States over property rights of investors and intellectual property protection even though they have resisted any negotiations over wages or working conditions. Civil society groups in Mexico perhaps have a more mixed reaction. On the one hand, Mexicans generally resent any U.S. efforts to dictate domestic policies, and U.S. pressure to raise wages is often seen as a thinly veiled effort to make Mexican industries less competitive. On the other hand, Mexicans are quite conscious that their wages have been stagnant in real terms since NAFTA went into effect, that their wages have lagged behind both productivity (especially in tradable goods industries) and rising wages in other emerging nations (for example, Korea and China), and that a falling labor share of national income is a contributing factor to high overall inequality in Mexico (Esquivel, 2015; Ibarra and Ros, 2017).

Perhaps the most principled response to this conundrum is to seek policy changes – either through the NAFTA renegotiation or in parallel with it – that could address wage stagnation and rising inequality in both Mexico and the United States, so that the onus not only placed on Mexico. In this respect, one area in which government policies can definitely make a difference is minimum wage legislation, which helps to set a floor below wages for less-skilled workers and (ideally) to prevent lower-paid workers from being in poverty.

In fact, the real value (purchasing power) of the legally mandated minimum wage has fallen dramatically in both countries in recent decades compared to earlier historical levels. In the

United States, the minimum wage provided an annual real income of only about $15,000 dollars in 2016, compared with an average of around $20,000 dollars in the late 1960s and early 1970s, both measured in constant 2015 dollar prices and assuming 2,080 hours of full-time work per year. This one-quarter cut in the real minimum wage occurred because legislated increases in the nominal minimum wage failed to keep pace with inflation. Moreover, this real decrease is even more shocking because it occurred during a period when U.S. labor productivity (output per hour) approximately doubled.[3] In Mexico, for which comparable data from the same source (the OECD's OECD.Stat) are available only starting in 1984, the real value of the minimum wage was cut by more than half, from an annual rate of about $4,000 dollars in 1984 to a mere $1,900 dollars in 2016, measured in constant 2015 dollars at 2015 dollar purchasing power parity (PPP) exchange rates. Mexico's average labor productivity (output per hour) grew by only 4% over that period, as rapid productivity growth in modern, large enterprises and export-oriented firms was offset by falling productivity in informal activity and services, but it was certainly not cut in half.[4] Hence, aside from not keeping up with inflation in nominal terms, minimum wages in real terms have not kept up with the average productivity of labor in both countries.

Moreover, the Mexican minimum wage provides an annual income equivalent to barely one-fifth (exactly 21%) of the poverty line for a family of four in Mexico and it is among the lowest minimum wages in Latin America (CONEVAL, 2017). Thus, even if two adult household members work full-time at the Mexican minimum wage, their family (assuming two children) would still be 57% below the poverty level. The U.S. minimum wage – in spite of being almost eight times higher than the Mexican minimum wage as of 2016 – still falls short of the U.S. poverty line for a single parent working full-time with two children, and is only barely above it for two full-time earners with two children (UC Davis Center for Poverty Research, 2016). Specific proposals for raising minimum wages in both countries are discussed in section 5, below.

Another labor-related proposal in the USTR Objectives is to "Establish rules that will ensure that NAFTA countries do not fail to effectively enforce their labor laws implementing internationally recognized core labor standards and acceptable conditions of work with respect to minimum wages, hours of work, and occupational safety and health laws through a sustained or recurring course of action in a matter affecting trade or investment between the parties". This is important because Mexico has very tough labor laws on the books, but is frequently accused of not enforcing them – especially in labor-intensive maquiladora industries. But labor standards are also under threat in the United States, given the push of the Trump administration toward deregulation of health and safety regulations and other protections for workers. Hence, a principled response to this initiative would be to endorse it, but to insist that it must be applied equally to all countries, and that the United States as well as Mexico must be held accountable for enforcing high labor standards (consistent with the ILO conventions and each country's own laws). In other words, the USTR is not wrong to

[3] Authors' calculations based on data from the Penn World Tables (PWT), version 9.0 http://www.rug.nl/ggdc/productivity/pwt/ [downloaded 4 April, 2017] (Feenstra, Inklaar and Timmer, 2015). We used the series for output-side real GDP at chained PPPs (in millions 2011 dollars) and average annual hours worked by persons engaged to compute output per hour worked. The exact hourly productivity numbers for the United States are 63.36 in 2014 versus 30.62 in 1970, measured in constant 2011 United States PPP dollars per hour. Note that 2014 is the last year available from this source.

[4] Using the same source and method as described in the previous note, we calculate that Mexican hourly labor productivity (measured in constant 2011 United States PPP dollars per hour) was 16.98 in 1984 and rose to 17.71 in 2014.

include this demand, but it should not be used as a protectionist measure against Mexico; rather, it should be used to leverage up the enforcement of workers' rights and labor standards in all NAFTA members.

### *3.3 Property rights and dispute settlement*

NAFTA contains several notable and controversial provisions regarding foreign investment, property rights, and dispute resolution. First, it requires Canada and Mexico to adopt U.S. levels of protection for intellectual property (copyrights, patents, among others) when these are higher than the other country's standards – although Mexico had already adopted higher intellectual property standards in advance of the NAFTA negotiations in the early 1990s (Shadlen, 2009). These strengthened intellectual property rules are a form of protectionism that makes many goods and services (for example, pharmaceuticals, software, and entertainment) more expensive for consumers while increasing corporate profit margins. This is contrary to the spirit of a free trade agreement, which should aim at making goods and services cheaper for consumers, and is especially problematic in Mexico given its emerging market status and lower level of per capita income. Indeed, overly strong intellectual property protection can be deleterious from a development perspective, as it can discourage domestic innovative efforts (which are essential for emerging countries to escape the "middle income trap" – see Lee, 2016). Extremely high levels of intellectual property protection (for example, very long time periods for patents and copyrights) do not make sense for a developing or emerging economy like Mexico, and have been adopted there under pressure from the United States as a condition for attracting foreign investment and securing a free trade agreement.

Second, NAFTA's chapter 11 famously prohibited "expropriation" of the property of foreign investors, a provision that has been interpreted broadly as referring not merely to the outright nationalization of foreign companies' assets, but also to the adoption of any types of regulations that might impinge on potential corporate profits even if those regulations serve a genuine public interest (for example, environmental laws). In this respect, chapter 11 created property rights that in many cases exceed those recognized in the laws of any member nation (including the United States). Third and most insidiously, the provision that has become known as "investor-state dispute settlement" (ISDS) allows foreign corporations to sue governments in special panels of "experts" (usually trade lawyers or officials favorable to corporate interests) appointed to enforce these broadly defined property "rights". Through this process, a foreign corporation can threaten federal, state or provincial, and local governments with costly lawsuits if they try to adopt regulations that might lessen a company's profits.

Fourth, chapter 19 of NAFTA allows national decisions about "trade remedies" or administered protection (for example, antidumping duties and safeguard tariffs) as well as alleged NAFTA violations to be appealed to tri-national dispute settlement panels, effectively taking such appeals out of national judicial systems. The USTR Objectives propose to eliminate the chapter 19 dispute settlement process entirely, which would effectively allow the United States to impose more administered protection on imports from Canada and Mexico (assuming that U.S. appeals courts would be less likely to overturn U.S. trade remedies than the NAFTA dispute resolution panels) – although of course, this would also allow Canada and Mexico to retaliate with more protection on imports from the United States. In related areas, it has been reported that the Trump negotiators are seeking to weaken or eliminate the exemption of NAFTA members from global U.S. safeguards and to institute new safeguard tariffs in cases of "surges" of imports from Canada or Mexico in certain product lines.

On a more positive note, the USTR Objectives call for reform of dispute settlement procedures under NAFTA by making any such proceedings more transparent and open to the public (although this call is ironic, given that the USTR Objectives propose to abolish the chapter 19 dispute settlement process). In a less positive spirit, the USTR Objectives propose to institute an asymmetrical regime for investor rights that would "Secure for U.S. investors in the NAFTA countries important rights consistent with U.S. legal principles and practice, while ensuring that NAFTA country investors in the United States are not accorded greater substantive rights than domestic investors". Such a shift would enable the United States to dictate protections for its investors in Canada and Mexico, while providing only national treatment for Canadian and Mexican investors in the United States. A much more sensible approach would be to offer national treatment for foreign investors in all three countries.

Unfortunately, the USTR Objectives propose to abolish the wrong dispute settlement mechanism. Eliminating the chapter 19 process under which a member country can appeal alleged violations of NAFTA's trade provisions or other trade rules would be a flat-out assault on the use of this process by Canada and Mexico to try to overturn various U.S. protectionist policies, such as the duties threatened or imposed on Canadian softwood lumber and Mexican tomatoes. To be sure, the USTR is right to propose that any dispute resolution panels within NAFTA should be more open and transparent. But the chapter 11 ISDS panels are far more objectionable than the chapter 19 trade dispute panels; the latter only need procedural reform and greater transparency (and a commitment of each country to honor their decisions), while the former should either be eliminated completely or have their powers drastically curtailed (and also be more transparent, if they are kept).

In contrast to chapter 19, very significant changes to NAFTA's chapter 11 are warranted. Property rights protection should be limited to national treatment under the laws of each country, while intellectual property laws should be allowed to vary (within some limits) in proportion to the development level of a country. Abolishing the ISDS panels altogether could help to restore a greater balance between the public interest and corporate greed in all three countries. Other proposals for reform of dispute settlement include the proposition that litigants should be required to pursue remedies in national courts first, and should only have recourse to trinational dispute settlement panels as a last resource – not as a first option or a means of circumventing national judicial systems (Shadlen, 2009); creating a more democratic appeals mechanism (for example, panels of appellate judges from the three countries, rather than trade "experts") could also help. Such adjustments to the property rights (intellectual and other) and dispute settlement mechanisms (especially ISDS) in NAFTA could go a long way to giving all three NAFTA members the "policy space" required to implement industrial, environmental, and social policies that are in the national interest of each country.

### *3.4 Trade balance objectives*

The USTR Objectives start with a declaration that the Trump administration seeks to "Improve the U.S. trade balance and reduce the trade deficit with the NAFTA countries". It is true that the U.S. trade deficit, which consists mainly of a deficit for manufactured goods, is symptomatic of the forces that have contributed to job losses in manufacturing and downward pressure on U.S. wages. However, a focus on bilateral trade deficit of the United States with Mexico (the United States actually had a surplus with Canada in 2016) in the NAFTA renegotiation would be mistaken for several reasons.

First, by far the largest bilateral trade deficit of the United States is with China, not Mexico. As of 2016, the U.S. deficit with China was about five times larger than the deficit with Mexico, whether measured in terms of goods only ($347 billion dollars compared with $71 billion) or goods and services ($309 billion versus $63 billion).[5] Therefore, even if one wanted to reduce bilateral U.S. trade deficits, the one with Mexico would be an odd place to start (especially given that Mexico buys far more U.S. exports than the much larger nation of China).[6]

Second, bilateral trade balances are clearly mismeasured and don't accurately reflect what is produced in the respective countries. On the one hand, U.S. exports to Canada and Mexico are exaggerated in the official U.S. statistics because these include "re-exports" of goods imported from other countries and transshipped to these neighboring nations; such re-exports are not U.S. products and don't create jobs in the United States (except possibly in transportation, and to the extent that some used goods are included in re-exports). Indeed, Mexico does not count such goods as imports from the United States – it reports them as coming from their countries of origin – which explains why Mexico's measure of its surplus with the United States is notably larger than the United States' measure of its deficit with Mexico (the U.S. data are much closer to the Mexican figures when they are adjusted to remove re-exports). On the other hand, all countries attribute their imports to the *immediate* country of origin, rather than the ultimate source of the value added included in those goods. Thus, for example, a television assembled in Mexico using components imported from South Korea and exported to the United States is counted as coming completely from Mexico; no adjustment is made for the imported Korean parts. As a result, the U.S. import statistics surely exaggerate the value added in imports from Mexico, many of which are assembled using large amounts of inputs imported from other countries.[7] Therefore, the officially reported bilateral U.S.-Mexican trade balance is surely mismeasured and a misleading guide to policy.

Third, and most importantly, what matters to U.S. industrial employment is the overall trade balance, not the bilateral balance with any particular trading partner. The overall U.S. trade balance depends heavily on macroeconomic factors such as the value of the dollar and U.S. growth relative to other countries. Hence, the fact that the United States has recovered more strongly from the 2008-2009 crisis than many other countries and that the dollar has strengthened in the last few years have contributed to the post-crisis rebound in the overall U.S. trade deficit.

Trade agreements – not only NAFTA, but also the WTO and many others – also matter insofar as they affect the structural parameters (for example, elasticities of import and export demand with respect to relative prices and incomes) that determine how such macro variables translate into flows of imports and exports (Blecker, 1992; 2000). To the extent that these agreements reduce U.S. tariffs and trade barriers and encourage U.S. companies to relocate offshore (for example, by liberalization of FDI flows), they can help to increase the U.S. trade deficit; to the extent that they open up foreign markets to U.S. exports, they help to reduce it.

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[5] Data from the United States Bureau of Economic Analysis, *U.S. International Trade by Selected Countries and Areas* [online: last updated June 2, 2017] www.bea.gov [October 13, 2017].
[6] In 2016, the United States exports of goods and services to Mexico totaled 262 billion of dollars, compared with 170 billion of dollars to China (ibid.).
[7] Of course, the United States-produced inputs that are imported into Mexico are counted as the United States exports to Mexico, and so help to reduce the United States deficit with Mexico even as officially measured.

It is likely that the encouragement that trade agreements (including NAFTA) have given to "offshoring" by U.S. companies has far outweighed the gains in U.S. exports. Nevertheless, the fact that U.S. exports have not responded more strongly to foreign market opening (via the WTO or other trade agreements) also depends on other factors such as the value of the dollar and various sorts of foreign interventions or violations (for example, China's exchange rate management in the early 2000s and its notorious lack of respect for intellectual property rights). In any case, the overall U.S. trade deficit would not be reduced if, say, the U.S. stopped importing so many automobiles from Mexico, but instead imported them from China – and if anything, the overall U.S. deficit might actually increase, since imports from China are likely to embody less U.S. content (capital equipment, intermediate goods, and raw materials) than imports from Mexico.

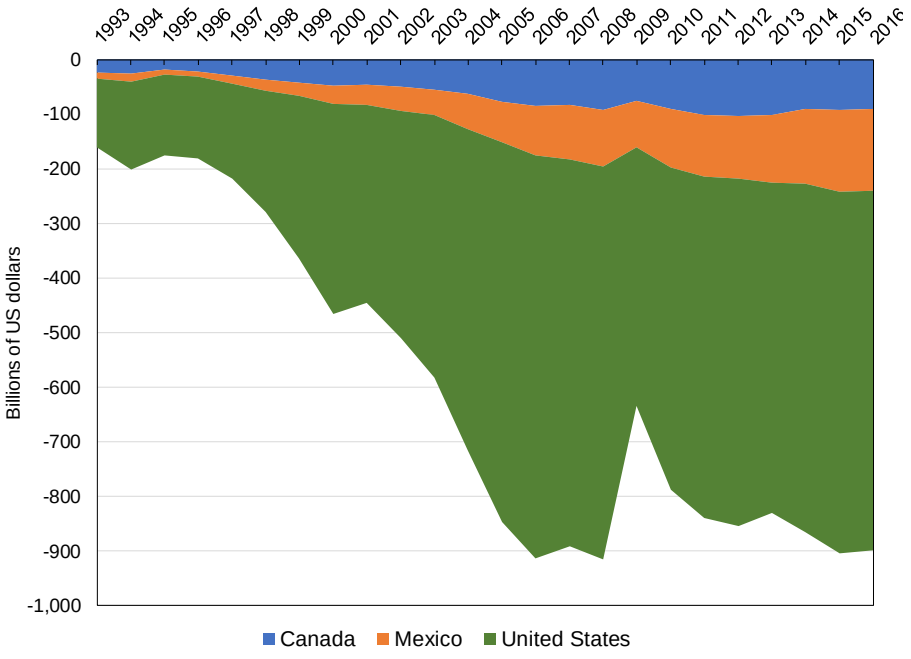
Furthermore, if one looks at the external trade balances of the three NAFTA members with the rest-of-the-world (that is, all countries except each other), one finds that North America as a whole is entirely a deficit region. The combined deficit of the three countries with non-NAFTA countries totaled over $900 billion dollars in 2016, as shown in figure 4. Indeed, Mexico's trade deficit with all other countries is larger than its surplus with the United States, implying an overall trade deficit for Mexico. In fact, Mexico has a net deficit in trade in manufactures, and its deficit with Asia (mainly China) and Europe more than outweighs its surplus with the United States (Moreno-Brid, 2013). If trade deficit is a problem in North America, this phenomenon is not confined to the U.S.-Mexican imbalance. Given how much the NAFTA economies have become integrated with each other via regional supply chains, it would make far more sense to address the root causes of the overall NAFTA deficit by transforming North America as a whole into a more competitive region. One place to begin is with exchange rates: the fact that all three countries have large external (non-NAFTA) trade deficit suggests that all three currencies (Mexican peso, Canadian dollar, U.S. dollar) are overvalued *vis-à-vis* the rest of the world. Exchange rate policy is addressed in the next section; other policy approaches for enhancing regional competitiveness are discussed below.

### *3.5 Currency manipulation and exchange rates*

As required by the Trade Promotion Authority granted by Congress to the President for negotiating all trade agreements, the USTR Objectives include a provision seeking to "ensure that the NAFTA countries avoid manipulating exchange rates in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage". In the NAFTA context, this stipulation makes little sense because all three members have flexible exchange rates rather than fixed or managed ones. Aside from the legal requirement, the USTR may have included this objective as a precedent for possible future trade negotiations, such as with Japan or other East Asian countries, but it has no relevance to Canada or Mexico today. It is also possible that the Trump administration wants to be able to claim that any depreciation of the Mexican peso or Canadian dollar constitutes "currency manipulation", even if it is market-driven.

However, there are two aspects of exchange rate policy that would make sense for the NAFTA renegotiation or future monetary policies to address. First, in order to keep the entire, integrated North American industrial complex competitive (and address the region-wide external deficit discussed above), it is vital that all three countries keep their exchange rates at competitive levels relative to external currencies such as the euro, yen, and yuan.

**Figure 4** Trade balances of NAFTA members with non-NAFTA countries, 1993–2016




**Source:** Authors' calculations based on data from IMF, *Direction of Trade Statistics*, http://www.imf.org/en/Data, accessed May 29, 2017.

All three North American currencies have gone through periods of being overvalued since the 1990s, and in each case the country's exports and manufacturing employment have suffered declines at that time (including both Mexico and the United States in the early 2000s – see Blecker, 2014). In this respect, it would it make sense to try to keep all three North American currencies (U.S. dollar, Canadian dollar, and Mexican peso) at competitive exchange rates *vis-à-vis* other global currencies (euro, pound, yuan, yen, among others), while maintaining a narrow range of fluctuations with each other in which none of the three currencies becomes over-or undervalued relative to the other two. This would require coordinating the monetary policies of the three NAFTA members by maintaining low, steady interest rates in order to keep all three currencies stable and externally competitive. It would be also helpful to allow Mexico to use capital controls to prevent large swings in the peso's exchange rate in response to capital flow volatility – something that NAFTA now prohibits, but could be amended to permit.

Second, a revised NAFTA could require the three members to work together when faced by currency manipulation (actively managed undervaluation) by *other* countries. In fact, all three NAFTA members have been strongly impacted by genuine currency manipulation when and where it has actually occurred, such as in China in the late 1990s and early 2000s. During the first decade of the 2000s, China greatly increased its share of the import markets in all three NAFTA countries and significantly displaced Mexican exports from the U.S. market, partly as a result of its artificially low exchange rate, with severe negative effects on industrial employment in the United States and export dynamism in Mexico (see Autor, Dorn and Gordon, 2016, on the United States, and Gallagher, Moreno-Brid and Porzecanski, 2008, on Mexico). Since the Chinese yuan has recently (since 2008) appreciated relative to both the dollar and the peso, Mexico has recovered some of its competitive advantages in the U.S.

market and its share of U.S. nonpetroleum imports has rebounded (Blecker, 2014). Therefore, the three countries should consider joint retaliation (such as tariffs justified by balance of payments deficits under the IMF Articles of Agreement) against non-NAFTA countries that actively undervalue currencies with managed exchange rates. But there seems to be little point in prohibiting the three NAFTA members from engaging in exchange rate practices that none of them actually follow.

Under the present policy regimes in both countries, such coordination of monetary policy is unlikely to materialize. The Mexican government is currently unwilling to negotiate any coordination of monetary policies between Mexico and other countries. Similarly, the U.S. Federal Reserve formulates its monetary policies only in regard to its dual objectives (low inflation and unemployment) for the U.S. economy. However, if the North American economies are ever to have a successful regional industrial development project, they will have to pay more attention to competitive exchange rates and be more willing to engage in trinational coordination of monetary policies than is possible under the current monetary policy regimes in the three countries. Indeed, to lower trade barriers both within North America and between the North American countries and the rest of the world, while allowing the North American currencies to become overvalued, as was done in the 1990s and early 2000s, is virtually a case of economic policy malpractice.

## 4. NAFTA and the Mexican economy's structural weaknesses

Trade liberalization and NAFTA helped to reshape Mexico's economic specialization model from an essentially oil-exporting economy in the early 1980s to rapidly become a major player in the world manufacturing market by the 1990s (Moreno-Brid and Ros, 2009). The impressive success in penetrating global and regional markets for manufactures was reflected in the change in the composition of exports. The export impulse has been accompanied by an increase in the technological sophistication of the manufactured goods that Mexico sells abroad. In fact, the percentage of high-technology exports[8] as a proportion of manufactured exports increased from 8% in 1990 to 15% by 2015 (World Bank, 2017).

In spite of that, the growth impact on the Mexican economy has not been what was expected because trade liberalization also induced a substantial increase of imports – especially of intermediate goods – which has limited the value added created by the export boom. The intense and sustained penetration of imports into the domestic market – especially the growth in imports of intermediate inputs for use in export production – has weakened the backward linkages of the export sector to the rest of the Mexican economy. The fact that value added in export production has lagged far behind the gross value of exports explains why booming manufacturing exports have not translated into more rapid growth of per capita income, formal-sector employment, or real wages. As manufactured exports are highly dependent on imported inputs, local content is relatively small and links with local suppliers are weak.

As a result of the increasing importance of imported inputs as well as the opening to imports of final (consumer and capital) goods, the long-run income elasticity of Mexico's import demand has increased significantly in the years since trade liberalization and NAFTA (Moreno-Brid, 1998, 1999, 2002; Pacheco-López, 2005; Blecker and Ibarra, 2013). In fact,

[8] According to the World Bank, high-technology exports are defined as products with high R&D intensity, such as in aerospace, computers, pharmaceuticals, scientific instruments, and electrical machinery.

these studies show that the increase in the income elasticity of Mexico's import demand has outweighed the increase in its export growth, resulting in a tighter balance-of-payments constraint on the country's growth in the post-liberalization, post-NAFTA period. Simply put, Mexico has to grow more slowly than in the past simply to prevent a rising trade deficit. As Ibarra and Blecker (2016) observe, Mexico was able to avoid significant balance-of-payments deficit in the period 2001-2012 only at the cost of extremely slow GDP growth (about 2% per year). Thus, trade liberalization (and associated macroeconomic reforms, such as inflation targeting) have failed to place Mexico on a sustained export-led growth path.

In this context, the adverse impact of Trump's protectionist policies is amplified due to various structural flaws in the Mexican economic development framework in place since the mid-1980s, flaws that have only deepened since then. The government's economic policy focused on boosting Mexico's economic growth by exporting to the U.S. market while neglecting the internal market has failed, altogether, to ensure high and sustained growth of GDP and employment. Also, this policy created deep dependencies between the Mexican and U.S. economies, in the context of NAFTA. For example, Blecker (2009) showed that the impact of the U.S. growth rate as well as the importance of the real value of the peso for determining Mexico's growth increased significantly after 1994. The risks and weaknesses of such dependencies have been dramatically revealed in the agenda of radical changes to previous trade, financial, and migration policies that the Trump administration is imposing.

There are two main types of factors that explain why Trump's attacks on NAFTA and Mexico pose such a serious threat to the Mexican economy. First, there are the structural factors that have conditioned the performance of the economy, including the adoption of an export-led growth strategy that is heavily dependent on the U.S. market. Especially, manufactured exports have become (along with FDI inflows) the main engine of growth, and these exports are strongly dependent on the dynamics of the U.S. economy. Second, there are important conjunctural factors: very slow economic growth, vast poverty and high inequality, rising inflation, and in 2017 the implementation of strict fiscal austerity with big cuts in public spending (mainly in public investment). Particularly worrying is the fact that now for seven straight years, public investment has been cut in real terms. In 2016, as a proportion of GDP it was below 4%, its lowest level since the 1930s. Such low levels of public investment impair Mexico's growth prospects as the (quantitative and qualitative) deficit in infrastructure widens and potential synergies with the private sector on investment projects remain unexploited (Moreno-Brid, Perez-Benitez, and Villarreal, 2016). Thus, the reduction of public investment is partly responsible for the fall in total investment and may even have had an adverse effect on private investment.

All of this has clearly affected the business climate in Mexico. Not only have the formation of fixed capital weakened and capital outflows increased, but also the exchange rate between the peso and the dollar has become very volatile, thereby clouding growth expectations and negatively affecting the dynamism and stability of the Mexican economy. Ironically, if the peso continues to depreciate, this could help to bolster Mexican exports if the Trump administration imposes new protectionist barriers (and the peso would likely fall even more, if the United States withdraws from NAFTA). However, a sharp depreciation of the peso would worsen other problems for Mexico, especially inflation – and a spike in inflation would surely induce a contractionary responses of a monetary policy focused on an inflation target. All of this would be occurring while productive activities are stuck on a very slow growth path – there is in fact continued economic deceleration. The labor market is deteriorating and both poverty as well as inequality remain at high levels (Esquivel, 2015).

In this scenario of decreasing economic activity, loss of stability of key macroeconomic variables, social upheaval, low government approval, and questioning of the policy regime by political representatives of business and labor sectors, Mexico now faces grave external threats from the Trump administration as it moves toward its own upcoming presidential election in July 2018.

## 5. The road ahead: towards a new agenda of development and shared prosperity

Mexico has an urgent need for a new development agenda based on strengthening the internal market (equality + structural transformation + fiscal reform). This is true and will remain true independently of any outcome of the NAFTA renegotiation. To the extent that the renegotiation is based on a Trumpian view of trade as a zero-sum game, the outcome will not favor Mexico's development prospects. If the spirit of the renegotiation is to enhance the competitiveness of the entire region and to promote Mexico's convergence (in income, earnings, among others), a revamped NAFTA could be a useful tool (not the fundamental one by any means) for improving Mexico's growth prospects.

The United States also needs a new policy regime to reverse rising inequality, secular stagnation, and regional divergences. The Trump negotiating agenda for NAFTA would do little if anything to achieve this. Protection could potentially benefit particular industries or areas, but would not reverse the national trends and could worsen competitiveness in other, unprotected sectors (and even some of the protected ones, such as automobiles, if their costs rise). However, a revised NAFTA that promotes industrial growth and competitiveness throughout North America could help the United States along with other measures. A progressive response to Trump must address concerns of U.S. workers over disappearing jobs and stagnant wages, or it will be a political non-starter. Raising incomes and wages in Mexico as well as legalizing undocumented immigrants and enabling them to obtain higher wages are win-win for U.S. and Mexican workers.

Mexico and Canada may stop negotiations if Trump keeps threatening a U.S. withdrawal, insists on national (U.S.) content regulations within NAFTA, or makes new outrageous attacks (for example more insulting tweets) against the other NAFTA members. However at a certain point Trump's "bluff" may have to be called. The bargaining leverage of Canada and Mexico is far from insignificant because: i) they are the two largest markets for U.S. exports; and ii) many states that were key to Trump's Electoral College victory have strong trade ties with Mexico, in agricultural or manufactured exports (for example, corn-exporting Iowa).

The Canadian and Mexican governments can't appear weak in the face of Trump's hostility. Peña Nieto cannot be seen to cave in to certain – for Mexico key – demands of Trump, but at the same time he must allow the U.S. team to earn some points. For the Mexican government to show weakness in the renegotiations would be much worse for the ruling Institutional Revolutionary Party (PRI, in its Spanish acronym) than allowing the United States to withdraw from NAFTA, as the former could guarantee a PRI defeat in the 2018 election and the possible victory of left-wing (Morena party) candidate Andrés Manuel López Obrador. If the terms of the renegotiation are not favorable for Mexico, the government knows that it would be better to abandon the agreement and allow the U.S.-Mexican trade relationship to be governed by WTO rules (see Mufson, 2017).

### *5.1 Globalization, jobs, and the new agenda*

The backlash against globalization and regional integration – which contributed strongly to the victories of Trump in the United States and Brexit in the United Kingdom – owes much to the impact that these processes have had on working-class citizens in those countries. Without question, opening to trade causes severe dislocations and losses of jobs and income, especially for less educated workers in affected industries and localities (see Trefler, 2004, on the impact of the Canada-U.S. Free Trade Agreement of 1989 on Canadian employment; Autor, Dorn and Gordon, 2016, on China's impact on the United States; and Hakobyan and McLaren, 2016, on NAFTA and the United States).

In the U.S. context, a debate has raged for more than two decades on how NAFTA (or trade with Mexico more generally) has affected employment, especially in manufacturing (the main sector producing tradable goods). Some estimates put U.S. job losses in manufacturing attributed to trade with Mexico as high as 650,000 (Scott, 2014, p. 438), while others claim that the number could be as low as 100,000 (Meltzer and Bahar, 2017). Sorting out which numbers are "right" would be beyond the scope of this paper, but we can note a few points. First, even the highest of these numbers represents only a small share of total U.S. employment, which reached 154 million in September 2017. However, the 650,000 number – if correct – would represent more than 10% of the 5 million decline in manufacturing jobs in the United States since the late 1990s. Second, regardless of whether the higher or lower estimates are correct, the relevant issue today is what would be the impact of higher U.S. trade barriers (for example, imposing U.S. content rules or higher tariffs within NAFTA, or a U.S. withdrawal from NAFTA) in the current economic environment. As the great economist Joan Robinson always emphasized, time is irreversible: new protectionist barriers would not return the U.S. industrial structure or level (and composition) of manufacturing employment to what they were in 1993 – and certainly not what they were in the pre-globalization era (1950s or 1960s). Given the tremendous changes in technology and the advent of global supply chains in the past few decades, the impact of such new protection is highly unpredictable, but it is unlikely to result in the return of anything close to the number of jobs that left (especially if we believe the higher estimates). Indeed, in the extreme event that the United States withdraws from NAFTA, while the effect could certainly be detrimental to North American integration (and possibly devastating to Mexico, at least in the short run), such a move could end up only accelerating the automation of manufacturing activities and the offshoring of jobs to other global regions such as East Asia.

In the past few decades, what has made the impact of globalization and regional trade agreements more painful than necessary is the fact that they have occurred in an environment in which adequate safety nets are not in place, full employment is not guaranteed, and the likely earnings from alternative employment (for example, in the service sector instead of manufacturing, especially informal activities in Mexico) are much lower than in the occupations lost due to trade or offshoring. Governments supporting trade agreements and integration projects have been reluctant to admit the severity of the potential adjustment costs, lest they lose support for their liberalization efforts – even though such efforts at denial are not only intellectually unjustified (even in theory, trade generally creates losers as well as winners), but also have often backfired politically (as in the success of the Trump and Brexit campaigns).

Moreover, all this is occurring in an era (since roughly the 1980s) when macroeconomic policies (especially monetary policy) have shifted in many countries (including Mexico and to

a lesser extent also the United States) toward a greater focus on price stability and balanced budgets than on full employment and economic growth. Mexican growth during the entire liberalization era (since the late 1980s) has been less than half as rapid as it was during the import substitution era (the decades from the 1940s to the 1970s), while U.S. employment growth has slowed down notably since the United States began to experience "secular stagnation" in the early 2000s (Blecker and Esquivel 2013; Blecker 2016).

Nevertheless, the renegotiation of NAFTA (or a possible U.S. withdrawal) paradoxically presents an opportunity for Mexico to diversify its exports to other countries and thus reduce its dependence on the U.S. market. This could help to reduce key vulnerabilities of the Mexican economy and should help to create a better business climate to boost investment in industrial development by strengthening the rule of law in Mexican institutions. In that sense, NAFTA was a key pillar: it was instrumental in transforming Mexico into an export platform to the United States, guaranteeing property rights of foreign investors in exchange for unrestricted access of Mexican exports to the U.S. market and "locking in" neoliberal market reforms through a trilateral agreement. Yet even when Mexican exports were soaring at two-digit annual rates of growth (in the 1990s), they failed to pull the rest of the Mexican economy onto a path of rapid growth, and now – ironically – it is the United States under Trump that is threatening to abandon the trilateral agreement that was supposed to guarantee the permanence of a neo-liberal policy regime in Mexico.

Thanks in part to the Great Recession/slow growth post-2008 and in part to Trump (and his threat to withdraw from NAFTA), today the external market has stalled as an engine of expansion for Mexico. There is thus an urgent need to implement a new agenda of development based on strengthening the domestic market, in the context of an open economy. The new agenda has three main priorities or lines of policies: i) income redistribution to tackle inequality; ii) structural transformation to, in particular, strengthen backward and forward linkages of the productive sector, and iii) much more active state intervention in the economy. In that sense, addressing industrial policies, financial policies, regional policies and public investment with the aim of strengthening backward and forward linkages of the productive sectors (including the export sector), promoting backward regions and boosting infrastructure are essential to transform the process of North American integration to one of "upward convergence" (defined as a process in which Mexico approaches U.S. levels of wages and per capita income, but with those levels continuing to rise in the United States and not being pulled down). The idea is not to disregard export capacities, but rather to supplement them with a strong impulse from the domestic market.

### *5.2 Tax policies for income redistribution*

For the United States, the best approach would be to restore high marginal tax rates on very high incomes and inherited wealth, which would help to reverse the heightened inequality that the United States has experienced since the 1980s (Piketty, 2014) at least in the post-tax distribution. Unfortunately, it is clear that this will not happen under the Trump administration. On the contrary, the administration's tax proposals instead seek lower taxes for the wealthy, abolition of the inheritance tax, and reductions in corporate tax rates (as well as deregulation) in order to "incentivize" investors. When Ronald Reagan tried such policies in the 1980s, he claimed that tax revenues would rise. Instead, tax revenues fell, the budget deficit increased, and workers suffered from an overvalued dollar and increased trade deficits. The big winners in relative terms were corporations and the rich, who benefited from dramatically reduced tax rates

(Stiglitz, 2017). It is also clear that tax policy should address a country's problems. The United States confronts widening income inequality. Nonetheless, what Trump administration has to offer is a tax plan that provides the overwhelming share of benefits not to the middle class – a large proportion of which may actually pay more taxes – but to America's millionaires and billionaires. Still, it is most unlikely that any of these individual or corporate tax cuts will do much to increase investment or employment.

In Mexico, inequality has also become a huge obstacle to economic growth. Moreover, it has reached such a level that it may start to threaten not only political stability but also social stability. In this regard, Mexico ranked 35th out of 35 OECD countries in terms of the tax-to-GDP ratio in 2015, with ratio of 17.4% compared with the OECD average of 34.3%.

The policy shift towards fiscal austerity in Mexico was further boosted by reforms implemented in the mid-1980s, which set low inflation and balanced budgets as macroeconomic guidelines, and pushed for a retrenchment of the public sector from the economic sphere and a commitment to trade and financial liberalization. Although there is much debate on the causes of Mexico's economic slowdown in the last three decades, an important element behind it is the weak performance of investment. The retrenchment of public investment was a by-product of the government's systematic push since the early 1980s to slash the fiscal deficit by cutting expenditures and to implement market reforms aimed at reducing the size of the public sector. The reduction of public investment was further accentuated by recurrent macroeconomic "stabilization" programs that targeted cuts in capital expenditures as the preferred tool for slashing the fiscal deficit when facing adverse external shocks through contractionary policies (see Moreno-Brid, Pérez-Benítez, and Villarreal, 2016).

Fiscal reform is urgently needed to bolster Mexican government tax revenue in a progressive way. This would allow funding for infrastructure investment and social expenditures, strengthen the state's capacity to implement countercyclical policies, and put in place a much more transparent and efficient system of public investment across the nation aligned with the priorities of the National Development Plan.

### *5.3 Infrastructure investment and industrial policies*

Both Mexico and the United States are notorious for having tremendous infrastructure "deficits" as a result of inadequate and declining public resources being invested in public capital in recent decades. A massive increase in infrastructure spending in both countries would boost demand and employment in the short run, while augmenting capacity and productivity in the long run. At least for the United States, a case can be made that it would be feasible to finance a significant part of the needed infrastructure expenditures through public sector borrowing at the federal level. Interest rates are at historical lows (and would stay there, if the Fed would abstain from unnecessary interest rate hikes), which means that the implied debt service would be easy to accommodate, and such expenditures should boost future incomes (via increased productive capacity and private sector productivity) so that such public investments would be partly self-financing in the long run (unlike tax cuts for the wealthy, which do nothing to expand productive capacity). Nevertheless, if one is concerned about increasing the U.S. budget deficit and federal government debt, then increased infrastructure spending could be paid for with the types of progressive tax changes advocated above. In any case, candidate Trump promised a large infrastructure program in 2016, but so far president Trump has not made any specific proposals for such a program; on the contrary

his administration's budget proposals actually call for cuts to infrastructure spending.

Deficit financing is more problematic in Mexico because of the country's long history of financial crises, which have often been associated with large public sector debt (especially when externally financed). Therefore, a fiscal reform of the type discussed above is essential to finance the urgently needed revival of public investment in Mexico.

In addition to infrastructure, both Mexico and the United States need to revive the use of industrial policies. NAFTA – assuming it remains in effect – prohibits the member countries from favoring nationally owned firms, except in certain areas such as national security and (although this could change in the renegotiation) energy. However, NAFTA does not prevent the member countries from engaging in many other types of industrial promotion policies, including support to research and development (R&D), scientific and technical education, and various kinds of incentives such as tax breaks or dedicated infrastructure.

Indeed, Mexico's success in building its emerging aerospace sector (largely in the state of Querétaro) stems from a tripartite alliance of government, academia, and the private sector (the latter led by the Canadian firm Bombardier), which includes a university that trains aerospace engineers. For the United States, its future success in manufacturing surely resides in high-tech fields such as biotechnology, renewable energy, and information technology, not in a return to coal mining, "smokestack" industries, or the "sweatshop" factories of the past. In this respect, the policies of the Trump administration are completely antithetical to improving U.S. competitiveness, given the administration's efforts to reduce funding for research, support for carbon fuel production (especially coal), and general hostility toward science and education (not to mention proposing to waste billions of dollars on an unnecessary and insulting border wall). But Mexico too has suffered setbacks in these areas, as budgetary restraints have impeded necessary investments in education, R&D, among others. If Mexico is going to escape from the trap of relying on low wages (relative to U.S. wages and relative to productivity) to be competitive in export markets, it too will have to upgrade its industries and – while some efforts in this direction have already begun – much more investment of public resources will be required.

One helpful measure for industrial policy and regional integration could be to strengthen the role of the North American Development Bank (NADB), which has been underfunded and limited in its scope since it was created in 1994. As one scholar of industrial policy has argued,

> "One of the main weaknesses of the NAFTA framework was its lack of regional development financing. The original [NADB] proposals called for a regional development bank that could address the asymmetries among the NAFTA countries and fund regional integration projects. The institution still exists, but its mandate has been significantly reduced. It should be revitalized and recapitalized... Part of its broadened mandate should include stimulating competitiveness in North American manufacturing through initiatives such as support for small- and medium-sized industries, financing of joint venture projects, financing technological transfer, export promotion, and expanding domestic markets, research and development, and innovation, as well as public infrastructure projects" (Dussel-Peters, 2009, p. 32).

### *5.4 Raising minimum wages*

One important way to pull up wages and living standards at the bottom end of the income scale – and to put upward pressure on median wages as well – is to raise the minimum wage. There have been campaigns to raise legal minimum wages in both Mexico and the United States in recent years. In the United States, the demand to raise the minimum wage to $15 dollars per hour from its current level of $7.25 dollars has become a key demand of the progressive movement since the Bernie Sanders campaign of 2016. In Mexico, a proposal made by some researchers of UNAM (Gobierno de la Ciudad de México, 2014) proposed to seek a broad national agreement to increase the minimum wage in 2015 and put it at $82.86 pesos per day, with the objective that a worker would receive the minimum welfare line (purchase the food basket). This would have represented an absolute increase of $15.57 pesos, or 23% initially. Such an increase would then be the beginning of a recovery trajectory would seek to achieve over time the constitutional mandate (the wellness line) of $171.03 pesos.

Recently, the Mexican government announced a raise of 10% on the minimum wage above inflation from $80.04 pesos to $88.36 (November, 2017). Nevertheless, the raise will be virtually cancelled by inflation. Currently, the CPI is growing at 7% on annual terms, with prices of staples increasing nearly 12%. It is projected that this year, 2017, real wages on average will suffer a contraction. This increase still leaves Mexican workers below the poverty line and it is a small step on the road that remains to be walked. Mexico is the country with the lowest minimum wage in the OECD, and one of the lowest in Latin America notwithstanding that its labour productivity is –with Chile's– among the highest in the sub-region (Moreno Brid and Garry, 2015).

It should be noted that, for decades, minimum wages in Mexico have not followed the evolution of productivity. If minimum wages had been linked to market conditions and the performance of workers' own efficiency, those salaries would have seen a path of increase, not of deterioration. In fact, the loss of the purchasing power of the minimum wage was 75% in 35 years of deterioration and stagnation (see Gobierno de la Ciudad de México, 2014). In addition, it should be stressed that the key indicators of the labor market of the International Labour Organization (ILO) reveal that, for more than 20 years, average labor productivity of Mexico – in constant dollars – has been and still is one of the highest in Latin America. In 2012 it was the second highest, only 3% lower than Chile's, and widely overtook Uruguay's (30%) and Brazil's (60%). Furthermore, labor productivity was more than double that of the average of the rest of the region (Moreno-Brid, Perez-Benitez, and Villarreal, 2016).

Increasing minimum wages in the context of a full commitment to give a more relevant role to the state in promoting a less unequal functional distribution of income is key to reducing the unacceptably high levels of inequality and poverty in Mexico. However, many Mexicans have been understandably reluctant to press for wage increases in response to the demands of the Trump administration, which seem aimed only at reducing Mexico's competitive advantages. Of course, minimum wages do not generally apply in most export industries, but by setting a floor under the entire wage structure, they can influence other wages as well. That is why it is also important to also raise the minimum wage in the United States at the same time as it is increased in Mexico, so that there is little or no net competitive impact and instead there is simply a redistribution of income toward lower-paid workers in both countries.

### *5.5 Strengthening coordination of macroeconomic and social policies*

To promote a new agenda of development in the United States and Mexico, what are most important are macro-level policies that can boost demand, augment supply capacity, and

ensure full employment. By "macro-level", we mean not only traditional fiscal and monetary policies, but also other types of measures that are economy-wide and can have a national impact on the bargaining power of workers in labor markets and competitiveness in external markets. And we do stress that increasing productive capacity is essential in order to prevent inflationary outcomes, which means that any fiscal stimulus should focus heavily on capacity-enhancing measures such as infrastructure, education, and innovation.

In regard to monetary policy, exchange rates have played an important part in the success, or lack of success, of exports in all three NAFTA members. At several key points in recent decades (such as 1990-1994 and again around 2000-2007), prolonged periods of currency overvaluation have impeded Mexico's export-led growth strategy, resulting in disappointing gains from the country's trade liberalization and economic integration policies. For Mexico, what matters is not only the exchange rate with the dollar, but also "cross-exchange rates" with "third countries" – especially the peso-yuan exchange rate with China. When the peso was overvalued and the yuan was undervalued in the early 2000s, Mexican exports were significantly displaced by Chinese exports in the U.S. market, and Mexico itself experienced significant penetration of Chinese imports (Gallagher, Moreno-Brid and Porzecanski, 2008; Blecker and Esquivel, 2013; Blecker, 2014).

Given that Mexico and the United States both have flexible exchange rates, they cannot directly determine the values of their currencies. However, there are policies that they can use to try to influence those values, policies that will vary depending on whether the other currency in question has a flexible exchange rate with liberalized financial flows (for example, the euro and United Kingdom pound) or a fixed or managed rate or one accompanied by capital controls (for example, the Chinese yuan, which is official flexible, but is still heavily managed, and Chinese capital flows are not fully liberalized). With respect to flexible rate currencies, the best policy is to maintain relatively low and steady interest rates, and not to raise them excessively in response to inflationary pressures (actual or perceived).

One suggestion is that the Banco de México should consider adopting something like the Fed's "dual mandate" of targeting both real activity (low unemployment or rapid growth) *and* stable, low inflation, instead of having only an inflation objective. More to the point, a monetary policy rule for Mexico could take the real value of the peso into account so that a real overvaluation would lead to a moderation of interest rates. Overall, some coordination of interest rate policy between the Fed, Banco de México, and Bank of Canada could go a long way toward keeping all three North American currencies at competitive levels, without going so far as to make the mistake of the euro zone and adopt a common currency at fixed and unchangeable nominal parities (see Blecker and Seccareccia, 2014).

As stated previously, redistributive policies have to be part of such a package, especially for solidifying the internal market and reducing dependence on exports in Mexico, but the strategy should not rely on redistribution alone. In the long run, it is solid and sustained growth that ultimately raises wages in step with productivity growth and – if Mexican productivity rises faster than U.S. productivity, as would be expected given Mexico's lower initial level of productivity – leads to upward convergence (as has been observed in other cases, such as South Korea and China). The best scenario should arise from conditions in which real wages can increase along with productivity and worsening inequality can be reversed.

For Mexico, we agree with the recommendations of the Grupo Nuevo Curso de Desarrollo of the National Autonomous University of Mexico (UNAM, in its Spanish acronym) (GNCD, 2017). In this spirit, we consider it an urgent priority to start a process of frank discussion and reflection, inclusive and democratic, leading to the creation of a national consensus and a pact prioritized on the following twin objectives:

> "To address both the conjunctural challenge posed by the external shock and the structural challenges imposed by our development framework requires undertaking policy actions with two different time horizons. The first is an emergency response that reduces risks and negative impacts for the most vulnerable populations in the country following the announced protectionist actions, investment diversions, and migrant restrictions [of the Trump administration]. The second and more far-reaching is to promptly build a political consensus to launch a new development agenda in which equality and the strengthening of the internal market hold the highest priority." (GNCD, 2017, authors' translation)

In this endeavor, placing inequality at the center of economic policy concerns is a central requirement for Mexico, as is to successfully tackle Donald Trump's threats, in order to escape the slow-growth trap in which Mexico is currently stuck, thereby reducing social vulnerabilities and political instability in the long term. At the same time, we hope that the United States will reverse the trend toward nationalism, xenophobia, and isolationism that has emerged under the Trump administration, and will turn instead to a more cooperative approach to fostering upward convergence of Mexico within North America as well as a return to more progressive (Esquivel, 2014) and economic policies at home. In all of this, the renegotiation of NAFTA can play at most a small part, if it is done with a cooperative, win-win spirit; whereas a nationalistic rewrite of NAFTA or a hasty U.S. withdrawal from it would only complicate the task of making North American integration work more in the interest of average U.S. and Mexican citizens.

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