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Relating to the Powerful One: Canada and Mexico's Trade and Investment Relations with the United States

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Abstract

Despite being members of the North American Free Trade Agreement and facing a common and powerful neighbor, Canada and Mexico have not always looked to each other for lessons in how to deal with the United States in economic affairs. This working paper provides an overview of Canada-United States and Mexico-United States economic relations, to explore the potential and limits for joint action in this regard.

Resumen

A pesar de que Canadá y México forman parte del Tratado de Libre Comercio de América del Norte y tienen en común a un poderoso vecino, no siempre han estado atentos a cómo cada uno ha lidiado con Estados Unidos en sus relaciones económicas. Este documento de trabajo ofrece una visión panorámica de las relaciones económicas Canadá-Estados Unidos y México-Estados Unidos para explorar los alcances y limitaciones de acciones concertadas en este importante tema.

Introduction

They were dubbed "the three amigos" by the assembled press corps as the leaders of the United States, Canada and Mexico wrapped up their day-long Texas meeting in March, 2005 with mutual expressions of respect and release of a grand-sounding trilateral pact: The Security and Prosperity Partnership of North America.[1]

For Mexican president Vicente Fox and Canadian prime minister Paul Martin, merely gathering together as leaders of North America's two junior partners at a stand-alone meeting with the U.S. president was unusual. Although the North American Free Trade Agreement (NAFTA) is now more than a decade old, there have been few such trilateral summits. By one analysts' count, no such event had occurred (other than quick meetings at hemispheric summits) since the mid-1950s.

For many, then, this meeting was progress alone. But it also was not so much what U.S. president George W. Bush, Mr. Martin and Mr. Fox said, but what they didn't say, that struck many observers as salient.

There was no mention of an emerging North American community in the sense of a common identity that would begin to blur the lines between three sovereign countries. Nor was there mention of any kind of sweeping post-NAFTA negotiation toward deeper continental integration.

Each leader, in his own way, referred to the need for North America to become more globally competitive, in the face of an expanding European Community and especially the burgeoning economic challenge of Asia.

But the suggestions set out struck many as barely evolutionary, let along revolutionary: vague hints at better coordinating transportation systems and energy markets, in addition to further study of means to reduce cross-border regulatory hurdles of goods and services and requirements for duty-free trade and movement of businesspeople.

"North America should be the most competitive region in the world", said Mr. Fox. But, as Mr. Martin emphasized, "What we're really talking about here is not a big thing."

Mr. Martin didn't actually mean to be disparaging his own work. By "big thing", he meant Big Idea or Big Bang, the moniker that has come to be attached to various proposals for something approaching a second-stage NAFTA negotiation involving sweeping new coordination of North American economic and security cooperation.

Indeed, the father of the Big Idea —though he didn't use that term— was Mr. Fox himself, who tried to interest Mr. Bush and Jean Chretien, Mr. Martin's predecessor, in late 2000/early 2001 in endorsing the vision of

[1] The Leader's Statement and Security Agenda and Prosperity Agenda are available at: http://www.news.gc.ca/cfmx/CCP/view/en/index.cfm?articleid=134149

reaching a common market arrangement within a generation. He was turned down flat.

Still, mere months after the Waco meeting, there is palpable progress, if not toward a Big Idea then certainly toward useful steps aimed at greater cooperation among the three governments.

Indeed, in June 2005, three ministers from each of the countries gathered in Ottawa to outline what had already been done among the myriad of working groups put together after the March leaders' meeting.

It got little attention because the initiatives were exclusively technical in nature. And that lack of notice is just fine with each government. The concept of deeper integration strikes all of them as politically problematic, primarily because the sense of sovereignty in each country has grown since September 11, 2001 —with anti-Americanism rising in Mexico and Canada, and American disquiet rising too about a supposed lack of attention to protection of its northern and southern borders.

But as the 40-page work product issued in June made clear, there is plenty that bureaucrats can do when they are working below the radar screen, focused on steps that can be completed through regulations alone rather than legislation. They include:

- Further measures to work together to improve the screening of individuals and goods entering North America, including "real-time" information sharing on high-risk individuals and cargo.
- Coordinated threat assessment and emergency preparedness exercises, including strengthened approaches to maritime and aviation security.
- Expansion of existing programs to speed the cross-border movement of low-risk individuals and cargo.
- Establishment of working groups to examine how individual sectors —including automotive and steel— could become fully integrated on a continental basis.

More important than the individual initiatives, though, may be two principles arising from the March summit that were also little-noticed.

Firstly, the ministers from the three countries will gather periodically to assess progress on specific items for which deadlines have been set through to 2007. In other words, North American's three nations now have established some minor degree of institutional architecture, if only through a commitment to future meetings on a trilateral basis. Even that has been lacking in the past in all but exceptional circumstances.

Secondly, that future progress need not be exclusively on a trilateral basis. "The Partnership is trilateral in concept; while allowing any two countries to move forward on an issue, it will create a path for a third to join later." Three will talk, in other words, but it only takes two to do a deal.

Within months, this flexible approach had already borne fruit in some technical areas, such as an agreement between the United States and Canada

to improve coordination of health and safety standards of consumer products, with Mexico expected to sign on later.

Is it the start of something big? It would be premature, some might say foolhardy, to predict that it is. Likewise, the three governments eschew any sense of having a vision of a common future, focused as they are on small steps. But progress it is.

1. Economic Relations with the Powerful One: An Overview

It wasn't so long ago that Canada and Mexico seemed to have little in common and even less to talk about. During the mid-seventies, when prime minister Pierre Elliott Trudeau made a state visit to Mexico, the idea of a free trade agreement involving the two countries and the United States was barely on the radar screen among academics, let alone politicians. Canada and Mexico had few points of contact and knew little about each other. Trade was low and investment minimal.

This had not always been the case. As with Brazil, Canadian companies invested heavily in Mexican sectors such as transportation and electricity in the later part of the 19th century and the early part of the 20th. But the Mexican Revolution ended all that. Indeed, it wasn't until 1944 that the two countries established diplomatic relations. And for decades afterward, Canada and Mexico might as well have been on opposite sides of the world.

Canada's historical ties were to Europe and its modern interests lay with the United States. Ottawa expended minimal energy looking south beyond the superpower, where unsustainable autarkic policies in Mexico had led to low living standards in the 1970s.

This began to change, though, in 1980 —when Ronald Reagan first put forward his vision of a free trade zone from Alaska to Tierra del Fuego (followed by George HW Bush a decade later).

Latin America was transformed in the 1980s. Mexico led the way economically, slashing trade barriers in the mid-1980s. This accelerated under Carlos Salinas de Gortari, who became president in 1988. Within three years, he was engaged in free trade talks with the United States and Canada that would lead to NAFTA. And Canada had become a member of the Organization of American States, signaling newfound interest in Mexico and all the countries of the Western hemisphere.

NAFTA proved to be a big step. The trade deal hardly approaches the expansive vision of the founders of European integration in the 1950s —"to lay the foundation of an ever-closer union among the peoples of Europe"—. NAFTA's pinched preamble speaks of measures to "reduce distortions to trade" and "enhance the competitiveness of firms". Nonetheless, NAFTA was a great leap forward for the Canada-Mexico relationship. Since then, dozens

of agreements have been signed between the two countries, primarily but not exclusively in the economic realm.[2]

And now? Negotiations for the proposed Free Trade Area of the Americas, which had set a deadline of 2005 for completion, stalled and, despite vows to revive talks toward a less sweeping outcome, continue to face significant hurdles. Meanwhile, though, the three nations of North America are taking the first halting steps toward considering what it means to share a continental economic space, though not at nearly the pace or scope to satisfy the multinational business community, which increasingly views North America as one economic zone, and wants to minimize hurdles standing in the way of acting as such.

There are massive differences between the three nations, to be sure. One is the world's dominant power, another is a mid-sized industrial nation and the third is a leader of the developing world. Between them, there are now four relationships. Two are long-standing and, indeed, there are many similarities between the Canada-U.S. relationship and the Mexico-U.S. relationship —from the history of war and invasion in the early 1800s through the increasingly symbiotic if asymmetrical nature of the two bilateral relationships today. The third relationship is less developed, between Canada and Mexico. And the fourth is just being born— what might be termed continentalization, the conception of a trilateral structure of nation-states. This section addresses primarily the two long-standing relationships.

1.1. Canada-U.S. Economic Relations: From Pre-1867 to NAFTA

The history of Canada is dominated by two overarching themes – relations between the French and English populations of the country and relations between Canada and the United States. While the first has dominated the country's domestic policy considerations, the second has dominated the country's foreign policy considerations. And while there is much more to Canada-U.S. relations than simply economic policy, the history of bilateral trade relations – the ebb and flow of protectionist initiatives and open border arrangements – has been a constant focus of Canadian decision-makers since the country was founded in 1867. Indeed, since before Confederation.

The signing of the 1988 free-trade agreement with the United States was not unprecedented for Canada. The two countries had, in fact, a free-trade pact in the years before Canada was born. The 1854 Reciprocity Treaty was abrogated by Washington in 1866, after the Civil War —one more reason why Conservative John A. Macdonald brought the Canadian colonies together in Confederation. Largely in response to Washington's cold shoulder, he

[2] A list of bilateral pacts on the website of Canada's Department of Foreign Affairs and International Trade goes on for 11 pages; Canadian exporters visited the pages devoted to Mexico on DFAIT's Virtual Trade Commissioner —a web portal— 200,000 times in the past nine months.

proceeded in 1879 with a "National Policy" to build indigenous industry through tariff barriers.

Canada and the United States would enter into two free trade negotiations before the FTA. In 1911, Liberal Wilfrid Laurier lost an election after concluding a trade pact; his credibility was damaged when the speaker of the U.S. House of Representatives suggested annexation would result. In 1948, William Lyon Mackenzie King refused, at the last minute, to approve a similar agreement secretly negotiated at his behest. He feared Laurier's fate.

King's tactical retreat was symptomatic of the careful trade-off that Canada had often made since the country's birth. The natural flows of economic production were North-South, but the political division of the continent was on East-West lines. As a result, national autonomy and economic interest were often at odds. Canada, from its birth, was a trading nation. It could hardly be otherwise if a country with such a small population was to build a high standard of living. But Canadians were leery of becoming too closely tied to the U.S. economy, fearing that this might inexorably lead to being swallowed up by the elephant.

King, who was Canada's longest-serving prime minister and a Liberal, pursued a quiet policy of creeping continentalism through much of his time in office, though. Despite American protectionism, particularly during the Great Depression with passage of the Smoot-Hawley bill, the primary destination of Canada's exports continued to change through the middle decades of the 20th century —from the United Kingdom to the United States.

In 1910, for example, fully half of Canada's exports were shipped to the United Kingdom while just 37% went to the United States. By 1930, this was reversed: 45% went to the United States and 27% to the United Kingdom. By 1950, fully 65% of Canada's exports were shipped across the 49th Parallel, and only 15% to the United Kingdom.

King's decision not to pursue a free trade pact did not end the debate, of course, nor the inexorable process of expanding Canada-U.S. economic ties. The Second World War had linked the two economies to an unprecedented degree through such agreements as the defence production arrangements negotiated at Hyde Park in 1941. American companies now dominated wide swaths of the Canadian economy.

This process of expanding trade and investment ties was further encouraged by King's Liberal successor, Louis St. Laurent, particularly as cross-border tariffs began to decline in the post-war era as part of the terms of the General Agreement on Tariffs and Trade —the antecedent to the World Trade Organization.

Canadian governments would, however, take a number of stabs in the post-war era at reducing the country's dependence on the U.S. market before Brian Mulroney decided to pursue and succeeded in negotiating the 1988 free-trade pact.

The first effort was particularly short-lived. Conservative prime minister John Diefenbaker had been elected in 1957 on a mildly nationalistic platform, and not long after he announced that his government would divert 15% of its exports from the United States to Great Britain. The proposal was illegal under GATT and, indeed, was met with less than enthusiasm by the United Kingdom, which was then dismantling the British Empire and beginning to consider membership in the European Economic Community.

A few nationalistic economic policies would be pursued by the successor Liberal government of Lester Pearson in the mid-1960s. But this government's major economic contribution would prove, instead, to be the 1965 Canada-U.S. Automotive Trade Agreement, which brought a regulated form of bilateral free trade in "road motor vehicles and parts". It was not then, but would later become, Canada's largest industry —providing a clear precedent for those Canadians who argued 20 years later that Canada could compete and win in an open continental marketplace.

Between Pearson's internationalism and Mulroney's continentalism came Pierre Trudeau. His 15 years in office were marked by particularly stormy relations with the United States. Trudeau was not an overt economic nationalist; indeed, he paid little attention to economic issues, at least in comparison to his focus on battling Quebec separatism and drafting a legal charter of rights for the country.

But many of his economic policies were nationalistic. In part, this was a matter of the times; European governments were interventionist too. But Trudeau, like Diefenbaker, was worried that Canada's destiny was too closely linked to the United States economically. And he acted, in part, because of U.S. economic nationalism of its own. When Richard Nixon took the United States off the gold standard in 1971, he also imposed a tariff on imports. Canada sought but failed to receive an exemption. This caused Trudeau to launch a government initiative known as the Third Option —to actively seek out new markets abroad to reduce Canada's dependency on the U.S. market. This initiative, however, proved to be largely a failure— as had Diefenbaker's own diversification effort 20 years earlier.

Trudeau would rile Washington further through two particularly nationalistic laws —the 1973 Foreign Investment Review Act and the 1980 National Energy Program—. The first was aimed at controlling U.S. takeovers of Canadian companies; the second was aimed at building Canadian control of the oil and gas industry. Both tested the limits of Canada-U.S. relations and showed, on balance, that Canada could ill-afford to forego U.S. investment.

By the time that Mulroney took power in 1984, the Canadian public was ready for a change in direction. Economic nationalism had been found wanting; government deficits were at record levels and GDP growth —which had been consistently high in the post-war era— had long since declined to inadequate levels amid rising inflation and unemployment.

Mulroney did not campaign on a free-trade theme in 1984; he was a Conservative, but not overtly conservative. Indeed, he opposed free trade on grounds that it would threaten the nation's autonomy by forcing it to give up many levers of economic power. But, shortly after he took power, a royal commission which had been established by Trudeau's Liberal government to study what ailed the Canadian economy reported its findings —which included advocacy of seeking free trade with the United States—. This "leap of faith" would quickly be supported by the Canadian business elite, by Westerners anxious to win greater ease of access to U.S. markets, and by Quebecers whose attenuated support of the Canadian nation-state had made them particularly North American in outlook.

These interests would prove to be a winning combination in the 1988 election, fought almost entirely on free trade, as the nationalist forces of English Canada would be defeated by Mulroney's continentalist coalition, which argued that the Canada-U.S. Free Trade Agreement (FTA) would guarantee access to the critical U.S. market for Canadian goods and services, thus allowing Canadian companies to raise domestic living standards.

The deal itself eliminated tariffs between the two countries over a 10-year period (with some exceptions, such as many agricultural products). It allowed companies in each country to bid on large government procurement contracts on a non-discriminatory basis. It liberalized trade in services, the fastest-growing sector of both countries' economies, by eliminating many remaining restrictions against foreign investment and by easing the temporary cross-border movements of business persons and other professionals. It grandfathered protections for particularly sensitive industries, such as cultural products in Canada. And, most critically for Canada, it provided for a bi-national dispute settlement process aimed at blunting the unilateral U.S. imposition of trade barriers against imports. Rising protectionist sentiment in the U.S. Congress had been a major factor in Mulroney's decision to seek an FTA and, though the final deal hardly eliminated the threat, as continuing battles over Canadian softwood exports would illustrate, it did represent progress. The FTA was the first signed by the two countries; Mexico would make the economic relationship a triumvirate just a few years later.

1.2. Mexico-U.S. Economic Relations: From a Closed Economy to NAFTA

Mexico's economy was closed throughout most of the 20th century; trade barriers were high and there were significant limits imposed on foreign direct investment. Only in the early 1980s did it start to open up its economy, largely as a result of the 1982 debt crisis and its aftermath.

Mexico's economic relations with the U.S. had both low points and high points during the closed economy era. A low point came in 1938 with the nationalization of the oil industry, after several U.S. (and British) oil

companies refused to comply with certain working condition guidelines set out by Mexican government authorities. However, World War II ushered in an era of unprecedented cooperation.

Mexico's main contribution to the war effort was economic. U.S. capital and technology stimulated the production of minerals, oil and food in Mexico, which were then exported to support the Allies. The unavailability of imported goods forced Mexico to produce some of the imported goods that had previously been imported. The substantial increase in industrial production led to job creation and a huge exodus from rural areas to the main urban centers. During this period, thousands of agricultural workers benefited from the *bracero* program of 1942.[3] The result of all this was a substantial increase of bilateral trade between Mexico and the U.S.

In 1942 a reciprocal trade agreement was signed, under which Mexico committed to providing the U.S. with strategic materials, in exchange for U.S. financing of the modernization of Mexico's industry.[4] That same year, an agreement on compensation was reached with U.S. oil companies.

Good relations remained until the early 1970s. The era from 1958 to 1970, the heyday of import-substituting industrialization (ISI) was characterized by high rates of economic growth accompanied by macroeconomic stability.[5] The economy remained closed, but the Mexican government's relations with foreign and domestic business interests were very good. Even though foreign direct investment (FDI) was only permitted under certain limits, approved sectors were specified, and majority ownership by Mexicans was the norm, foreign investment did increase as a result of the growth of the country during this period.[6]

The golden years of Mexico's economic performance through ISI came to an end in the mid 1970s. President Echeverría (1970-1976), like Diefenbaker and Trudeau, attempted to reduce Mexico's economic "dependence" on the U.S. but the efforts likewise came to naught.[7] It was difficult to diversify trade relations if the economy remained closed; likewise, FDI was regarded as a threat to national autonomy and the government sought to foster domestic investment and limit it. In 1973 the Mexican Congress approved the Law to Promote Mexican Investment and to Regulate Foreign Investment ostensibly to favor Mexican business against its foreign competitors. Instead of courting favor with domestic business interest at the expense of foreign investors with measures such as the Foreign Investment Law, an erratic conduct of economic policy generated animosity and mistrust between the Echeverría administration and foreign and domestic business groups, although the most

[3] Riding, 1985, p. 56.
[4] Chabat, 2002.
[5] Ortiz Mena, 1998; Lustig, 1992, p. 16.
[6] Whiting, 1991, pp. 64-70.
[7] See Flores, 1998, pp. 152-196.

striking outcome of FDI regulations was that foreign investment capital into Mexico did not stop: in every year from 1971 through 1987, net inflows of FDI went into Mexico.[8]

Economic mismanagement during the Echeverría period, largely the result of deficit spending and irresponsible macroeconomic management under an increasingly unstable international economic environment, led to a devaluation of the peso in 1976 after twenty-two years of a fixed parity of 12.50 pesos per dollar, and a concomitant economic crisis. Mismanagement, together with a strident populist rhetoric allegedly in favor of Third World interests, provoked a negative reaction in the international and domestic business communities that undermined the confidence of investors.[9]

President López Portillo (1976-1982) assumed the presidency with the intention of mending relations with U.S. and domestic business interests and under an International Monetary Fund stabilization program for the Mexican economy. The intention was short-lived, due in part to the newly discovered oil reserves at a time when world oil prices were on the rise. Fresh resources derived from oil meant that the government no longer had to rely on IMF loans —and strictures— to stabilize its economy.

Even though Portillo did not express the strong anti-U.S. rhetoric of his predecessor, populism and mismanagement once again gave way after a cautious start. Relations became strained in 1978, after Mexico had engaged in a costly infrastructure project involving the building of a gas pipeline to export gas to the U.S. Once construction was under way, López Portillo had a serious disagreement with U.S. president Jimmy Carter over the price Mexico would receive for the gas, and ordered a halt to construction.[10] The most salient feature of bilateral economic relations during the López Portillo presidency was that Mexico became the main provider of oil to the U.S., although this was market-led rather than the result of explicit policies by either government.

In 1979 Mexico balked at the last minute at joining the General Agreement on Tariffs and Trade, even though it had been pressed by the United States and accession negotiations had been completed. GATT rules were viewed widely as potentially constraining the government's autonomy at a time when active government involvement in the economy and oil-led growth was the basis of Mexican economic development.[11]

In 1978-1979 there were also frictions over the export of Mexican agricultural products which were subject to anti-dumping duties. Mexico managed to solve some of these problems by hiring top U.S. trade attorneys, rather than by reaching an understating with the U.S. on the matter of unfair

[8] Whiting, 1991.
[9] Lustig, 1992, p. 17.
[10] Odell, 2000, pp. 94-102.
[11] Ortiz Mena L. N., 2004.

trade practices.[12] It was only in June 1981 that the Mexican government finally decided to seek the establishment of a bilateral mechanism to settle trade irritants. López Portillo and his cabinet traveled to Camp David to meet with their U.S. counterparts, but by that time Mexico was in the midst of an economic crisis and the meeting produced no lasting results.[13]

Economic growth in Mexico had been fueled by high oil prices coupled with a growing foreign debt, which was borne to a large extent by U.S. private commercial banks. When oil prices started to decline and international interest rates started to rise in 1981, López Portillo responded by acquiring still more debt at ever increasing interest rates and shortening maturities.

When the situation finally unraveled, he tried to put an end to a foreign exchange drain by imposing capital exchange controls and nationalized Mexican banks (although U.S. banks —Bank of America and CITIBANK— were spared). The incoming administration of De la Madrid (1982-1988) had to deal with large fiscal and trade imbalances, an unserviceable foreign debt, unsympathetic creditor banks, and the realization that Mexico could no longer isolate itself from the United States.[14]

The debt crisis of 1982 forced Mexico to put its finances in order and adopt an outward-looking development strategy. President De la Madrid unilaterally opened the economy in the early 1980s, and in 1986 Mexico finally decided to join the GATT. Soon after, president Ronald Reagan proposed a Free Trade Agreement to Mexico, but De la Madrid deemed it premature and acquiesced only to a series of more limited agreements with the U.S.

The strategy prior to De la Madrid had been for Mexico to seek unilateral concessions on trade issues from the U.S., most of them related to the Generalized System of Preferences (GSP), under which the U.S. awarded preferential entry into its market to a series of Mexican exports. But since concessions were unilateral they did not generate certainty in the bilateral economic relations.

De la Madrid sought a new understanding with the U.S., given the severe economic crisis he inherited and the need to secure foreign exchange to service foreign debt, that at time when the U.S. was becoming more protectionist than at any time since the 1930's Smoot-Hawley tariff.[15] Mexico faced not only the threat of countervailing and antidumping duties, but also tariff escalation. The latter meant that, as exports became more sophisticated and turned away from raw materials, they would face higher tariffs. Accordingly, this was a disincentive to change Mexico's export structure.

[12] Odell, 2000, pp. 102-104.
[13] Lyman, 1989, p. 247.
[14] Weintraub, 1990, p. 204.
[15] Weintraub, 1990, p. 203.

A great deal of pragmatism led Mexico to seek a series of agreements with the U.S. to regulate their bilateral economic relations. Accordingly, in 1985 they reached a Bilateral Understanding on Subsidies and Countervailing Duties whose main provision of interest to Mexico was that it would receive a "material injury test", whereby no countervailing or antidumping duties would be imposed until it had been determined that its exports had indeed caused injury to U.S. producers.[16] This agreement signaled a sea-change in Mexico's way of dealing with its economic relations with the U.S. It is the first significant economic agreement since WWII, and a turn away from attempts at diversification and requests for unilateral concessions from the U.S.

The April 1985 press release on the Subsidies and Dumping Understanding mentioned that Mexico and the U.S. would seek to establish a framework agreement to deal with trade and investment, and in November Mexico announced that it had decided to start negotiations aimed at GATT membership. In the view of an insider to these negotiations, Mexico had tacitly accepted to join GATT as part of the price for the Subsidies agreement, and as a logical consequence of the new approach towards its international economic relations.[17]

This Subsidies agreement was followed in 1987 by the Framework of Principles and Procedures for Consultations Regarding Trade and Investment Relations. The Framework agreement contains what would later be central elements of the NAFTA agreement, *i.e.* mechanisms to deal with investment-related issues, intellectual property right provisions, and a very basic dispute settlement system.[18] The Framework was followed by a series of sectoral agreements on steel, some agricultural products, textiles, electronic products, and beer, wine, and distilled spirits, all of which had been subject to or threatened by U.S. restrictions.[19]

The last trade agreement concluded by the De la Madrid administration was the 1988 renewal of the 1975 bilateral agreement on textiles, which allowed Mexico a larger quota for its textile exports to the U.S.[20]

The striking change in strategy for dealing with U.S. economic relations during the De la Madrid government does not mean that the evolution toward NAFTA was "natural" or a foregone conclusion; far from it. It was, as mentioned above, a pragmatic response to adverse economic developments at home and a hostile international economic environment. The tug-of-war between Mexican and U.S. diplomats over the pharmaceutical decree is not an

[16] Seeking to establish a limit on U.S. unilateralism regarding unfair trade practices was important given that Mexico was not a member of GATT and its Subsidies and Dumping Code, and thus U.S. was under no obligation to grant it the "material injury test".
[17] Lyman, 1989, p. 254.
[18] Weintraub, 1990, p. 19.
[19] *Ibídem*, 1990, p. 203-204.
[20] For an overview of the Mexico-U.S. agreements on trade and related issues during the De la Madrid administration, see Blanco, 1994; Bravo Aguilera, 1989; Lyman, 1989; Weintraub, 1990 and Lustig, 1992.

exception. The 1985 National Railroad Law, which maintained that sector under strict government control and is reminiscent of bygone eras of Mexican state participation in the economy,[21] and the 1989 automotive decree, which incorporated a host of performance requirements, readily come to mind.[22]

Further economic liberalization and rapprochement with the U.S. would nevertheless take place soon after, during the presidency of Carlos Salinas (1988-1994). With Salinas, liberalism replaced statism as the dominant strategy for national development, after a lukewarm engagement with liberalization under De la Madrid. The new approach favored a rapprochement in economic relations with the U.S., which is epitomized by NAFTA.

NAFTA dovetailed with a series of legal reforms, which further liberalized Mexico's economy and facilitated closer economic relations with the U.S.[23] For instance, in 1989 new regulations expanded the range of operations open to 100% foreign ownership,[24] and in 1993 Congress approved a new Foreign Investment Law; as a result of the new law and subsequent reforms 90% of economic activities were now open to foreign investment.

If Mexico's economic reliance on the U.S. increased during Salinas, it was also true that economic relations also became increasingly institutionalized through NAFTA and thus awarded Mexico a certain degree of protection from what would otherwise could have been unilateral actions by the U.S., especially the arbitrary imposition of antidumping and countervailing duties.

The peso crisis of December 1994, which erupted a little under a year after NAFTA's entry into force, showed the relevance and magnitude of the economic interdependence between Mexico and the United States. Bypassing the U.S. Congress, U.S. president Bill Clinton offered a rescue package worth several billion dollars to Mexico, whose political (and thus economic) stability mattered a great deal. Despite the severe financial crisis, president Ernesto Zedillo (1994-2000) followed the path traced by the Salinas administration and continued deepening economic relations with the United States. A boom in the U.S. economy during the second half of the 1990s helped Mexico grow its way out of the crisis.

The stage appeared set for a stable bilateral economic relationship with the U.S.: there was a basic consensus on bilateral trade and investment rules, and both governments had learned to decouple the different strands that compose bilateral interaction, to avoid problems in one area hindering cooperation in others.

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[21] See Ley Orgánica de los Ferrocarriles Nacionales de México, *Diario Oficial de la Federación*, 14 de enero de 1985. I am indebted to Fernando de Mateo for bringing this law to my attention.

[22] The Decree was prepared by the De la Madrid administration and published only 10 days after Salinas took office. For an overview of the Decree and the automotive sector under NAFTA, see De Remes, Fitzpatrick and Ortiz Mena L. N., 1996.

[23] López Ayllón, 1997.

[24] Lustig, 1992, pp. 128-129.

At the same time, Zedillo followed a strategy to diversify Mexico's foreign economic relations. The landmark agreements were an Association Agreement with the European Union, one of whose main components was a trade agreement, and an FTA with the European Free Trade Association (EFTA).

The FTAs negotiated during the Zedillo administration dovetailed nicely with a host of FTAs that had been negotiated by Salinas since the conclusion of NAFTA negotiations but entered into force during the Zedillo presidency; Fox continued fostering regional initiatives, albeit at a slower pace. Notwithstanding these agreements, NAFTA, and especially Mexico-U.S. trade relations, continued to dominate Mexico's foreign trade links.

TABLE 1. MEXICO'S FREE TRADE AGREEMENTS

AGREEMENT	PARTNER COUNTRIES	DATE OF ENTRY INTO FORCE
NAFTA	Canada, United States	January 1, 1994
G-3	Colombia, Venezuela *	January 1, 1995
Costa Rica	Costa Rica	January 1, 1995
Bolivia	Bolivia	January 1, 1995
Nicaragua	Nicaragua	July 1, 1998
Chile	Chile	August 1, 1999
EU Association Agreement	European Union	July 1, 2000
Israel	Israel	July 1, 2000
Northern Triangle	El Salvador, Guatemala, Honduras	March 15, 2001 (El Salvador, Guatemala), June 1, (Honduras)
EFTA	Iceland, Norway, Liechtenstein, Switzerland	July 1, 2001
Uruguay	Uruguay	July 15, 2004
Japan	Japan	April 1, 2005

*Since November 19, 2006, only Mexico and Colombia are part of the FTA of the G-3.
Source: www.economia-snci.gob.mx/sic_php/ls23al.php?s=20&p=1&l=1#

Politics, and with it economic policymaking, has become more pluralistic in the past few years. In 2000, Vicente Fox won the presidential election for a single six-year term after 71 years of PRI dominance. During the first year in office, he enjoyed a short "honey moon" with the new U.S. president, George W. Bush, who made the bilateral relationship with Mexico one of his top priorities.

Fox attempted to use the opportunity to push for what he informally called "NAFTA Plus", which in practice meant, above all, staying the course in

terms of liberal economic policy and very close economic links with the U.S., and securing a major agreement on migration.

Fox made a much-vaunted visit to Washington in early September 2001 and, at least from his perspective, a major breakthrough on migration seemed within grasp. Whether that was an objective assessment became a mute point, for the bilateral relationship radically shifted as a result of the 9/11 terrorist attacks.

In April 2003, Fox announced that the NAFTA era was over, intending to re-state once again his "NAFTA Plus" concept, but given the lack of clarity on the government's stances, priority and direction, it naturally generated a great deal of confusion among business leaders, and also with U.S. trade authorities, who were not sure if his declaration meant a push toward the "NAFTA Plus" vision or rather a turn away from it as a result of the scant gains made by his administration in migration, despite repeated entreaties.

Domestic economic reforms that were of paramount importance for the Fox administration, such as a fiscal reform, reform of labor laws, and liberalization of the energy sector to favor private (foreign and domestic) investment in oil and electricity (which was of great interest to U.S. corporations) came to naught due to the lack of consensus in an increasingly pluralistic Mexican legislature.[25] Despite the watershed represented by NAFTA, internal disagreements meant that the path towards North American integration would not be easy to traverse. Domestic political difficulties were compounded, and eclipsed by the 9/11 terrorist attacks on the U.S. and their aftermath, for from then on U.S.-Mexico relations were no longer a priority for the U.S.

2. Why NAFTA?

The basis for Canada-Mexico ties and for a more close-knit continent lies with the North American Free Trade Agreement. The pact that went into effect on January 1, 1994 didn't reflect what originally was conceived. Mr. Salinas' intention was to lock in his economic reforms through a deal with the United States. He was to some extent following Canada's lead, which acted as the demandeur when it entered into free-trade talks with Washington in 1985.

In fact, NAFTA (or for that matter a bilateral FTA with the U.S.) was not envisioned by Salinas either during his campaign of the first year of his administration. At the outset of his administration, Salinas' strategy for dealing with the United States was more a continuation of the path tread by De la Madrid than a full embrace of economic cooperation with Mexico's northern neighbor. During his presidential campaign, Salinas did not mention that he would seek to establish a free trade agreement with the U.S. (or

[25] Baer, 2004.

Canada, for that matter), and instead followed the same pragmatic and piecemeal approach of De la Madrid. For instance, in 1989 Salinas sought and obtained an extension of a 1984 bilateral agreement on steel exports. Likewise, that same year Mexico and the U.S. signed an Understanding to Facilitate Trade and Investment, which built upon the 1987 Framework agreement.

Salinas' first priority had been a renegotiation of the foreign debt. Once that was taken care of, he sought, like some of his predecessors, to diversify Mexico's trade relations and thus reduce dependence on the U.S. The turn to Europe was not surprising, as it fit with a long held desire by the Foreign Ministry to diversify economic relations. In practice, diversification meant a turn away from the U.S. and an increase in economic interactions in Europe.[26]

With that end in mind, he traveled to the World Economic Forum at Davos in early 1990. However, developments in Europe foreclosed this option. His overtures toward European leaders were received with scant interest; given the fall of the Berlin wall the previous year, their attention and actions were concentrating on relations with the former COMECON countries.[27]

Thus, Mexico decided to focus on negotiating a free trade agreement with the United States only after entry into GATT had not generated a significant increase in foreign investment and renewed economic growth, and after its overtures toward Europe had been rebuffed.[28]

With NAFTA, Mexico attempted to foster economic growth by attracting FDI and securing access to the U.S. market through the elimination of most tariffs and regulation of non-tariff barriers. In addition, it generated certainty over economic policy, ensuring a "lock-in" of Mexican foreign economic policy, which would no longer depend on the whims of the Mexican chief executive, as in the 1982 bank nationalization and imposition of exchange controls.

From the U.S. perspective, the realization that it was in its own interest to cooperate with Mexico on trade issues was the result of a concern with Mexico's political stability and foreign policy stances. In 1991 U.S. ambassador to Mexico John D. Negroponte wrote a cable to his superiors at the State Department, which was subsequently leaked, stating that the passage of NAFTA would benefit the U.S. by ensuring Mexico's alignment with U.S. interests. His view on the political primacy of NAFTA from the U.S. perspective also concurs with Paul Krugman's views expressed at the time, in

[26] See, for example, Ojeda, 1984.

[27] COMECON was an economic organization established after World War II to manage economic relations between the Soviet Union and mostly central and eastern European countries (countries from other regions joined later). The following countries were members of COMECON: Bulgaria, Czechoslovakia, Hungary, Poland, Romania, East Germany, Mongolia, Albania, Cuba and Vietnam. COMECON was envisaged as a response to the U.S. Marshall Plan of economic aid to Western Europe, and was disbanded in 1991.

[28] Cameron and Tomlin, 2000; Salinas, 2000 and Ortiz Mena L. N., 2004.

that the "uncomfortable truth about NAFTA" was that it did not matter much for the U.S. from a strictly economic perspective.[29]

It seemed that the answer to Porfirio Diaz's predicament —*poor Mexico, so far from God so close to the United States*— was to make the most out of a situation that could not be altered.[30] NAFTA signaled recognition that, at least in the short and medium term, Mexico's best option was to exact the most benefits out of its geographic location and minimize the costs of increased reliance on the U.S.[31]

Meanwhile, Canada had been determined that a bilateral U.S.-Mexico deal not be signed, and had insisted it be at the table too. Ottawa feared that a U.S.-Mexico pact would mean the United States was successfully initiating a hub-and-spoke approach to hemispheric economic relations, with the United States at the hub of an ever-expanding series of trade agreements. Canada knew this would place it at the margins, as companies naturally would seek advantage by locating operations in the United States. It was so important to Ottawa that this not take place, and that Canada be on a level playing field vis-à-vis the United States, that prime minister Brian Mulroney's government essentially agreed to reopen the Canada-U.S. Free Trade Agreement finalized just a few years earlier amid so much controversy. In the end, much of the Canada-U.S. FTA was replicated in NAFTA, with some significant additions such as the controversial investor protections in Chapter 11.

Still, it was evident during negotiations that Mr. Salinas viewed Canada as an afterthought. He sometimes displayed a peculiar understanding of Canadian interests, even repeating in Canada a core argument he used in the United States when pitching a deal —that illegal migration would be reduced because NAFTA would create jobs at home in Mexico—. That wasn't an issue for Canada, considering that few Mexicans bothered to move far beyond the Southwest United States let alone cross the 49th Parallel, except for thousands who arrive each summer to harvest crops as part of a successful Canadian government program.

Mr. Salinas's lack of acquaintance with Canadian domestic politics was remarkable, but Canadian politicians hardly had much more than stereotypical knowledge about Mexico at the time, either. Likewise, Canadians knew little about Mexico (internal government polls taken in the early 1990s showed that Mexico evoked images solely of beaches and tequila), and Mexicans little about Canada.

Regardless, NAFTA proved to be a big step. It was quite a start, and hardly insignificant, particularly in light of the vast differences in size and economic

[29] Krugman, 1993.

[30] Porfirio Díaz was Mexico's president (and for some brief periods the de facto leader) from 1876 to 1911.

[31] Although by 2001 Mexico was the country with the most FTAs at a world level, NAFTA was by far the most significant one in economic terms; only the 2000 Association Agreement with the European Union promised to have some potential to reduce Mexico's reliance on the U.S. economy. The other agreements are of limited economic significance. See Ortiz Mena L. N., 2004.

development among the three countries - far greater than anything experienced in Europe.

NAFTA dovetailed with a series of legal reforms, which further liberalized Mexico's economy and facilitated closer economic relations with the U.S.[32] For instance, in 1989 new regulations expanded the range of operations open to 100% foreign ownership,[33] and in 1993 Congress approved a new Foreign Investment Law; as a result of the new law and subsequent reforms 90% of economic activities were now open to foreign investment.

If Mexico's economic reliance on the U.S. increased during Salinas, it was also true that economic relations also became increasingly institutionalized through NAFTA and thus awarded Mexico a certain degree of protection from what would otherwise could have been unilateral actions by the U.S., especially the arbitrary imposition of antidumping and countervailing duties.

The peso crisis of December 1994, which erupted a little under a year after NAFTA's entry into force, showed the relevance and magnitude of the economic interdependence between Mexico and the United States. Bypassing the U.S. Congress, U.S. president Bill Clinton offered a rescue package worth several billion dollars to Mexico, whose political (and thus economic) stability mattered a great deal. Despite the severe financial crisis, president Ernesto Zedillo (1994-2000) followed the path traced by the Salinas administration and continued deepening economic relations with the United States. A boom in the U.S. economy during the second half of the 1990s helped Mexico grow its way out of the crisis.

The stage appeared set for a stable bilateral economic relationship with the U.S.: there was a basic consensus on bilateral trade and investment rules, and both governments had learned to decouple the different strands that compose bilateral interaction, to avoid problems in one area hindering cooperation in others.

At the same time, Zedillo followed a strategy to diversify Mexico's foreign economic relations. The landmark agreements were an Association Agreement with the European Union, one of whose main components was a trade agreement, and an FTA with the European Free Trade Association (EFTA).

The FTAs negotiated during the Zedillo administration dovetailed nicely with a host of FTAs that had been negotiated by Salinas since the conclusion of NAFTA negotiations but entered into force during the Zedillo presidency; Fox continued fostering regional initiatives, albeit at a slower pace. Notwithstanding these agreements, NAFTA, and especially Mexico-U.S. trade relations, continued to dominate Mexico's foreign trade links.

[32] López Ayllón, 1997.
[33] Lustig, 1992, pp. 128-129.

3. NAFTA'S Performance

The tenth anniversary of NAFTA occurred on January 1, 2004. The last stage of tariff reductions (except for a small number of sensitive agricultural products) was completed on January 1, 2003; trade among the three countries is now almost entirely free of customs duties. The leaders who signed NAFTA —Mr. Salinas, Mr. Mulroney and George H.W. Bush— didn't wait for that step before celebrating, marking the deal at a high-profile conference in Washington in December, 2002, where each suggested NAFTA had brought the three countries significantly closer.

Canada and Mexico are the most export-oriented of the North American economies, with shipments of goods and services now accounting for roughly 40% of GDP.

In Canada's case, that represents a major increase from about 25% in 1990, when the Canada-U.S. trade pact was just getting underway. About 80% of Canadian exports are shipped to the United States (substantially higher in the case of Ontario); indeed, 48% of Canadian manufacturing production was exported to the U.S. in 2003, up from 35% in 1992. Bilateral Canada-U.S. trade in 2003 amounted to $643-billion —representing an average annual increase of 8.3% since 1989 in terms of exports and 6.5% in terms of imports—. There has also been a strong increase in levels of foreign direct investment between the two countries. Canadian investment in the United States rose at an annual rate of 10.3% to reach more than $200-billion, while U.S. investment in Canada rose at a slightly slower pace of 8.2% to each $225-billion.

Mexico is roughly as open as Canada in terms of its economic dependency on trade (especially with the United States) and has experienced the fastest transformation; as late as 1980, barely 10% of Mexican GDP was composed of exports. About 85% of exports are now shipped to the United States. The United States and Mexico exchanged goods valued at $266.8 billion in 2004, an increase of 213% since 1993.[34] During the period from 1994 to 2001, U.S. firms invested almost $65-billion in Mexico —about 45% going into the manufacturing sector.

(The United States, incidentally, is not nearly so dependent on trade as Canada and the United States. Exports represent just 13% of GDP, but this is still almost double the level 15 years ago.)

NAFTA was controversial during the negotiations, and its 10th anniversary has proved to be no exception. While some assessments highlight the significant increases in trade and investment across North America that it has spurred, others argue that overall it has had more costs than benefits.[35] We will concentrate on the overall impact of NAFTA on trade and investment in

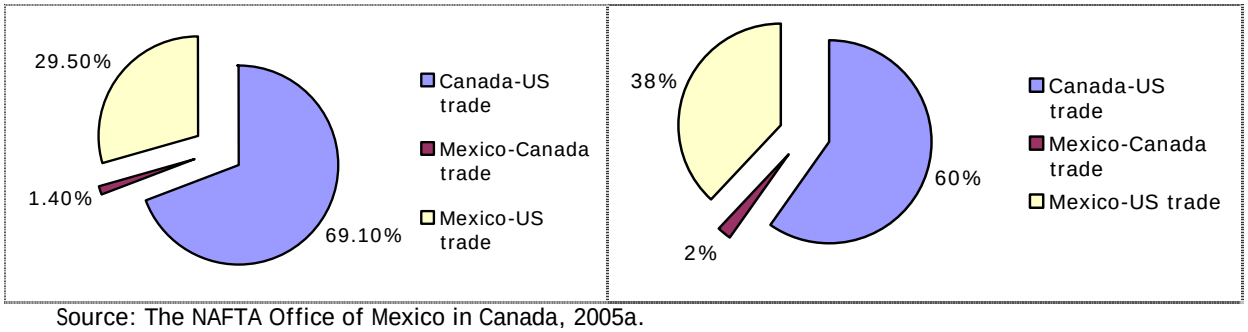
[34] Brason, 2005.

[35] For instance, Lederman, Maloney and Servén (2003) regard NAFTA as positive for all three countries involved, while Audley, Polaski, Papademetriou and Scott (2003) are more critical.

the region, on its institutional framework, and on that way it has affected relations among the three North American countries.

Notwithstanding debates over the distribution of the gains from increased trade and investment, no one questions the remarkable economic dynamism ushered in by NAFTA. Trade between NAFTA partners grew by 141.8% from 1993 to 2004, reaching close to 700 trillion USD in the latter year.[36] While Mexico-Canada trade increased four-fold during the same period, in terms of trade NAFTA has remained as two large bilateral trading relationships.

FIGURE 1. NAFTA PARTNERS TRILATERAL TRADE SHARES 1993 *VS.* 2004



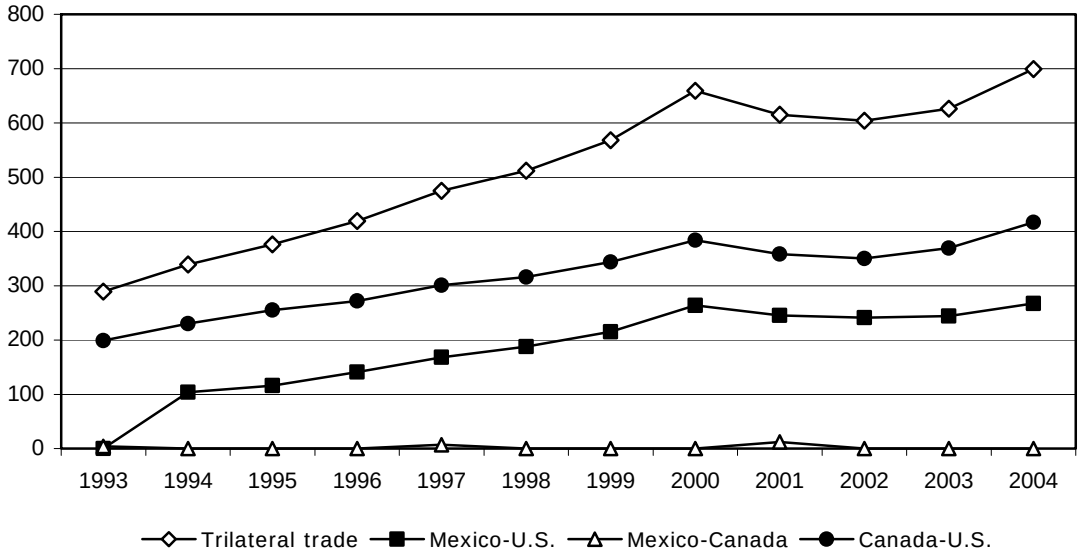
Source: The NAFTA Office of Mexico in Canada, 2005a.

As can be seen in figure 1, Canada-U.S. trade and Mexico-U.S. trade accounts for 98.6% of total North American trade in 1993, and by 2004 the two bilateral relationships still accounts for an extremely high 97.7% of total trade. The major shift in shares is due to a relative increase in Mexico-U.S. trade and a relative decrease of Canada-U.S. trade.

The U.S. remains by far the most important trading partner for Canada and Mexico; in 2004, 96% of Canada's North American trade was with the U.S., and the corresponding figure for Mexico was 94%.[37] Clearly, there is still much room for growth in Canada-Mexico trade, albeit their economic links have strengthened since the onset of NAFTA.

[36] The NAFTA Office of Mexico in Canada, 2005a.
[37] Calculated by the author with Brason (2005) data.

FIGURE 2. MEXICO-CANADA TRADE 1993-2004 (BILLIONS OF USD)[38]



Source: Brason, 2005.

With the four-fold increase in bilateral trade, Canada has easily become Mexico's second most important export market, after the U.S. In fact, by 2004 Mexican exports to Canada were equivalent to Mexican exports to the European Union and Japan combined.[39] It is also worth pointing out that Mexico has a 4.9 billion USD trade surplus with Canada, once statistics are corrected for underreporting due to transshipment via the U.S. In turn, by 2004 Mexico was Canada's third foreign supplier (after the U.S. and China), and its fourth export market (after the U.S., Japan, and the UK).[40]

Mexican-Canadian trade is quite concentrated in terms of the Canadian provinces that participate in such trade: in 2004, Ontario accounted for 74.4% of total trade, followed by Alberta (7.3%) and Quebec (7.2%). While Mexico has diversified its exports to Canada (from less than 1000 products in 1993 to close to 4000 in 2004), trade involving the auto sector looms large: Mexico's top five exports to Canada in 204 were automobiles (10.8%), ignition wiring

[38] These figures use Mexican and Canadian import statistics, to correct for underreporting of Canadian exports that go to Mexico via the U.S. The sources used are INEGI (Instituto Nacional de Estadística, Geografía e Informática de México), USDOC (United status Department of Commerce) and Statistics Canada.
[39] The figures are 10,327 *vs.* 10,308.7 million USD, respectively. Brason, 2005.
[40] The NAFTA Office of Mexico, 2005a, p. 9.

sets for automobiles and aircraft (5.3%), television sets (5%), gas-powered trucks weighing less than 5 tonnes (5%), and parts of vehicle seats (4.9%).[41]

Canada's exports to Mexico also involve the automotive industry, but agricultural exports are also significant; in 2004 its top five exports were automobiles (8%), beef (4.5%), rape or colza seeds (3.3%), motor vehicle parts (2.7%), and wheat (2.5%).[42]

Still, the high level of mutual dependency among the three countries masks a new trend: all three countries are looking increasingly beyond North America for export sales. While intra-NAFTA exports easily outpaced exports beyond the continent through 2002, the reverse has been true in 2003 and 2004. The trend is even more apparent in terms of imports as corporations (many of which built up continent-wide supply chains through the 1990s) look increasingly offshore, particularly to Asia, for lower-cost components.

The recent weakening of continental integration is particularly the case in terms of Canada-U.S. trade. Canada's share of U.S. imports has fallen by 2 percentage points since 1999 to about 17% after holding steady through the 1990s, while Mexico's has held still of late at roughly 12% —about double the rate in 1990.

The reason? The most obvious factor appears to be the emergence of China as a major supplier to the U.S. market. Since just the turn of the century, China has increased its share of U.S. imports to about 14% from less than 10% in 1999. China overtook Mexico in 2003 as the second-largest exporter to the United States and a key U.S. government agency has suggested that China could overtake Canada as the United States' most important trading partner within five years.

3.1. Institutions

Turning to institutional issues, one of NAFTA's main criticisms has been the one regarding its dispute settlement mechanisms (DSM), which still face challenges. Unlike most preferential trade agreements, which tend to contain a single DSM, NAFTA incorporates three different mechanisms: *I)* Chapter 11, which deals with investor-state disputes; *II)* Chapter 19, which covers subsidy and dumping disputes and *III)* Chapter 20, which deals with the interpretation of the agreement.

There were twenty-two Chapter 11 cases between 1994 and 2003, three of which were solved before arbitration. Of the nineteen cases that ended with an arbitral award, none were between Canada and Mexico but, interestingly, eleven of them involved Canada and the U.S. While CUSFTA did not contain an investor-state dispute settlement system, the U.S. was adamant that NAFTA have one, under the assumption that in was Mexican authorities that had to

[41] The NAFTA Office of Mexico, 2005c.
[42] *Ibídem.*

be kept in line. While the U.S. investor did bring Mexican authorities before international arbitration in five instances, Canadian investor have brought U.S. authorities to arbitration five times, while U.S. investors have managed to undertake arbitration procedures against Canadian authorities seven times.[43]

In the upcoming years, the greatest challenge to the NAFTA DSM will involve the investor-state mechanism (Chapter 11). A primary concern is the lack of transparency in the process regarding the arbitration proceedings themselves and the dissemination of information on cases and rulings, which are basically untenable since governments are not obliged to make awards public. While Canada and the U.S. have made strides in this regard Mexico is still a laggard; its stance exacerbates concerns about the secrecy of the procedures, and casts suspicion of the system as a whole.[44]

Environmental matters are also of concern. Chapter 11 has been under pressure from environmental groups, non-governmental organizations, and a Canadian provincial government. These groups argue that the mechanism is an instrument used by multinational corporations to evade its environmental responsibilities and manipulate governments when they try to implement policies to protect the environment.[45] There have been no Chapter 11 cases between Canada and Mexico.[46]

Even though Chapter 19 has performed acceptably well, the continuing predominance of antidumping disputes speaks to the need for efforts to reduce their incidence or, at a minimum, their disruptive effects. Between 1994 and 2003, 87 cases were filed (29 initiated by Mexico), among those 90% were on antidumping measures and 10% on subsidy disputes.[47]

As one would imagine due to the large trade volumes between Canada and the U.S. and Mexico and the U.S., 94% of cases have involved U.S. producers and/ or competent authorities; only 6% of Chapter 19 cases have been between Canadian and Mexican producers and/ or authorities.[48] As can be seen in Table 2 (below), the majority of cases have involved semi-manufactures products.

[43] Vega, *et al.*, 2005, pp. 98-100.
[44] Ortiz Mena L. N., 2002a, pp. 434-435.
[45] *Ibídem*, pp. 435-436.
[46] Signa, S.A. de C.V., a Mexican chemical manufacturer, started proceedings against the Canadian government but decided to desist. Vega, *et al.*, 2005, p. 99.
[47] Ortiz Mena L.N. 2002a; Macrory, 2002.
[48] Vega, *et al.*, 2005, p. 57.

TABLE 2. CHAPTER 19 CASES BY ECONOMIC SECTOR 1994-2003
(TOP THREE TYPES OF CASES, AS % OF TOTAL CASES AGAINST THE DEFENDANT)

DEFENDANT	NUMBER OF CASES	TOP THREE TYPES OF CASE	%
Canadian authorities	19	Semi-manufactured products	47
		Chemical products	16
		Processed foods, agricultural products, domestic products	11 (each sector)
U.S. authorities	56	Semi-manufactured products	43
		Minerals	29
		Live animals, agricultural products	5 (each)

Source: adapted by the authors from Vega, *et al.* 2005, p. 62, (Table 11).

While the system can certainly improved, there are many actions that can be taken, from relatively minor ones such as amending current Mexican law so that reimbursements for duties paid by exporters under a preliminary investigation would either be avoided or made in more timely manner, to more challenging ones like macroeconomic coordination. The coordination of macroeconomic policies (or perhaps more realistically unilateral actions by Canada and Mexico to take into account U.S. macroeconomic policies) would reduce the need to resort to antidumping measures, given that wide swings in exchange rates greatly increase the pressure to use antidumping actions.[49]

Chapter 20 has been the least frequently used dispute settlement mechanism in NAFTA. Between 1994 and 2003 three cases reached the panel stage: the U.S. *vs*. Canada (certain U.S. origin agricultural products), Mexico *vs*. the U.S. (Broomcorn brooms), and Mexico *vs*. the U.S. (Cross-border services and investment in the trucking sector). In addition, Mexico has requested the establishment of a panel to review U.S. authorities' decision to curtail Mexican sugar exporters, but there have been inordinate delays in the establishment of the panel.

Regarding Chapter 20, the flexible nature of the mechanism has become more a liability than an asset. While the Broomcorn case was satisfactorily resolved, the U.S. origin agricultural products case has remained an irritant between Canada and the U.S., eventhough the panel ruled in Canada's favor and there was little else U.S. authorities could do; and the ability to block the establishment of a panel means that the Mexico-U.S. sugar dispute has been festering. However, the most troubling case has been Mexico *vs*. the U.S. on trucking.

[49] Ortiz Mena L. N., 2002a, pp. 436, 437.

While Canada and the U.S. have liberalized trucking under their bilateral FTA, this is not the case between Mexico and the U.S. Under NAFTA, the U.S. committed to opening up trucking services to its border states, and by 2000 to all of its territory. Trucking is of major importance for North American economic integration and competitiveness, insofar as most trade is carried out by land. Trucking groups in Mexico and the U.S. were against trucking liberalization, preferring to curtail competition in their domestic markets; Mexico is prepared to open up its market when the U.S. does so. A Chapter 20 panel ruled in Mexico's favor in February 2000, but at the time of this writing Mexican truck are still unable to circulate freely in the U.S. according to NAFTA commitments.[50]

4. The Challenges Ahead

What have Canada and Mexico learned through the different strategies each country has pursued in dealing with the U.S.? Have Canada and Mexico learned from each other's experience in this regard? Is there scope for greater cooperation between Canada and Mexico? How will their bilateral relationship affect their dealings with the Powerful One? In this final section, we offer some thoughts on these issues.

4.1. Canada and Mexico and their relationship with the United States: Lessons Learned

During the last Century, Canada and Mexico dealt with the Powerful One through maintaining a closed or largely-closed economy through tariff and other barriers, as well as attempts at trade diversification.

These strategies (Mexico added a stage of direct confrontation in terms of the 1938 oil nationalization episode) did not prove to be very successful.

While several Mexican groups —mostly on the political left, but also members of the right-of center National Action Party (PAN)— criticized NAFTA during the negotiations[51] few appear nowadays to seriously question the agreement as a whole and regard it as a fait accompli, although in 2002 some agricultural interests groups sought a renegotiation of the agricultural chapter. It appeared that a lesson had been learned: instead of confronting the U.S. or trying to turn away from it, the best strategy was to address the costs and benefits of the unassailable fact of physical proximity and significant asymmetries in power, and make the best of the situation through increased economic interaction and greater institutionalization of North American economic relations.

[50] Spring,, 2005. See Ortiz Mena L. N., 2002b for a chronology of the trucking dispute. In addition to the cross-border provision of services, the dispute covered foreign investment in the trucking sector.
[51] For a leftist critic, see Cárdenas, 1991; for a rightist critic, see Conchello, 1992.

The same is largely the case for Canada. The 1988 free-trade debate regarding the bilateral Canada-U.S. pact was among the most divisive in the country's history but few organizations beyond the left-wing fringe would now support the withdrawal of Canada from the successor NAFTA.

Despite these similarities, it is striking that neither Canada nor Mexico came to this state of affairs in any sort of coordinated fashion. When Mexico tried to diversify its trade relations it looked either south —toward Latin America -or east- towards Europe—. It did not pay attention to Canada in any systematic way as a possible source of trade and investment diversification, nor did it take its actions elsewhere with anything but a marginal sense of Canada's own trade diversification efforts (most recently by Pierre Trudeau in the 1970s).

If Mexico did not contemplate Canada as a potential market throughout most of the 20th century, neither did it consider that some lessons may be learned by the way it dealt with the Powerful One. The Canada-U.S. FTA barely registered even among government officials and trade specialists, and when Mexico finally decided to propose an FTA to the U.S., it was Canada which had to ask to participate in the negotiations. At several points during NAFTA negotiations, Mexico feared that Canada's s tough stance on issues like cultural industries was putting the whole negotiation at risk, and seemed to be turning into a stumbling bloc for the project Mexico had envisioned.

But Canada could learn from Mexico in one sense now —in terms of the aggressive way Mexico has pursued free-trade agreements with other countries even as it has continued to seek close economic ties with the United States—. In recent years, for example, Ottawa's free-trade talks with EFTA and the Central American countries have been frozen due to domestic political concerns over protection of the shipbuilding and agricultural sectors.

Likewise, Mexico has been more successful at engaging major economies in economic integration. Canada is only now, for example, negotiating a trade pact with Japan; one that will not be as sweeping as the free-trade agreement already signed by Japan with Mexico.

The Fox administration's lack of focus and coherence, together with the U.S.'s apparent one track mind regarding security and terrorism will make cooperation much more difficult to attain that envisaged during the brief "honeymoon" during early 2001. However, given both countries' interest in the stability, security, and prosperity of its neighbor, the demand for cooperation will be ever present, even if circumstances and domestic politics make it difficult to attain, and leaders are not always up to the task.

The same in a different context is true for Canada. The Martin government, caught in a minority situation in Parliament, has had to be super-sensitive about being perceived as getting too close to the White House. But, again, the demand for cooperation is ever-present given the Canadian

dependence on the U.S. economy and the need to take U.S. security concerns seriously in order to ensure continued open access to that market.

The Challenges

The main challenge for Canada and Mexico is to make the most out of their being neighbors to the Powerful One: to ensure that the full economic potential of North America is realized, for the benefit of its citizens, and to have a say in how this is to be achieved, despite overwhelming power disparities.

Realizing the full economic potential of the region will require deeper integration, and in order to attain deeper integration several issues must be tackled. First and foremost is the inescapable link between security and the economy. Whilst in the past it was possible for Canada and Mexico to de-link these issues, since 9-11 this is no longer the case. The transportation bottlenecks experienced at the Canada-U.S. border after 9-11 is just one example of the many challenges that security poses for day-to-day business interactions.

In fact, Canada and Mexico's economic potential derived in large part from their being the Powerful One's neighbors. Should U.S. authorities decide to combat terrorism through ever increasing barriers at its borders, this would be tantamount to Canada and Mexico being unable to reap the advantages of their geographic location. Under these circumstances, other countries would be poised to pose even greater challenges for Canadian and Mexican companies in the U.S. market.

On the other hand, if Canada and Mexico are able to reap the advantages of their geographic location under the new security-intensive environment, no other country would be able to compete with them regarding degree of access to the U.S. market. That is to say, the U.S. may negotiate FTAs with other countries and proceed apace with multilateral trade negotiations, but it is unlikely that trade liberalization with on neighbors will be able to tackle a host of security-related on-tariff barriers. If North American integration is to proceed, then a North American security perimeter (however that may be defined) is a must.

Apart from deep cooperation in security matters, further integration will require improved infrastructure, not only along the Canada-U.S. border but along the Mexico-U.S. border and throughout Mexican territory approaching it, and this in turn will entail significant investment commitments and a long-term commitments and outlook by both the three North American governments and by the private sector.

There exist great complementarities regarding energy. In recent years, the U.S. government has become increasingly knowledgeable about the energy resources available in Canada —especially Alberta's oil sands—. But, on the other hand, Washington has been quietly frustrated by Mexican restrictions on foreign investment, leaving the potential for bilateral cooperation unrealized.

Like energy, migration is a very contentious issue in Mexico-U.S. relations, but given push factors in Mexico and pull factors in the U.S. it is unlikely that migration to the U.S. —illegal or otherwise— will decline in the near future. It is also increasingly difficult for political reasons to sell the benefits of free trade in goods and serviced and the free movement of capital while putting the free movement of labor in a different category altogether.

Which forces enable deeper integration, and which ones will make it more difficult? As it is often said, predictions are difficult and especially so regarding the future, but it is nevertheless possible to note the forces that are arrayed in favor and against deeper integration.

External developments, such as 9-11, the rise of China and U.S. regionalism all work as catalysts for deeper integration. Canada and Mexico have understood that the privileged position they were in due to their exclusive trade deals with the U.S. is at risk. First of all, as mentioned, security concerns will increase transaction costs, and such an increase may significantly impair the improvements gained under NAFTA.

China, which only recently joined the WTO, has a significant disadvantage due to its distant location from the U.S. and has no free trade agreement with the U.S., overtook Mexico as the U.S.'s second trade partner in 2004. Canada fears, meanwhile, that it will itself be overtaken by China as the United States' number one trade partner in as little as a decade.

U.S. regionalism is also watering down Canada and Mexico's privileged access through preference erosion. In other words, there is no such thing as the status quo as far as trade and investment links with the U.S. are concerned: either Canada and Mexico move forward, or they will face much stiffer competition from new rivals.

Three politicians —Pedro Aspe (former Mexican finance minister), John P. Manley (former Canadian deputy prime minister), and William F. Weld (former Governor of Massachusetts and U.S. Assistant Attorney General)— took up these challenges, and on May 17, 2005 issued "Building a North American Community", a call for action and ambitious action plan under the aegis of the Council on Foreign Relations.[52] They headed and independent task force that noted the challenges derived from international security threats, increased competition from abroad and uneven economic development in North America. They envision a new North American community by 2010 that will be able to address these challenges. They propose, among other measures:

- The establishment of a common security perimeter.
- The adoption of a common external tariff.
- An "open skies" and "open roads" policy.
- An expansion of temporary worker permits.

[52] Aspe, *et al.*, 2005.

- Full labor mobility between Canada and the U.S.
- The establishment of a North American Investment Fund to build infrastructure to connect Mexico's poorer regions with the markets in the North.
- Greater use of international technology and capital in Mexico's energy sector.
- The establishment of a permanent tribunal for the settlement of trade and investment disputes.
- The establishment of a Tri-national Competition Commission to develop a common approach to trade remedies.

There are many valuable and concrete proposals in "Building a North American Community, but political realities mean that actions will fall well short of the Aspe, Manley, and Weld's vision.

In Canada, while few opposed NAFTA there is considerable unease at further steps beyond the technical. In Mexico, the same is the case, mixed with reform fatigue as well at a time when well-founded studies state that much deeper reforms are needed if Mexico is to reap its full economic potential and that of NAFTA.[53]

The Mexican public at large, although having generally favorable views on NAFTA, is weary of allowing foreign investment in key areas such as energy, and does not favor coordinating with Canada to defend both countries' interests against the United States.

Regarding relations with Canada, 52% of Mexicans believe that Mexico should seek special treatment from the United States independently from its relations with Canada, while only 25% said that Mexico should coordinate its positions with Canada in Order to defend its interests against the United States.[54]

This need not translate into insurmountable barriers regarding closer cooperation with Canada. Mexicans have a very positive view of Canada; it was awarded with a "65 degree" rating in terms of warmth of feelings toward other countries on a scale of 0 to 100, with only the U.S. and Japan topping it with 68 degrees each.[55] Leaders must take up the challenge posed by the opportunities offered by Mexican views on NAFTA and Canada-Mexico relations.

Perhaps it is Canadian legislators who have been the most active in making concrete efforts and proposals to further North American integration, but actions have fallen short of the actual potential of the region. In December 2002 the Standing Committee on Foreign Affairs and International Trade of

[53] Lederman, *et al.*, 2003; IMCO, 2005.
[54] CIDE and COMEXI, 2004b, p. 56.
[55] CIDE and COMEXI, 2004a, p. 31.

the Canadian House of Commons issued a very thorough report on Canada's relations with the United States and Mexico.[56]

The Committee issued 39 recommendations that address both security and economic concerns, while recognizing that it does not envision a "grandly ambitious North American "community".[57]

Regarding relations with Mexico, the report recommends that Canada strengthen its relations by supporting initiatives to deepen Canadians and Mexicans' knowledge of each other, by identifying specific aspects of North American relations that warrant closer collaboration between Canada and Mexico, by exploring bilateral Canada-Mexico collaboration that may include joint rather than separate dealings with the U.S., by investigating the feasibility of increasing Canadian support for Mexico's development efforts, and by involving parliamentarians as much as possible in the deepening of Canada-Mexico relations.[58]

In March 2004, the Canadian Senate's Standing Committee on Foreign Affairs issued a report specifically on Canada-Mexico relations.[59] While the report signals a growing interest in Canada-Mexico relations, the six recommendations also reflect a cautious and timid approach toward greater cooperation both bilaterally and in their dealings with the Powerful One. Recommendation 1 states that Canada should examine Mexico's success in negotiating free trade agreements, so that Canada can likewise develop its own trade networks. If the basic thrust behind this recommendation is for Canada to diversify its trade and investment links, the Mexican experience shows that it is very difficult to do so. However, one wonders why Canada does not see Mexico in earnest as an important source of trade and investment diversification (and vice versa). Recommendation 5 states that officials in both countries should explore the potential of common approaches in dealing with North American economic and trade-related security issues and that, should common ground be found, joint proposals could then be made to U.S. authorities.[60]

While commendable, the recommendations regarding closer Canada-Mexico cooperation in dealing with the U.S. seem appropriate for the time of entry into force of NAFTA. It is striking that eight (and ten) years after NAFTA had been in force the language of cooperation still involved such preliminary and non-committal phrases such as "identifying", "exploring", "investigating the feasibility", "should common ground be found", etc.

While a gradual and piecemeal approach to further regional integration may be a pragmatic and politically expedient approach, it may not be

[56] House of Commons, Canada, 2002.
[57] *Ibídem*, p. 278.
[58] *Ibídem*, p. 289 (Recommendation 35).
[59] Senate, Canada, 2004.
[60] *Ibídem*.

adequate to fully rise to the challenges of North American integration. After all, it took quite a leap of faith for both CUSFTA and NAFTA to come into effect, but it is through these initiatives that North American relations have been enhanced and the effects of power asymmetries diluted.

Canada "discovered" Mexico only once Mexico had started to negotiate a bilateral free trade agreement with the U.S.,[61] and Mexico negotiated NAFTA only once it had run out of other viable options and the costs of the status quo were increasing. Perhaps only a marked deterioration of the security and economic situation in North America will bring Canada, Mexico and the U.S. together again in that kind of sweeping fashion.

September 11 might have done that, if not for the marked upsurge in anti-American sentiment in both Canada and Mexico that followed the Bush administration's military response in the Middle East.

But it was the September 11 attacks themselves, ironically, that may in the longer term have given the three countries a template for how to move forward in terms of continental coordination. The attacks added a huge new factor —border security— to the continental equation. Both the 49th parallel and the Rio Grande, which had been opened to the freer movement of goods and services under NAFTA, suddenly looked a great deal riskier economically as the United States moved onto a war footing.

The Canadian government responded rapidly by leading the process of reaching a "smart border" accord with Washington in late 2001 aimed at speeding the cross-border movement of legitimate trade while ramping up efforts to patrol the border against security threats.

Mexico had wanted to be involved from the start, hoping for a three-way negotiation dealing with both the United States' northern and southern borders simultaneously. Not incidentally, Mexico hoped this would be a step toward building the kind of trilateral architecture beyond NAFTA that Mr. Fox had been seeking on a less ad hoc basis just months earlier.

Canada was determined that this not occur, as it likely would have prolonged its talks with Washington. But Ottawa did keep Mexico informed during the bilateral negotiations, and the Canada-U.S. deal provided the template for key aspects of the U.S.-Mexico border deal reached some months later.

Is this a model for the future? The work plan arising out of the Waco summit suggests so.

This would serve the interests of all three countries. It is not a dual bilateral structure giving advantage to Washington, nor is it an inflexible trilateral process. It is a two-speed road map, taking into account the nature of the three countries of North America.

[61] Cameron and Tomlin, 2002.

How that process plays out remains to be seen —small-scale technical agreements as are now being pursued or a sweeping trade and security pact necessitated by much larger challenges than now exist— (and a more visionary leadership capable of delivering on that vision at home).

But, in any case, it is certain that Mexico and Canada —after virtually ignoring each other for decades— will have much to consider together as they seek in their own fashion to pursue mutually-advantageous relations with the United States.

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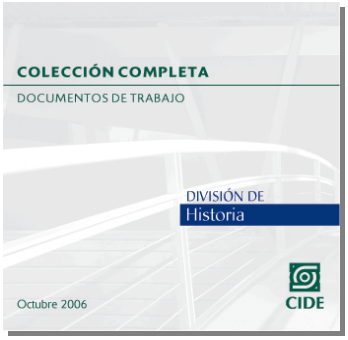

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