



The Stock Exchange, Mexico City.
(Photo by Marco Guzmán, Jr.)

TRADE

The Nafta Paradox

by Harley Shaiken

The North American Free Trade Agreement (Nafta) “ignited an explosion in cross-border economic activity,” wrote former U.S. Trade Representative Carla A. Hills in the January 2014 issue of *Foreign Affairs* magazine, reflecting on the 20th anniversary of the agreement. Nafta was truly historic. It was the first regional trade agreement to link economies at such sharply different levels of development as Mexico on the one hand and the United States and Canada on the other. The agreement provoked a highly contentious public debate in the United States — the sharpest trade debate since World War II — centered around globalization in general and the economic relationship between the United States and Mexico in particular. The debate went far beyond trade experts and high-powered lobbyists in Washington and spilled over onto Main Street in union halls, environmental groups, community meetings, and small business associations.

As the agreement headed to a vote in the U.S. Congress in November 1993, proponents sought to define the choice as a vote for free trade or protectionism. They argued that lowering trade barriers and guaranteeing investment would supercharge trade and, as a result, economic growth, new jobs, environmental protection, and other benefits would automatically follow in its wake. Critics argued that the choice was not between free trade and protectionism but rather between trade whose benefits would largely flow to the top versus trade whose gains would be shared more widely. They accepted the notion that growing trade could bring strong benefits but warned that effective labor and environmental provisions were essential to translate expanded trade into a broadly shared, sustainable prosperity. The key to integrating three very disparate economies was defining the rules of the game. Trade among complex economies is inherently managed trade — the final Nafta agreement approaches 1,200 pages of highly technical language — so the real question became: what was being managed and with what goals in mind?

What then has happened after 20 years under Nafta? The agreement encompasses many areas, from agriculture to banking, from safeguarding intellectual property rights to resolving investment disputes. The most profound

changes took place in manufacturing trade between Mexico and the United States — Canada and the U.S. had already adopted a free trade agreement in 1987 — so the economic integration of these two neighbors will be the focus of this article. I plan to explore three broad areas: first, the character of the trade underlying Nafta’s widely hailed, supercharged growth; second, the troubling paradox at the heart of the agreement: rising productivity and falling wages; and, finally, what the agreement looks like on the ground as seen through the transformation of automobile production, a flagship industry throughout North America.

A Spectacular Rise in Trade

Carla Hills was certainly right about the explosion in cross-border economic activity. Total merchandise trade between the United States and Mexico increased almost sixfold after the passage of Nafta, from \$80 billion in 1993 to \$459 billion in 2013, a far steeper and faster rise than either proponents or critics predicted when the treaty was being debated.

While expanded trade can provide considerable benefits, a closer look at these numbers reveals a more complex, troubling picture. “Viewed exclusively as a trade deal, Nafta has been an undeniable success story for Mexico, ushering in a dramatic surge in exports,” wrote Jorge Castañeda in the same January 2014 issue of *Foreign Affairs* as Carla Hills. Castañeda, a critic of Nafta during the trade debate and Mexico’s Foreign Minister from 2000 to 2003, then added “But if the purpose of the agreement was to spur economic growth, create jobs, boost productivity, lift wages, and discourage emigration, then the results have been less clear-cut.”

The key issue isn’t simply the growth in trade — important as it is for all three countries involved — but more importantly the character of that trade. Consider the unbalanced trading relationship. At the time of the debate, President Bill Clinton projected an “export boom to Mexico” that would generate 200,000 jobs as early as 1995 and one million jobs in five years. A study by Gary Hufbauer and Jeffrey Schott, two noted proponents of the agreement at the Institute for International Economics, predicted a “U.S. trade surplus with Mexico of about

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\$7 billion to \$9 billion annually by 1995, rising to \$9 billion to \$12 billion between the years 2000 and 2010.”

The actual results have been very different. U.S. trade with Mexico went from a slight surplus in 1994 to an almost \$100 billion deficit in 2013. The Economic Policy Institute estimates that 700,000 U.S. workers were displaced as a result of U.S.-Mexico trade under Nafta. To put this number in context, this displacement approaches total current domestic employment in the U.S. auto industry.

While Mexico has a large trade surplus with the United States, it has a growing trade deficit with China. Mexico’s trade with China went from barely registering — Mexico didn’t even publish the data separately in 1990 — to taking off in the new millennium. In fact, China emerged as the second-largest trading partner of both the United States and Mexico by 2009. China’s exports to Mexico totaled \$56.9 billion in 2012, while its imports from Mexico were \$5.7 billion, leaving Mexico with a \$51.2 billion trade deficit with China, or more than half Mexico’s trade surplus with the United States.

Trade under Nafta is not simply Mexican consumers buying U.S. goods or the other way around. Rather, Mexican plants import parts, assemble them, and export

them for sale, largely to the United States. One might call these imports, whether from the United States or China, “industrial tourists” since they stay in Mexico only long enough to become cars, televisions, and other goods that are then bought by U.S. consumers. Mexicans may handle these imports on assembly lines, but they don’t purchase them in stores. Products made from these temporary imports accounted for an average of 72 percent of Mexico’s manufacturing exports between 1993 and 2010, a high concentration by global standards.

Nonetheless, sharply expanded trade has brought benefits to Mexico, although it has hardly been the “undeniable success story” that some herald. Mexico has gained much-needed jobs, access to advanced production technology, and new ways of organizing work. However, only 3 percent of border plant exports are sourced domestically, and a mere 0.4 percent of gross domestic product (GDP) is invested in research and development. Moreover, low wages diminish purchasing power, limit the domestic market, and slow Mexico’s potential growth. Carol Wise points out that Mexico’s per capita income remains mired at “about one-third that of the wealthier countries in the OECD [Organization for Economic Cooperation and Development].”

President Clinton signs legislation implementing the North American Free Trade Agreement on December 8, 1993.

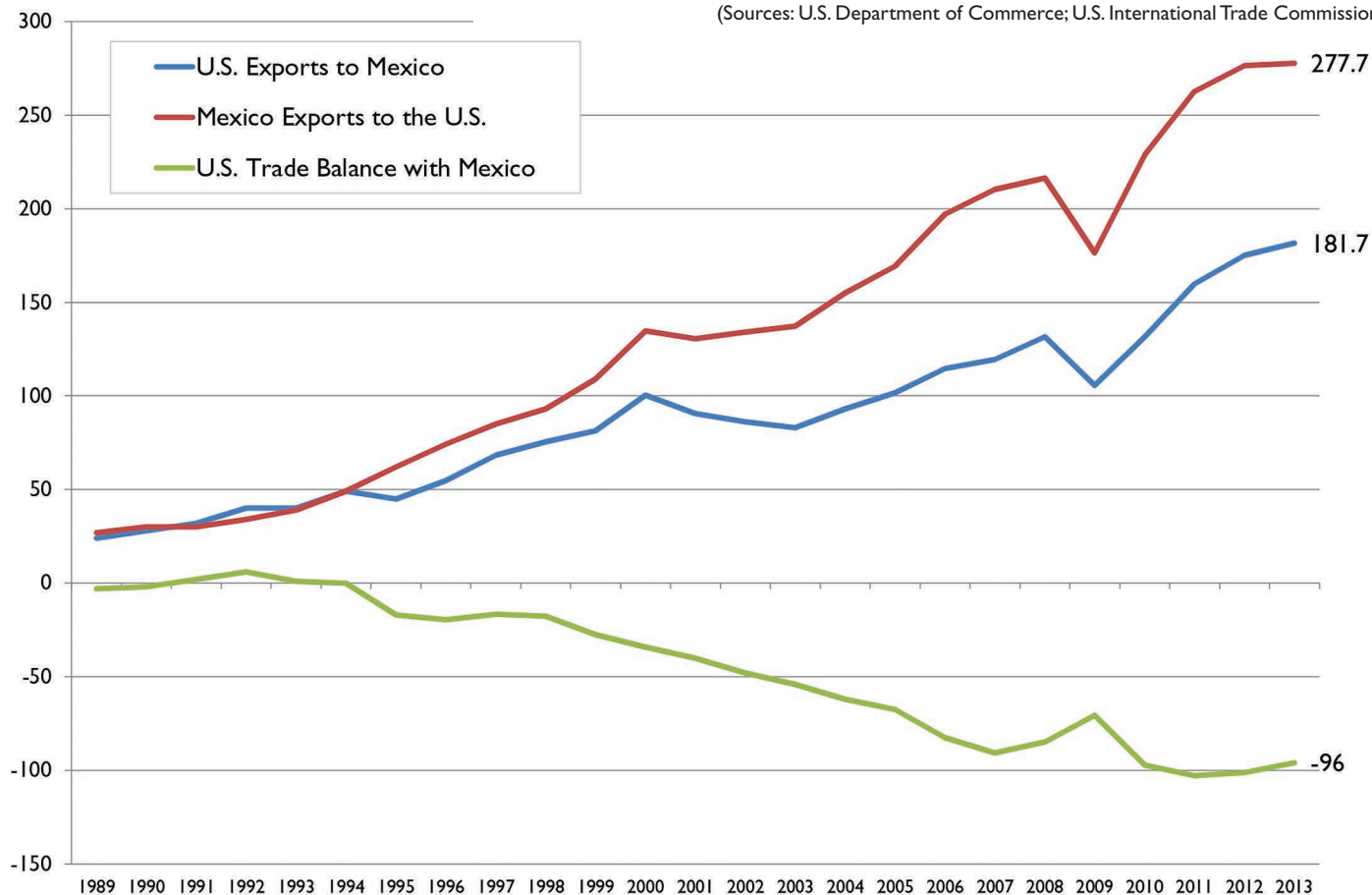


Photo by Doug Mills/Associated Press.

U.S.-Mexico Merchandise Trade Balance, 1989-2013

Figures in billions of U.S. dollars

(Sources: U.S. Department of Commerce; U.S. International Trade Commission)



The United Nations Development Program concluded in a 2007 report that, “Nafta has produced disappointing results in terms of growth and development.” Economists Gerardo Fujii Gambero and Rosario Cervantes Martínez writing in the April 2013 issue of the UN Economic Commission for Latin America and the Caribbean Review found that “the gap between exports and GDP [in Mexico] has been widening, which indicates that the export sector is underperforming as a driver of economic growth.” They argued that “the ability of exports to galvanize the economy will be heightened if export activity leads to an expansion of the domestic market.”

Rising Productivity and Declining Wages

While very different economies, the United States and Mexico share similar problems: sharp income inequality, slow growth, high unemployment, and persistent underemployment. These problems are exacerbated by a troubling paradox: rising productivity combined with falling real wages. As a result, much of the economic gain has flowed to the top as workers and communities have faced downward pressure on wages and working conditions. While this productivity/wage disconnect

emerged as a key issue during the Nafta debate, it now feeds into a growing concern in many countries throughout the world, including the United States, about the corrosive effects of economic inequality, which President Obama has called the defining issue of our time.

Consider the dimensions of this disconnect in Mexico. Mexican manufacturing productivity rose by almost 80 percent under Nafta between 1994 and 2010, while real hourly compensation — wages and benefits — slid by nearly 20 percent. In fact, this data understates the productivity/wage disconnect. Wages in 1994, the base year, were already 30 percent below their 1980 level despite significant increases in productivity during this period. Although they are producing more, millions of Mexican workers are earning less than they did three decades ago.

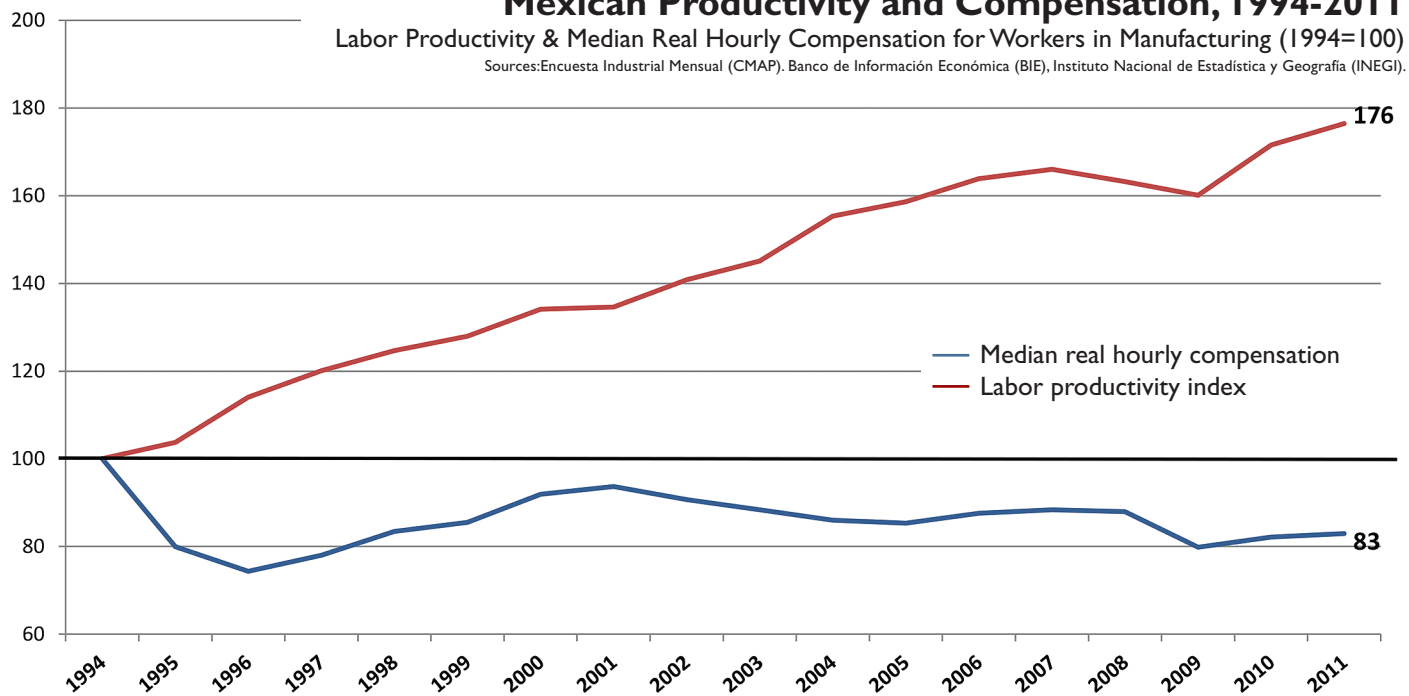
Economists often maintain that if wages are low, their level simply reflects low productivity. In the Mexican case, however, low wages exist in spite of strong gains in manufacturing productivity. These low wages reflect a number of factors, from government policy to globalization, but a central issue is the lack of labor rights in the export sector. As a result, it is difficult to form independent unions that can exert pressure to restore a more robust

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Mexican Productivity and Compensation, 1994-2011

Labor Productivity & Median Real Hourly Compensation for Workers in Manufacturing (1994=100)

Sources: Encuesta Industrial Mensual (CMAF), Banco de Información Económica (BIE), Instituto Nacional de Estadística y Geografía (INEGI).



link between productivity and wages. If workers are unable to share in the gains, high-productivity poverty becomes a danger. The damage affects more than Mexican workers. The gap between productivity and wages results in low purchasing power, which depresses consumer demand and slows economic growth.

This gap in Mexico also puts downward pressure on wages in the United States, contributing to a U.S. wage/productivity gap that began opening up in the mid-1970s. Between 1947 and the early 1970s, strong unions forged a link between rising productivity and higher wages, and the entire economy benefitted. As union strength waned, the U.S. wage/productivity gap opened and wages stagnated. What does this have to do with Nafta? A key question during the Nafta debates in 1993 was whether Mexican and U.S. wages would harmonize upwards or be pulled downwards by the agreement. Proponents argued that expanding trade alone would lift all boats, while critics maintained that effective labor standards were essential to insure that everyone would benefit.

Mexico and the United States are both in a far tougher, more competitive global economy today. Mexico may be the low-wage producer in Nafta, but it is a medium-wage country globally. How can wages rise in Mexico, given powerful global competitors such as China? It is a tough challenge but not an impossible one. Consider this challenge in the context of the automobile industry.

Restructuring of the North American Auto Industry

Autos remain the flagship North American manufacturing industry. The U.S. auto industry contributed more than 3 percent of GDP, and motor vehicle and parts manufacturers accounted for 786,000 jobs, as 2012 drew to a close. Autos play a defining economic role in Mexico as well, accounting for 2.7 percent of GDP and 579,000 jobs. Mexico is now the world's eighth largest auto producer; the sector was responsible for \$88 billion in exports or almost 30 percent of total manufacturing exports in 2012.

Under Nafta, the auto industry in Mexico has grown rapidly, and it is in the midst of an unprecedented expansion. Mexico assembled over three million vehicles in 2013 — more than Canada — and exported over 80 percent of them, most to the United States. Global automakers plan to invest \$6.8 billion in Mexico between 2013 and 2015, The Detroit Free Press calculates. As a result, Mexico is on track to become the leading source of imported vehicles for the U.S. market by 2015, surpassing both Canada and Japan. Moreover, Mexico exported \$44.8 billion in auto parts to the United States last year, more than Japan, Germany, and Korea combined.

Mexico's impressive success rests on a new reality: world-class productivity and quality in its best assembly plants which utilize the most advanced manufacturing technology available globally. These results are a tribute to firms and Mexican workers as well as good news for the economy. The lure for investment, however, remains

low wages. “The automakers are shy about saying so,” the trade newspaper *Automotive News* writes, “but the reality is that in 2012 Mexican wages are still very low.” Estimates of Mexican compensation in the auto industry — wages and benefits — ranges from about 20 percent of U.S. levels, according to the Center for Automotive Research, to 11 percent, according to the CEO of Mazda’s Mexican operations.

Can Mexico be globally competitive at higher wage rates? While the challenge is far from trivial, the answer is yes. Competitiveness depends on innovation, productivity, and quality, areas in which Mexican plants have excelled. The most competitive plants are not those that pay the lowest wages but rather those that achieve the lowest unit costs, a combination of wages, productivity, and quality. In this context, higher wages in a competitive industry expand purchasing power and lay the basis for higher, sustainable domestic growth.

Consider the experience of the U.S. auto industry. GM and Chrysler drove off a cliff into bankruptcy in 2009, and Ford skidded to the edge. A partnership between Washington, the automakers, and the United Auto Workers (UAW) union has resulted in a remarkable renaissance that seemed unlikely, if not impossible, at the time. The Detroit-based industry and the UAW are

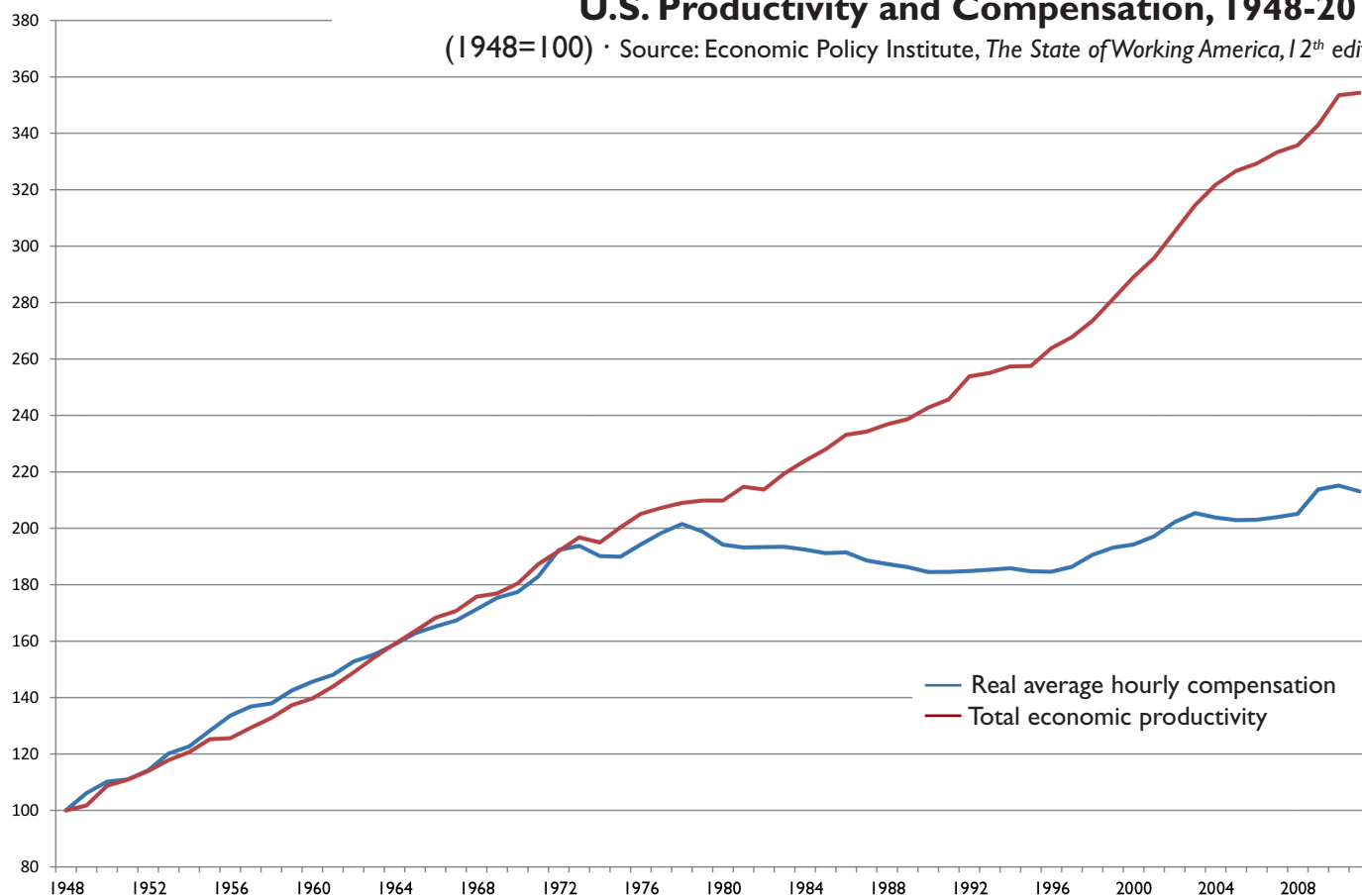
now in the midst of redefining competitiveness in the United States. Labor agreements signed in 2011 have led to 28,000 new jobs while a total of 150,000 jobs will be added in the U.S. auto industry as a whole. As a result, the Ford Fusion — a critical, mid-sized vehicle for Ford — is now built in Flat Rock, Michigan, as well as in Hermosillo, Mexico. These new factories promise to be very competitive. They will build on a skilled workforce that can deliver innovation on the line as well as high productivity and quality.

The Detroit automakers are now announcing impressive profits in North America, particularly the United States, at wages considerably higher than those paid in Mexico. In 2013, Ford announced record profits in its North American operations — \$8.8 billion — and 47,000 Ford hourly workers in the United States received profit-sharing checks averaging \$8,800 based on U.S. profits. The ability to build vehicles profitably in the United States demonstrates that it is possible to move toward a highly competitive North America, in which wages harmonize upwards, laying the basis for a faster-growing consumer market and stronger economic growth. In other words, if U.S. automakers are competitive at high wages, automakers located in Mexico could be competitive at higher wages.

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U.S. Productivity and Compensation, 1948-2011

(1948=100) · Source: Economic Policy Institute, *The State of Working America*, 12th edition



What about China? Chinese exports of auto parts to the United States have risen more than ninefold from 2000 to 2010, causing a \$9 billion U.S. trade deficit in this sector. Now, labor shortages and tens of thousands of labor demonstrations in cities large and small are driving wages up. Annual wage increases of as much as 50 percent have been reported in export-oriented Guangzhou province. As *The New York Times* put it in mid-February 2012, “the cheap labor that has made China’s factories nearly unbeatable is not so cheap anymore.” Estimates indicate that Chinese manufacturing wages are already between 11 and 20 percent higher than those in Mexico, and shipping costs add an additional burden.

Insuring Broadly Shared Prosperity

The evidence over the last two decades indicates a gap between the promise of trade and the reality of Nafta. Despite some impressive gains, an opportunity has been squandered for all three countries. Expanding trade between Mexico and the United States in particular could fuel economic growth, build an environment-friendly partnership, and bring broadly shared prosperity to people and communities on both sides of the border. Nafta, however, resulted in far-reaching reforms that reduced risks for investors but locked in an unsatisfactory status quo for workers and the environment in Mexico.

Nafta is unlikely to be reopened, let alone repealed, anytime soon. As noted critic Jeff Faux put it “the toothpaste of Nafta cannot be put back into the tube.” Nonetheless, a surprising consensus has emerged among some leading Nafta proponents and critics: the U.S.-Mexico economic relationship should be deepened if it is to succeed. This may be off the political radar currently, but it is worth exploring nonetheless. A more effective integration would involve cross-border cooperation on issues such as infrastructure, education, renewable energy, and development, strengthening both economies.

Along these lines, Mexico announced an ambitious plan in 2014 to move towards 100,000 Mexicans studying in the United States and 50,000 Americans studying in Mexico. California Governor Jerry Brown embraced the idea and signed a Memorandum of Understanding on education to move in this direction while leading a trade mission to Mexico in the summer of 2014. On the same trip, the governor proposed a cross-border photovoltaic solar facility in which each country would build complementary plants in order to supply energy to both California and Baja California. This highly innovative proposal would underscore the cost-effectiveness of solar energy and showcase the benefits of California



Photo by Kyodo/Associated Press.

Workers at the new Honda plant in Celaya, Mexico.

and Mexico working together on shared issues. After all, the sun shines on both sides of the border, and Mexico and California would be taking the same road to the sun. The initial response of Mexican officials was highly positive. These projects could lay the basis for far broader cooperation. A new generation of state-of-the-art auto plants on both sides of the border could commit to generating a sizeable part of their power needs from solar energy and new highways could have solar medians. Renewable energy production and installation could create jobs on both sides of the border.

Unions also have a critical international role to play. They have proven essential to building a highly competitive U.S. auto industry and, at the same time, have sought to insure a share of that success for their members. The result is more robust consumer demand



— what the legendary UAW leader Walter Reuther called “high-velocity” purchasing power — and a more successful economy. In Blue/Green alliances in the United States, unions are embracing the urgency of working with environmental groups to address climate change and build a more sustainable future, an idea that is equally urgent across North America and the rest of the world. Ultimately, trade success requires a broad, sustainable economic context that works. This context means policies in each of the countries that promote growth, jobs, and consumer demand while respecting the environment — not an easy task but an essential one in today’s global economy.

Looking at the first 20 years of Nafta is not simply a lesson in history but a guide to the issues raised by the Trans Pacific Partnership (TPP), a proposed 12-nation

agreement with Mexico as well as other Latin American and Asian countries. These countries account for 40 percent of global output and more than 30 percent of global trade. If this far larger trade agreement doesn’t incorporate the lessons of the Nafta experience, it is bound to repeat Nafta’s mistakes rather than realizing the gains that trade makes possible.

Harley Shaiken is a professor in the Departments of Geography and Education and the chair of the Center for Latin American Studies at UC Berkeley.