The North American Free Trade Area: Impacts and Implications

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The North American Free Trade Area (NAFTA) – comprising the United States, Canada, and Mexico – will soon come into being as the world's largest trading bloc, directly challenging the growing primacy of the European Community and the Japan-East Asia bloc.

NAFTA will offer huge opportunities to private firms in all three member countries. For U.S. and Canadian firms, NAFTA will mean a chance to regain competitive positions eroded by Japanese and European rivals. For Mexican firms, NAFTA will mean vertical integration of U.S. and Canadian capital and technology with lower-cost – but highly skilled – Mexican labor. In short, NAFTA will permit businesses to exploit natural comparative advantages in production and distribution across the entire North American land mass.

For European and Asian firms, the entry of Mexico into an economic alliance with the United States and Canada will present a dual challenge. On the one hand, the immense North American consumer market will exert a strong pull on these firms to find footholds in NAFTA markets. On the other hand, the increasing competitiveness of North American firms may gradually begin to „turn the tables“ on European and Asian competitors, forcing the latter to devise new strategies.

In this article, we briefly review the circumstances leading to the formation of NAFTA and suggest the impact it will have on businesses worldwide.

Why NAFTA Now?

The first stage of the North American Free Trade Area came into existence on January 1, 1989, when the United States and Canada entered into a free trade agreement (FTA). The U.S.-Canada FTA is in the process of reducing most of the significant barriers to the flow of goods, services, and capital between the two countries. The FTA is being phased in over a 10-year period as a means to manage the adjustment process that both the countries will undergo. It is an unprecedented case of two first-world countries joining forces with a third-world country in a far-reaching economic alliance. Mexico's entry into this market involves complex issues but also many opportunities.

While Mexico's economy equals only 4 percent of the U.S. economy, its population is one-third as large. Its workers earn less than 15 percent of what comparable U.S. workers earn. For decades, Mexico's market has been protected from outside competition by an economic policy that has promoted industrialization through import-substitution. While this policy can be credited with launching Mexico's industrialization process, it was maintained far too long to serve the long-term interests of a growing and diverse market economy. As a result, few Mexican industries were ever able to compete beyond their borders.

The radical reorientation of Mexico's economic policies in the late 1980s under President Salinas de Gortari fundamentally altered the direction of the country's economy. The decision of the United States and Mexico to negotiate a free trade agreement is the culmination of this reform process. The successful conclusion of such an agreement will have especially strong impacts on Mexico's companies, forcing them to become competitive after decades of protection.

For their part, U.S. and Canadian firms have been beset by declining competitiveness in world markets, particularly in traditional low- and mid-tech industries. Historically, the large size of North America's internal market has given traditional manufacturers little motivation or sense of urgency to expand globally – unlike Europeans and Asians, who were faced with much smaller national markets. North America's relatively parochial orientation has caused its businesses to respond too slowly to new global competitive challenges.

The United States, in particular, has found itself in a difficult position. Its ideological commitment to laissez faire economic policies, combined with its relatively open market, have put its firms at a disadvantage vis-a-vis their competitors in the EC and the Japan-East Asia bloc, who have enjoyed not only greater protection from external competition but also selective government support and intervention on their behalf.

Furthermore, the fact that U.S. companies have not developed global networks of complementary production-sharing partners – as Japan has done for decades in Asia – has left U.S. companies with higher costs of production and rapidly declining market shares, both globally and domestically.

What NAFTA Will Do

With Mexico as a part of the North American economy, U.S. and Canadian firms will be in a favorable position to create much-needed production-sharing networks. They will enjoy ready access to lower-cost manufacturing – in a contiguous area, just across the 2,000-mile border that Mexico shares with the United States. In addition, Mexico will eventually represent a very substantial mass market. Already, its 90 million consumers are culturally inclined to consume goods produced in North America.

Even though NAFTA is basically a free trade agreement rather than a common market, the advantages it offers are seen to be of strategic importance by business and government leaders in both the United States and Canada. Successful completion of the trilateral NAFTA treaty will likely mean that tariff and nontariff barriers in most goods and services will be gradually but systematically dismantled. The pace of implementation is likely to be swift, despite the fact that, as this article goes to press, there is still much give-and-take in the ongoing negotiations. Focal areas are issues such as rules of origin and implications for individual industries, including financial services, auto parts, textiles, and agricultural products.

Similarly, agreements will be negotiated on the regulatory environment affecting investment flows, intellectual property rights, dispute settlement, and other key issues. The resulting transparency of rules and regulations, together with the ability to arbitrate differences, will encourage U.S. and Canadian firms to invest more heavily in Mexican production facilities by reducing much former risk.

Finally, very strict rules of origin will be imposed to prohibit any of the three countries from being a duty-free conduit for manufactured goods that have very little North American content.

These changes in production systems, markets, and regulations will have considerable impact on the way companies do business in the Western Hemisphere and around the globe. In the pages that follow, we discuss the implications of NAFTA in three areas:

production sharing, the Mexican consumer market, and foreign investment.

Production Sharing. For years, Japanese firms have vertically integrated their manufacturing operations by combining Japanese capital, technology, and skilled labor with low-cost manufacturing in nearby Asian countries. More than 35 percent of Japanese exporting firms are operating through such production-sharing arrangements with developing countries.

U.S. and Canadian firms have been painfully slow to adopt this model and have paid the price in declining market shares at home and abroad. Mexico's entry into NAFTA gives U.S. and Canadian firms a valuable opportunity to vertically integrate the factors of production by combining their own capital, technology, and skilled labor with the lower-cost labor of Mexico. Such arrangements will enable firms in all three countries to maximize their respective comparative advantages – and their profits.

Healthy precedents for such arrangements exist today. Production-sharing specialization between the United States and Mexico has been successfully demonstrated in the *maquiladora* system (in-bond manufacturing) that has flourished along the U.S.-Mexican border since the late 1960s and has grown especially rapidly in recent years. *Maquiladoras* are the forerunners of full-fledged production-sharing systems.

Almost 800 firms, of which 100 are non-American, are now engaged in production-sharing operations in the *maquiladora* sector, employing half a million Mexican workers in 2,000 plants. *Maquiladora* operations have contributed dramatically to companies' competitiveness by substantially reducing costs of production; for many firms, they have made the difference between failure and survival.[1]

A recent Arthur D. Little study of U.S.-Mexican complementarity produced the following observations:

• The production-sharing cases studied revealed large benefits to the United States and its firms as sales, market shares, and profits grew rapidly.

• Employment increased, rather than decreased, in both the U.S. and the Mexican enterprises involved.

• Production sharing in Mexico is characterized by high productivity and general adherence to environmental, health, and safety standards.

• The firms studied achieved their strategic goals – to recover competitive position and defend market shares – in a few years.

The Mexican Consumer Market. A second advantage that NAFTA brings to U.S. and Canadian firms is the rapidly expanding Mexican consumer market – with strong preferences for North American products. Mexico's population is now 90 million. Although per capita income is only $2,250, Mexico buys from the United States about one-half of what Japan imports per capita from the United States. Assuming conservatively that in 20 years the Mexican per capita income amounts to one-fourth to one-third that of the United States today, U.S. exports to Mexico could more than triple, reaching $100 billion.

This large and growing consumer market will offer a number of opportunities in merchandising, wholesaling, and retailing. Mexico today has very few large merchandisers. We expect that U.S. and Canadian distribution and wholesale firms will move rapidly into this vacuum. For example, the Walmart chain is taking advantage of the wholesaling gap in the Mexican market by rapidly launching a new wholesaling chain in alliance with CIFRA, Mexico's largest supermarket chain.

Similarly, few franchise chains exist in Mexico today. Some U.S. specialists, such as McDonald's and Mail Boxes Etc., are now pioneering in Mexico. Mail Boxes Etc. has worked out an unprecedented agreement that will allow it to operate in tandem with the Mexican Federal Postal Service and with U.S. and Mexican telecommunications suppliers as well.

Suppliers and partners to infrastructure industries in both the public and private sectors will face rich opportunities as Mexico begins to correct its many glaring deficiencies in its infrastructure. Weaknesses in such critical areas as railroads, power, and telecommunications has already led to the entry of such companies as Alcatel, Ericsson, and Southwestern Bell.

Financial services will be another large area of opportunity. Mexico already has a large banking sector. U.S. banks, currently undergoing their own structural changes through mergers, are considering buying into the Mexican financial services market. Consumer credit, traditionally underdeveloped in Mexico, is likely to expand rapidly, opening up consumption in many areas, particularly housing. Companies that rely on consumer credit will benefit greatly from these changes.

Foreign Investment. Contributing to the strong growth of Mexico's domestic market will be investment activity by large and proven international firms. Recent examples include Citibank, Ford, Hoechst, Rhone-Poulenc, IBM, Kimberly-Clark, Nissan, Unilever, Walmart, and Sears, Roebuck. Once NAFTA is in place, the pace of foreign direct investment not only in Mexico but throughout North America, particularly from Europe and Asia, will no doubt accelerate. In the current negotiations, the United States and Canada will press for very stringent rules of origin to make certain that Mexico is not used as point of entry for non-North American firms seeking privileged access to the U.S. and Canadian markets. High requirements for North American content – perhaps on the order of 50-60 percent – will force Asian and European firms to reassess their North American export and investment strategies.

All three NAFTA countries are GATT signatories. All three favor free trade and maintain relatively low barriers to imported goods and services. Nonetheless, for non-North American firms, NAFTA will represent a growing uncertainty. They will need to decide whether to establish businesses inside NAFTA or to risk possible changes in tariff and nontariff barriers in the future.

In making these decisions, firms outside NAFTA will have to contend with an important psychological dimension. For decades, the United States has represented not only the world's largest economy but also the most open economy, strongly committed to laissez-faire principles. It has been a persistent proponent of freer and fairer trade, decrying protectionist barriers around the globe. Ironically, this position – coupled with U.S. slowness to develop global production-sharing networks – has cost the United States large shares of its own domestic market.

In entering NAFTA, the United States becomes for the first time a member of a regional trading bloc with potentially strong preferences for internal trade and an implied degree of protection from outside competition. European and Asian firms are likely to be uneasy about the possibility of losing the equal access they have enjoyed for decades. Concern about this prospect will induce many of these firms to invest in NAFTA to comply with its rules of origin and compete on an equal footing within North America.

NAFTA Impacts on Mexico

By far the largest impact of the NAFTA trading bloc will be felt in Mexico. For the United States and Canada, NAFTA will be a framework in which to respond more effectively to the protectionism of other trading blocs and defend their own interests vis-a-vis Asian and European competition. For Mexico, however, NAFTA represents a commitment to an irreversible process that will move the country from the third world into the first world in the next two decades.

Inevitably, this process will entail painful adjustments for the Mexican economy. Many Mexican firms have already seen their market shares eroded by imports from the United States. Examples include process-industry capital equipment, office furniture, telecommunications, and oil field services and accessories.

For Mexican firms that succeed in making the required transformation, NAFTA will mean a more certain access to U.S. markets that have previously been blocked by „dumping" litigation and nontariff barriers. Mexican makers of building products, household glass, and agricultural specialties, among others, have often experienced such obstacles. Anticipating NAFTA, some of the most forward-thinking Mexican firms have already adjusted their strategies to become major exporters: Cuauhtemoc (breweries), Vitromex (tiles), Lanzagorta (Walworth industrial valves), Metalsa (automotive castings), Printaform (desktop computers), and Bimbo (breads and pastries). Some Mexican firms are rushing into strategic alliances to gain stronger competitive positions (such as CIFRA's alliance with Walmart). Others are acquiring U.S. partners to gain a foothold in the U.S. market (such as Vitro's acquisition of Anchor Glass, as well as its alliance with Corning).

There is a tendency to underestimate the strength of Mexico's private sector, given the weakness of the Mexican economy during the 1980s. However, many Mexican firms have not only survived the immense problems of the 1980s but are efficiently preparing themselves for NAFTA. They are likely to prove far more competitive than some of their counterparts anticipate. For example, many of them now wield a significant psychological advantage: the realization, deeply embedded throughout the organization, that radical change is not only tolerable but often essential in global competition.

Conclusions

NAFTA will stimulate U.S. and Canadian firms – particularly in low-tech and mid-tech sectors – to act to reverse their declining market shares. It will offer them factors of production similar to those that their Asian competitors, in particular, have used since 1970. For U.S. and Canadian companies, the obvious moves are to begin building or expanding market positions in the growing Mexican market. With NAFTA, firms will be able to move and market such products throughout North America duty-free (or almost duty-free).

For labor-intensive firms, a second option is to launch binational production-sharing operations, using high-value U.S.-made inputs and assembling or finishing components in Mexico. In particular, U.S. firms that transferred their assembly operations to Asia in the '70s and '80s now have the opportunity to return them to North America. Such relocations have been taking place among firms that manufacture garments, electronics, and electrical machinery. They are looking to benefit from lower costs as well as the advantages of working in the same time zone, with more convenient travel and communications.

For Mexican manufacturers, NAFTA represents the challenge of achieving world-class standards of competitiveness by 1992, when NAFTA start-up is expected. The transformation of Mexican industry, in sum, will be swift, painful, and productive. Many Mexican firms will have to find suitable partners to upgrade their product lines. For others, NAFTA will facilitate establishing subcontracting arrangements through which they will supply components and assemblies to U.S. and Canadian firms.

For Asian and European firms, NAFTA means a renewed opportunity to grow in the Mexican market, much as it does for U.S. firms. However, in the longer term – and perhaps more important – it also means the strengthening of North American competitors, the potential for losing some cost-competitiveness, and the possibility that they will not meet the rules of origin that will be specified by the NAFTA treaty. The United States will likely press strongly to preclude the use of Mexico as a springboard for Asian products flowing into the United States as Mexican-made goods.

For the United States as a whole, membership in its own trading bloc, reinforced by the valuable complementarity of Mexico's economy and work force, will finally establish the „level playing field" that it has long sought. For companies around the globe, playing on that field will entail new rules, new risks – and unprecedented new opportunities.

[1] *See „The New Production-Sharing Networks" by Roberto E. Batres in* Prism, *third quarter 1990.*

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