

**Canada-Mexico-United States Free Trade
A Canadian Business Perspective**

A submission by the Business Council on National Issues
to the House of Commons Standing Committee on
External Affairs and International Trade

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The Business Council on National Issues is the senior voice of Canadian business on policy issues in Canada and abroad. Composed of 150 chief executives of Canada's leading companies, the Council's member companies employ some 1.5 million Canadians and administer in excess of \$975 billion in assets.

A non-partisan group committed to an active program of research, consultation, and advocacy on economic and non-economic issues, the Council's priorities are: to strengthen Canada's national economy; to ensure that Canada continues to play a leading role among the industrialized nations; to support progressive social and environmental policies; and to foster healthy political institutions.

The Council has a longstanding involvement in trade policy matters and played a leading private sector role in the development of the Canada-United States Free Trade initiative.

INTRODUCTION

The Business Council on National Issues is pleased to have this opportunity to present our views on the question of possible Canadian participation in the negotiation of a Mexico-United States Free Agreement to the House of Commons Standing Committee on External Affairs and International Trade. A careful examination of the issue and its potential consequences for Canada has led the Council to conclude that Canada's interests will best be served by becoming an active participant in the negotiations. This brief will touch on the main factors that prompted us to come to this conclusion.

Together with this brief, we are pleased to table a study by Michael Hart titled A North American Free Trade Agreement: The Strategic Implications for Canada which offers an extensive analysis of the questions we will address in our presentation. This study, written by an experienced trade policy practitioner, grew out of an earlier report commissioned by the Business Council on the issue of a Mexico-United States free trade agreement and the consequences for Canada.

The first section of our brief reviews the principal aspects of the economic reform program on which Mexico has embarked in the course of the last two years. We then highlight the salient features of Canada-Mexico bilateral trade. Thirdly, in light of the broader context described in the previous sections, we will outline Canada's options assuming free trade negotiations between Mexico and the United States proceed.

MEXICO'S ECONOMIC REFORM PROGRAM

Since the ascension to power of President Carlos Salinas de Gortari in December 1988, Mexico has undertaken significant domestic reforms aimed at establishing a market-oriented and open economy. Among the principal elements of its economic policy, the Mexican government has sought to moderate price and wage volatility through an agreement between government, labour, and the private sector; and has successfully renegotiated the country's foreign debt.¹

Over the last two years, these policies have produced impressive economic results, thereby greatly improving Mexico's economic and fiscal situation, as shown by recent economic indicators². Inflation dropped from an annual rate of nearly 160% in early 1988 to less than 20% at the end of 1989, the lowest level since 1977. Real GDP grew by 2.9% in 1989 and the dynamism of the economy has steadily improved for each subsequent quarter, thus surpassing official growth projections.

In the area of trade policy, Mexico's accession to GATT membership in 1986, under the government of former President Miguel de la Madrid, marked the start of a massive reform of its trading regime. The program of unilateral reform introduced in 1985, combined with the more recent measures described above, has brought about a substantial liberalization of the Mexican economy.

¹Other important features of Mexico's current economic reform program include: trade liberalization measures, the liberalization of foreign investment laws, the privatization of public enterprises, the reform of the tax system, the maintenance of strict fiscal discipline, and the development of urgent public works projects. For a more detailed description see, Presidency of Mexico, Office of the Press Secretary to the President, Mexican Agenda: Background Information on Mexico, June 1990, pp. 5-6.

²Imede and World Economic Forum, The Competitiveness of the Mexican Economy: A Progress Report, 1989, pp. 3 and 7.

- The trade-weighted average of Mexican tariffs has been reduced to about 8%, less than that of Canada.
- Import licences have been eliminated for a majority of products. However, almost one-third of imports still require prior import authorization.
- Quantitative restrictions have been eliminated for many sectors. However, restrictions remain in several sensitive sectors -- agriculture; oil and petrochemicals, motor vehicles, pharmaceuticals, footwear, and electronic equipment.
- Official prices for customs valuation purposes have been abolished.
- Import fees and formalities have been standardized.
- Export incentives have been reduced.
- Investment restrictions have been loosened, opening many sectors to 100% foreign participation.

This ambitious program of economic reform, combined with extensive trade liberalization, has greatly increased the openness of the Mexican economy. Since these reforms, Mexico presents itself to its North American and other trading partners as a much more attractive destination for exports and investment.

CANADA-MEXICO TRADE

Total bilateral trade and investment between Canada and Mexico reached \$2.4 billion in 1989, with Mexican exports approximately twice those of Canada. Although the value of trade between the two countries is modest, it is probable that figures are significantly under-reported as a result of transshipment through the United States. Nevertheless, Mexico is Canada's leading trading partner in Latin America, with two-way trade increasing at a rate of 17% a year since 1987.

Canada's exports to Mexico are divided chiefly among agricultural products, machinery, and transportation equipment. In the area of trade in services, links between Canada and Mexico are insignificant other than a small amount of engineering services exports from Canada to Mexico. In the case of Canada's imports from Mexico, crude oil imports have fallen sharply since the beginning of the 1980s, when they accounted for 80% of imports. The bulk of Canada's imports is now composed of manufactured products, principally machinery parts and various consumer goods. The level of bilateral direct investment between the two countries is very limited. Mexican holdings of Canadian productive assets are virtually non-existent, while according to the Bank of Mexico, the total value of Canadian investment in the Mexican manufacturing industry amounted to U.S.\$ 371 million in 1987.³

Despite the low level of current bilateral trade between Canada and Mexico, we believe that these levels will increase in the future. As a recent Royal Bank report on Mexico-United States free trade talks points out, in considering future opportunities vis-à-vis Mexico:

³Royal Bank of Canada, "Mexico-U.S. free trade talks: Why Canada should get involved." Econoscope (Special Edition), September 1990, p.10.

"it is not sufficient only to examine current trade and investment flows. Consideration must be given to Mexico's growth potential. Improved economic prospects following Mexico's economic adjustment and debt reduction programmes, and the establishment of a North American free trade zone should create substantial investment opportunities over the coming years." ⁴

As the Mexican economy develops, Canada will increasingly experience greater competition both in product markets and in attracting investment capital. That is a reality Canada must face regardless of whether Mexico negotiates a free trade agreement with the United States. In this sense, Canada clearly has an interest in the shape of the trading relationship which will evolve between Mexico and the United States since it could have implications for the Canada-United States Free Trade Agreement. And Canada also has a strong interest in ensuring that Canadian industry -- not just American industry -- is able to gain improved access to the large and rapidly-growing Mexican market of 85 million.

THE ISSUE OF LABOUR COSTS

The low level of trade between Canada and Mexico cannot be attributed primarily to the presence of tariff and other trade barriers in Canada. The removal of existing trade barriers will not flood Canada with low-cost Mexican goods. Indeed, under the current Canadian tariff structure, about 80% of Mexico's exports to Canada in 1989 entered duty-free. Moreover, Canada's generally low tariffs (5-10%) are not a major impediment to imports of goods produced in Mexico. These considerations suggest that concerns within Canada about the impact of low Mexican labour costs are exaggerated. Those who

⁴Royal Bank of Canada, op. cit.

criticize the idea of a trade agreement with Mexico are mistaken in focusing almost exclusively on Mexico's relatively low average wage levels (about one-tenth of Canadian wages). As Richard Lipsey recently argued, what matters in assessing international competition is not differences in absolute wage levels, but relative unit production costs and productivity. "By and large, Mexican wages are low in terms of purchasing power because the productivity of Mexican workers is low."⁵

Thus, it should not be assumed that low Mexican wages "threaten" all manufacturing in Canada and the United States. If wages were such an important factor in the cost of producing manufactured goods, most manufacturing activity in the United States would have gravitated to states such as Alabama, Mississippi, and Louisiana -- instead of to high wage states such as Connecticut, New York, Ohio, Pennsylvania and California. Competitiveness depends on much more than labour costs. Productivity levels and technology infrastructure are poor in Mexico. International economic experience has shown that, as these improve, wages in Mexico should rise, as has happened in the Newly Industrialized Countries of Asia (South Korea, Taiwan, etc.). In any case, it should be noted that according to the Canadian Manufacturers' Association, wages account for only a modest portion (18-20%) of direct manufacturing costs in Canada.

OPTIONS FOR CANADA

Assuming Mexico-United States free trade negotiations proceed, Canada is faced with two basic options: opting for the status quo and not taking part in the negotiations, or active participation in such discussions.

⁵Richard Lipsey, "Canada at the U.S.-Mexico Free Trade Dance: Wallflower or Partner?" C.D. Howe Institute, Commentary (August 1990), p. 10.

Although Canada could choose the first of these two options, the implications of a changing North American trading environment cannot be avoided. Even if it chose to sit on the sidelines, Canada would still be affected by a bilateral Mexico-United States agreement. Such a bilateral trade deal would erode Canada's present preferential access to the American market with no offsetting access to the Mexican market, and probably divert trade and investment as a result of increased competition from Mexico in attracting United States as well as offshore trade and investment. In our view, it is not in Canada's interests to sit idly by while the United States negotiates separate free trade agreements with Mexico and perhaps other countries in the Western hemisphere. The evolution of this type of "hub and spoke" system of bilateral trade accords would clearly work to Canada's disadvantage, for at least three reasons: i) the United States would be the only country to enjoy tariff-free access to the markets of all participating countries; ii) the United States would benefit from investment diversion at the expense of "spoke" countries such as Canada and Mexico; and iii) with separate bilateral trade agreements, the United States' bargaining power would be maximized.⁶

For these reasons, Canada should adopt the second option and become an active participant in the negotiating process. Direct involvement in these negotiations would enable Canada to promote its interests and benefit from the creation of a larger plurilateral North American free trade area. As a participant in the negotiations, Canada should pursue the following broad objectives:

- Encourage the continuation of market-oriented economic reform in Mexico in order to promote a macroeconomic environment favourable to trade and investment.

⁶Ibid., pp. 4-5.

- Improve Canada's access to Mexico for goods, services, and investment. There are several sectors in which Canada's expertise could find a market in Mexico. These include agriculture, fishery, forestry, and financial services. Also, with its expertise in transportation, telecommunications, and civil engineering, Canada is in a favourable position to take advantage of Mexico's drive to modernize its economy⁷.

- Work to ensure common rules of origin in any agreement in order to minimize compliance costs. In this respect, Canada should be able to draw profitably on its experience in negotiating the Canada-United States Free Trade Agreement.

- Strengthen linkages between Canadian and Mexican business and industry, as well as between the two governments. This process has already begun through various initiatives by Canadian and Mexican business organizations and the signing, in March 1990, of a Canada-Mexico framework agreement to bolster trade and investment ties.

- Build a basis for improved Canadian commercial ties and business opportunities in Central and South America, which have been areas of limited Canadian involvement until now. Many countries in these regions have undertaken market oriented reforms of their economies, thereby opening new potential trade and investment opportunities for Canadian business.

⁷Royal Bank, op. cit., p.2.

CONCLUSION

In recent years, Mexico has embarked upon an ambitious program of economic reforms designed to improve the performance of its economy through trade liberalization. As part of this broad economic strategy, Mexico is now seeking to expand its access to foreign markets, by negotiating a free trade agreement with its principal trading partner, the United States. Assuming these negotiations proceed, such a development will have significant implications for Canada in terms of its own Free Trade Agreement with the United States and its relative position within the North American trading environment. The Business Council on National Issues is convinced that only by becoming a participant in the development of a larger North American trading area, will Canada be in a position to significantly influence its future trading environment and effectively promote its commercial interests.