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NAFTA's First Five Years (Part 2)

U.S.–Mexico Trade and Investment Under NAFTA

U.S.–Mexico trade has been on the rise since the beginning of the North American Free Trade Agreement.¹ This article, the second in a three-part series on NAFTA, looks at key aspects of the U.S.–Mexico trade and investment relationship since the agreement took effect in January 1994.

TOTAL BILATERAL TRADE

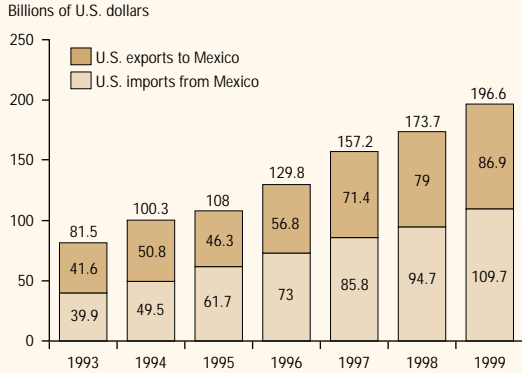
Total U.S.–Mexico trade reached \$196.6 billion in 1999, up more than 141 percent from its 1993 pre-NAFTA level of \$81.5 billion (*Chart 1*). Because trade between two countries is influenced by more than just whether they have a free trade agreement, how do we determine how much of this increased trade is attributable to NAFTA?

Two important factors that affect trade are each country's income (ability to purchase goods from the other country) and the price at which the goods are traded, expressed in the other country's currency (the exchange rate). When a country's income, or gross domestic product (GDP), falls, its ability to purchase goods from another country also falls. The opposite also holds true: if a country's GDP rises, purchases of goods from another country are likely to rise as well.

Chart 2 shows Mexico's GDP growth and the growth of U.S. exports to Mexico (or growth in the volume of goods Mexico buys from the United States). When Mexico's GDP goes up, so do U.S. exports to Mexico. When Mexico's GDP falls, as it did sharply in 1995, U.S. exports to Mexico also decline.

The price at which goods are traded, as expressed in another country's currency, impacts trade in a similar fashion. A country's goods become more expensive if its currency appreciates, that is, when the price of the country's goods as expressed in another country's currency goes up. When this happens, foreign demand for that country's goods tends to go down. Conversely, a country's goods become less expensive when its currency depreciates or when their price as expressed in

Chart 1
U.S.–Mexico Trade, 1993–99



SOURCE: U.S. Bureau of the Census, Foreign Trade Division.

another country's currency falls, raising demand for them abroad.

Chart 3 displays the performance of U.S. exports to Mexico and U.S. imports from Mexico alongside the peso/dollar exchange rate. When the exchange rate fell in December 1994, U.S. exports to Mexico also fell, while U.S. imports from Mexico rose. The exchange rate drop meant the peso had depreciated in relation to the dollar and, conversely, the U.S. dollar had appreciated against the peso. This made Mexican goods less expensive to acquire in the United States, raising the demand for them. But it also made U.S. goods more expensive in Mexico, thereby lowering demand.

A free trade agreement's reason for being is to boost trade between the countries involved by eliminating trade barriers. Thus, NAFTA would be expected to increase trade between the United States, Mexico and Canada. Yet, because other

factors such as those outlined above act simultaneously either to raise or lower trade, it is not easy to distinguish each specific factor's impact. However, econometric analysis can help isolate the individual influence of different factors on trade.

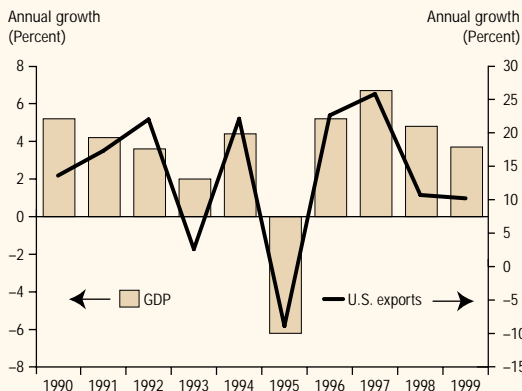
Such work has been conducted at the Dallas Fed to discern the specific impact of NAFTA on trade between the United States, Mexico and Canada.² The findings show that when controlling for other factors that affect trade—such as the December 1994 peso devaluation and the ensuing Mexican recession, which pushed U.S. exports to Mexico downward—overall U.S.–Mexico trade is significantly higher with NAFTA than would have occurred without it. Without NAFTA, U.S. exports to Mexico would have declined by 3.4 percent per year on average during 1994–98, rather than growing by 13.8 percent per year, as occurred with NAFTA. Moreover, U.S. imports from Mexico would have recorded an average annual increase of only 1.5 percent without NAFTA, rather than 18.5 percent with NAFTA. In terms of dollar amounts, without the agreement U.S. exports to Mexico in 1998 would have been \$44 billion lower than the \$79 billion reached that year; U.S. imports from Mexico would have been \$43 billion, or \$51.7 billion less than their 1998 level.³

Clearly, NAFTA has been an important stimulus to U.S.–Mexico trade.

BILATERAL INVESTMENT

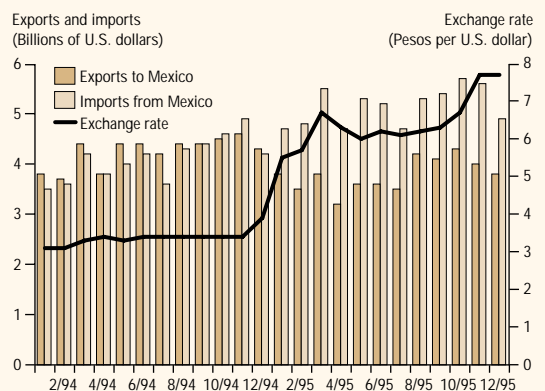
In addition to opening trade, free trade agreements usually also ease foreign investment rules. Indeed, although NAFTA's main aim is trade liberalization, the agreement includes four other objectives that complement the trade provisions:⁴

Chart 2
U.S. Exports to Mexico and Mexican GDP



SOURCE: Instituto Nacional de Estadística, Geografía e Informática and MISER.

Chart 3
U.S. Trade with Mexico and the Exchange Rate, 1994–95



SOURCE: U.S. International Trade Commission and Banco de México.

- Promote fair competition;
- Substantially increase investment opportunities;
- Protect and enforce intellectual property rights; and
- Create effective procedures for the agreement's implementation and application, joint administration and dispute resolution.

Each of these objectives is covered in a chapter of the NAFTA document. The investment provisions (chapter 11) are aimed at creating greater opportunities on this front. The provisions on fair competition (chapter 15) and protection of intellectual property (chapter 17) add certainty to investors in the NAFTA region. In essence, then, NAFTA's "rules of the game" foster a more market-oriented, internationally competitive North American economic environment. The favorable investment conditions draw investors to the region. The agreement also attracts investment from international companies that seek to penetrate the region's open markets. Hence, NAFTA promotes investment flows not only among the United States, Mexico and Canada but from other countries as well.

An important outcome of NAFTA's investment provisions was an overhaul of Mexico's foreign investment law to reconcile it with the agreement. Mexico's foreign investment law had been on the books since 1973 and reflected the country's nationalism during that time. Even its title—Law for the Promotion of Mexican Investment and the Regulation of Foreign Investment—conveyed the priority given to national investment and the regulatory approach to foreign investment. The law stipulated that foreign investments must be held in a minority position (up to 49 percent). In other words, all investments in Mexico had to be majority-owned by Mexicans.⁵

Although 1989 rules opened up more investment opportunities to foreigners, the law remained unchanged until 1993—20 years after it was enacted—when it was replaced with the current one, simply called Law on Foreign Investment. The new law allows foreigners up to 100 percent ownership of their investments, with exceptions in only a few sectors (basic petrochemicals, for example). Thanks to NAFTA, the entire institutional framework behind foreign investment in Mexico is now much more open to conform with the liberalized investment rules stipulated in the agreement for the three participating countries.

Foreign investors responded positively to Mexico's more favorable investment climate, as evidenced by the increased foreign direct investment (FDI) the country received in 1994, when

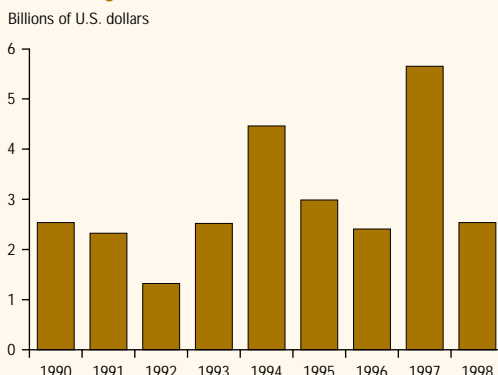
NAFTA (and Mexico's new foreign investment law) took effect. While annual FDI flows in Mexico during 1990–93 averaged \$3.7 billion, they jumped to an annual average of \$11.4 billion during 1994–98.

NAFTA also positively impacted FDI flows to Mexico from the United States (*Chart 4*). U.S. FDI in Mexico equaled \$1.3 billion in 1992. The following year FDI jumped to \$2.5 billion, very likely in anticipation of NAFTA, and in 1994—NAFTA's first year—U.S. FDI increased further, to \$4.4 billion. U.S. FDI flows averaged \$3.6 billion per year during 1994–98, up almost 64 percent from an average annual level of \$2.2 billion during 1990–93.

Some important examples of U.S. direct investment in Mexico since the mid-1990s are found in the telecommunications and insurance industries. After privatizing the huge telephone monopoly *Teléfonos de México (TELMEX)* in 1990, Mexico in 1997 opened its telecommunications sector to greater foreign investment. Thus, AT&T Corp., MCI WorldCom and other U.S. long-distance carriers are now part of the Mexican telecommunications landscape. Also, major U.S. insurance companies have increased their presence in Mexico.⁶ Recently, for example, the overseas division of New York Life Insurance Co. purchased Mexico's third-largest insurance company, *Seguros Monterrey Aetna*.

As a developing country, Mexico does not have an abundance of capital; thus, it has traditionally not been a big player in direct investment abroad. There are, however, several notable examples of such investments, some in the United States. CEMEX, the third-largest cement company in the world and Mexico's most multinational corporation, has U.S. operations in California, Texas and Arizona. Grupo Bimbo, Mexico's leading

Chart 4
U.S. Foreign Direct Investment in Mexico, 1990–98

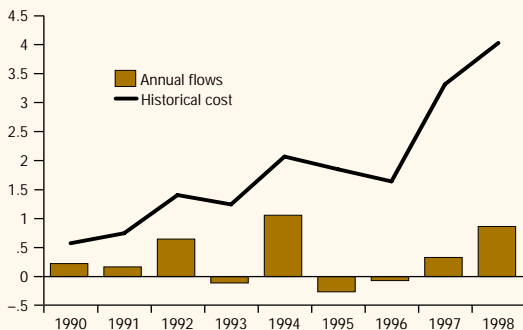


SOURCE: Bureau of Economic Analysis International Investment Data.

Chart 5

Mexican Foreign Direct Investment in the United States

Billions of U.S. dollars



SOURCE: Bureau of Economic Analysis International Investment Data.

bread maker and another important multinational corporation, has about 30 operations in the United States. In 1998, it acquired Texas-based Mrs Baird's Bakeries. Grupo Vitro is yet another example. The largest glass producer in Mexico, it has been active in the United States through acquisitions and joint ventures, including joint ventures with Libbey and General Electric Co.

Chart 5 shows Mexican FDI in the United States. Although Mexican FDI flows were at a negative \$110 million in 1993, they jumped to \$1.1 billion in 1994, NAFTA's first year. Mexican FDI was negative in 1995 and 1996—a reflection of crisis conditions in Mexico's economy—but turned positive again in 1997 and increased further in 1998, to \$864 million. When taking into account the historical cost⁷ of total Mexican FDI in the United States before and after NAFTA, Mexican FDI grew from \$1.2 billion in 1993 to over \$4 billion in 1998.

CONCLUSION

NAFTA has definitely worked to increase trade between the United States and Mexico. Trade between the two countries is higher today because of NAFTA than it would have been without the agreement. In addition to trade liberalization, NAFTA's objectives include opening up investment opportunities as well as providing more certainty for these investments through rules on fair competition and protection of intellectual property. These conditions, combined with the open markets NAFTA encompasses, have drawn investors worldwide to the North American region. Clearly, NAFTA has been a positive force in trade and investment growth for both the Mexican and U.S. economies.

—Lucinda Vargas

NOTES

- ¹ For a review of trade performance among the United States, Mexico and Canada since NAFTA's implementation, see "NAFTA's First Five Years (Part 1)," Federal Reserve Bank of Dallas El Paso Branch *Business Frontier*, Issue 2, 1999.
- ² See David M. Gould, "Distinguishing NAFTA from the Peso Crisis," Federal Reserve Bank of Dallas *Southwest Economy*, Issue 5, September/October 1996, pp. 6–10, and "Has NAFTA Changed North American Trade?" Federal Reserve Bank of Dallas *Economic Review*, First Quarter 1998, pp. 12–23. An updated version of Gould's work that summed up NAFTA's impact on trilateral trade during the agreement's first five years was presented by William C. Gruben at the fourth international economic conference of the Federal Reserve Bank of Dallas El Paso Branch, *NAFTA: The First Five Years*, November 4–5, 1999, El Paso, Texas.
- ³ The average annual growth rates pertinent to the scenario of U.S.–Mexico trade without NAFTA were applied to non-seasonally-adjusted trade levels.
- ⁴ See *The North American Free Trade Agreement Between the Government of the United States of America, the Government of Canada and the Government of the United Mexican States*, vol. 1, art. 102, p. 1-1.
- ⁵ Mexico allowed 100 percent foreign ownership of an investment only through its maquiladora industry program. However, this program, launched in 1965, stipulated that all maquiladora production be exported from Mexico to keep this industry from competing with domestic producers in the Mexican market.
- ⁶ Although NAFTA did liberalize Mexico's financial sector from its pre-NAFTA conditions, Mexico kept the sector somewhat restricted to foreign investment even within the agreement. However, in February 1995—outside of NAFTA and more than a year after the agreement started—Mexico enacted laws that opened the sector much more to foreign investment. Also, in 1998 Mexico further liberalized the foreign investment rules that applied specifically to the banking industry.
- ⁷ Historical cost is a measure of a foreign direct investment position according to the values carried on the books of affiliates. Therefore, this valuation reflects price levels of earlier time periods.

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