NAFTA: Neither Villain Nor Saviour

by Roberta L. Cook

General Background

The Clinton administration recently released its official three-year assessment of NAFTA focusing on the U.S.-Mexico trading relationship. According to the Associated Press, the highlighted conclusions of the 100-plus page study are no surprise: The U.S. share of Mexico's total imports has risen to a sizable seventy-six percent, up from a seventy percent share prior to NAFTA. Trade is more vibrant than ever. Mexico is increasing its investment in environmental protection and restoration.

Similar conclusions were drawn by the State of California's NAFTA assessment earlier this year. Since the trade agreement took effect in January 1994, California exports to Mexico have grown by $2.6 billion, reaching $9.1 billion in 1996. California is now responsible for sixteen percent of all U.S. exports to Mexico.

Yet critics cite Labor Department reports that 7,211 California workers at seventy-one companies allegedly have lost their jobs due to free trade with Mexico. Nevertheless, the Department of Commerce asserts that thousands of job gains have also occurred. Recent research published by the North American Integration and Development Center at UCLA indicates that, to date, NAFTA's net effect on jobs has been almost nil, although slightly positive.


SoftKey International Inc.

When all the emotion is removed from the NAFTA debate, the result is clear: There has not been a "giant sucking sound" of American jobs drawn to Mexico (as Ross Perot predicted) or major job creation in the U.S. (as many proponents of NAFTA predicted). In the third year of NAFTA's implementation Mexico remains the U.S.'s third largest trading partner, just as it was prior to NAFTA.

However, Mexico has been gaining ground relative to Japan, our second largest trading partner. In the first four months of 1997 U.S. exports to Mexico equaled exports to Japan despite Japan's economy being twelve times larger than Mexico's. Our geographic proximity to Mexico's burgeoning population, already at ninety million, bodes well for the future of U.S.-Mexico trade.

NAFTA Is Only Part of the Picture

It is important to understand that NAFTA is only one of many factors affecting trade flows within the North American region. Before attributing most of the recent changes in U.S.-Mexico trade flows directly to policy changes implemented under NAFTA, it is helpful to consider other factors and understand a few specifics.

U.S. Tariff Protection Was Already Minimal Prior to NAFTA

A major thrust of NAFTA is simply the eventual elimination of tariff and most non-tariff barriers (NTBs) such as quotas, licenses, and scientifically unfounded phytosanitary restrictions. Yet in general, U.S. tariffs and NTBs were already low before the agreement was signed. U.S. tariffs averaged only 2.07% on Mexican goods before NAFTA was implemented, while Mexico applied tariffs on U.S. goods at a rate averaging ten percent. Under NAFTA, Mexico has reduced its tariffs on U.S. goods by 7.1 percentage points to an average rate of 2.9%, while the U.S. reduction has been only 1.4 percentage points down to 0.65%. Mexico also continues to dismantle many significant NTBs benefiting U.S. exporters. Hence, the U.S. has received greater benefits from tariff and NTB reduction under NAFTA than has Mexico.

Tariffs on the most import-sensitive items (both for Mexico and the U.S.) are being reduced gradually, with phaseout schedules varying from five to ten, and in some cases, up to fifteen years. A few sensitive commodities also continue to receive protection from tariff rate quotas (TRQs). TRQs require reversion to the pre-NAFTA tariff once seasonal/annual imports exceed a specified quota. In other words, for commodities covered by TRQs, the benefits of tariff reduction may be received by only a portion of total imports. All TRQs, as well as tariffs on those products with fifteen year phaseouts, will eventually be eliminated by the year 2009. Clearly the effects of tariff reduction on many sensitive goods are yet to come.

To Date, the Devaluation and Mexican Economic Crisis Outweigh NAFTA

At least so far, the devaluation of the Mexican *peso* relative to the dollar in December 1994 and Mexico's subsequent economic crisis have had a far greater influence on trade flows than has NAFTA. Prior to the devaluation the *peso* was substantially overvalued relative to the dollar, stimulating an artificially high level of import demand. Not surprisingly this level of Mexican import demand for many U.S. commodities could not be sustained under more realistic terms of trade.

Conversely, the devaluation greatly increased the competitiveness of Mexican export-quality goods and created record levels of exports. Mexican exports to the U.S. were further stimulated by a robust U.S. economy with strong import demand.

"La Crisis" and Recovery

The Mexican government moved swiftly in the aftermath of the devaluation to impose an economic austerity program designed to reduce the deficit in the current account (which had precipitated the devaluation), stabilize financial markets, and restore growth and investor confidence. As expected, Mexico experienced a major contraction in domestic demand, with real gross domestic product declining by over six percent in 1995. With an economic crisis of this magnitude taking place in the second year of NAFTA's implementation, it is clearly inappropriate to attribute changes in trade flows solely, or even primarily, to NAFTA.

The good news for both the Mexican population and U.S. exporters is that the economic recovery program is working and the Mexican economy is now estimated to be growing at about a six percent annual rate. Investors are regaining confidence in Mexico, as evidenced by the expected return of foreign investment levels this year to the pre-devaluation level.

Furthermore, in 1996 the U.S. regained its traditional agricultural trade surplus with Mexico, temporarily lost in 1995 after the devaluation (see accompanying table). In 1996 the U.S. imported about $3.8 billion dollars worth of food and agricultural products of all types from Mexico, over half of which were horticultural commodities. The U.S. sent $5.3 billion dollars worth of food and agricultural products to Mexico in the same year, over half of which were high-value products including processed foods.

However, as always weather will continue to be a major factor affecting trade flows for agricultural commodities independent of NAFTA. We should still expect significant variation in seasonal/annual trade flows on a commodity-by-commodity basis depending on crop yields and international prices. Agricultural producers can never afford to take any market for granted.

TOTAL U.S.-MEXICO BILATERAL FOOD AND AG TRADE[1]
(in constant 1995 dollars)

Year	U.S. Exports to Mexico	U.S. Imports from Mexico
1990	2,978,536,560	3,448,603,612
1991	3,380,165,296	3,201,885,839
1992	4,147,773,873	2,949,954,790
1993	3,877,098,079	3,278,925,488
1994	4,746,423,615	3,446,555,194
1995	3,500,391,097	4,407,869,349
1996	5,271,068,091	3,862,625,236

[1]Includes crops, livestock, seafood, flowers, processed food, and beverages

Source: U.S. Customs, NAID Center, UCLA

Some Specific Implications for U.S. and California Horticulture

Competitive relationships are always very dynamic but they become even more so as markets integrate internationally and trade is allowed to flow unimpaired or less impaired by tariff and non-tariff barriers. Technological change, as well as changes in wholesale/retail or consumer demand and preferences, can have sudden and important effects on trade flows. The U.S.-Mexico fruit and vegetable trading relationship is a case in point.

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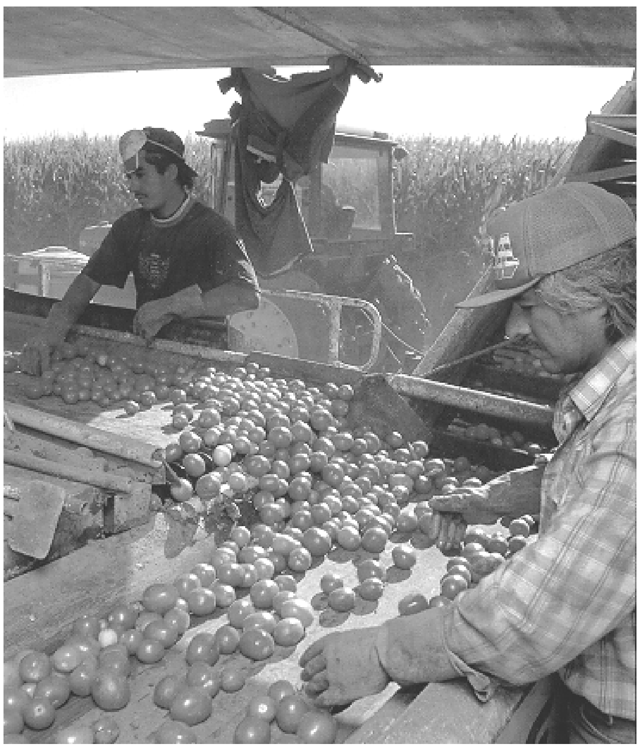
On the Import Competition Side

Mexico's fruit and vegetable exports to the U.S. increased in value by twenty-eight percent between 1993 and 1995 despite average tariff reduction of only 2.8% over approximately the same period (1993-96) as provided for under NAFTA. Much of the expansion in exports has come in crops produced during the winter season in Sinaloa, competing with Florida rather than with California.

This growth in exports is in large part due to the adoption by Mexican growers of new technology for producing vegetables, such as tomatoes and colored bell peppers, rather than being a direct effect of NAFTA. For example, Mexican fresh-market tomato exporters have adopted new extended shelf-life varieties of vine-ripe tomatoes with improved yields and physical attributes. These have been well-received in the U.S. market, capturing market share away from U.S.-grown mature green tomatoes. The Mexican horticultural export industry had embarked on a process of technological change prior to NAFTA and this ongoing process will likely extend to more crops and regions as we enter the next century.



California Agriculture

Mexican exports to the U.S. were also stimulated by the contraction in domestic demand during the recession. Some fresh produce crops are dual-market and exporters can ship either to the national market or to the U.S. depending on relative prices. This is especially true for fresh-market tomatoes, Mexico's number two agricultural export. Actually, since sixty to seventy percent of the production and marketing costs of many vegetable export crops are in dollar-denominated terms, they did not receive the full benefit of the devaluation. Increased exports to the U.S. likely have been stimulated just as much by plummeting demand in Mexico as by the cost advantages received by the devaluation.

Over the longer run, Mexico's ability to increase exports to the U.S. partly depends on its ability to attract foreign investment. Mexico's track record for attracting foreign investment to the agricultural sector is less than impressive. According to SECOFI, the Mexican Ministry of Commerce and Industry, during the 1994-96 period cumulative direct foreign investment in the agricultural and livestock sectors totaled only $11.2 million including under $8 million invested in the horticultural sector.

While these figures exclude investments in joint ventures of the type normally involved in financing fresh produce export deals, they nevertheless highlight the challenge faced by Mexico in modernizing its agriculture. Mexico also still has important legal barriers to large-scale farming with even greater barriers directed at foreign investors. These generate uncertainty, increase transaction costs, and reduce the attractiveness to foreigners of investing in the long-term future of the Mexican horticultural sector.

In contrast, the U.S. horticultural sector has many advantages relative to Mexico that help it to retain its competitiveness for most products. Despite the recent growth in Mexican horticultural exports to the U.S., they are still equivalent to under ten percent of U.S. horticultural production. U.S. advantages relative to Mexico include: Technology; capital; transportation; post-harvest handling facilities and other forms of infrastructure; efficient marketing channels and marketing acumen; marketing institutions including PACA and mandated-marketing programs; and the research and extension support of the land-grant university system. U.S., especially California producers, substitute capital and technology for labor, enabling them to compete in a relatively labor-intensive sector.

On the Export Side

On the other side of the equation, the market potential for California horticultural exports to Mexico was temporarily reduced by the *peso* devaluation. Mexican demand for stone fruit, grapes, tomatoes, and other fresh produce imports from the U.S. dropped by forty-nine percent in 1995 despite continued tariff and NTB reduction under NAFTA. This was predictable

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WINE GRAPES - *continued from page 8*

A federal law, the Organic Foods Production Act, was passed in 1993 but still has not been implemented or enforced. Once it is in place it will override any state laws and will be administered by USDA. The federal law will require that all growers with over $5,000 dollars in annual sales be certified by an accredited agency.

Organic Production Versus Organic Processing

California follows the standards and guidelines of the COFA to regulate processing of organic products including organic wine. Organic wines currently represent only a very small segment of the total wine market. At issue in the winemaking process are naturally occurring *versus* added sulfites. Although sulfites are naturally produced at extremely low levels during wine fermentation, they are normally added during wine processing to decrease the risk of oxidation and microbial spoilage. Under the COFA sulfite additives are prohibited in organic wine production. Therefore, wines with added sulfites may not be labeled as organic regardless of whether or not the wine grapes used in processing were organically grown. However, these wines may be labeled as produced from organically grown wine grapes. When no sulfites are added wine can be labeled as organic provided all regulations governing organic commodities are met and that organically grown wine grapes are used.

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given the jump in the cost of imported U.S. fruits in *peso*-denominated terms.

Nevertheless, consumer demand is slowly beginning to recover and the rapid development of the supermarket industry in Mexico favors imports. Large Mexican retailers increasingly require imports to meet the growing demand for year-round availability of consistent quality fresh produce. Fortunately most California industries made a concerted effort to maintain ties with Mexican importers and retailers during the economic crisis. In the long run this good will should pay off for our exporters as the standard of living increases and Mexican consumers improve the quality of their diets, in part through greater consumption of imported fresh produce.

To Summarize

When considering the relative competitiveness of the Mexican and U.S. horticultural sectors, one can summarize as follows:

- So far the effects of the *peso* devaluation have been much more important than NAFTA in influencing trade flows.
- The devaluation has been more important in influencing short term trade flows than in fundamentally changing the relative competitiveness of the fruit and vegetable sectors.
- The U.S., Mexican, and Canadian fruit and vegetable industries are gradually evolving toward an integrated North American horticultural sector, simultaneously raising the performance standards for firms in all three countries.
- This integration is being driven by retail and food service demand for year-round supply of consistent quantities and qualities of fresh produce.

NAFTA Produces Other Benefits

Analysts should not lose sight of a less direct but nevertheless highly significant benefit of NAFTA. NAFTA (in conjunction with Mexico's 1986 entry into the GATT and later entrance into the OECD) has institutionalized many of the market reforms introduced over the last decade. Despite Mexico's recent economic crisis, Mexico has remained on the path of trade liberalization, not closing its borders as it did during the economic crisis in the early 1980s. Indeed, U.S. exports to Mexico have already rebounded to pre-NAFTA levels.

Conclusions

Mexico is likely to remain a major importer of U.S. processed food products and basic agricultural commodities. Major annual variation in U.S. exports of field corn, wheat, dry beans, and other basic commodities can be expected depending on annual weather conditions. Mexico's agricultural exports to the U.S. will remain dominated by horticultural products.

Trade liberalization, in conjunction with Mexico's geographic proximity to the U.S. and its expanding population of ninety million, insure that the long-standing U.S.-Mexico trading relationship will continue to grow.

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