WORKING PAPER SERIES

THE OPPORTUNITIES AND CHALLENGES OF NORTH AMERICAN FREE TRADE: A CANADIAN PERSPECTIVE

Working paper number 7
April, 1991

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THE OPPORTUNITIES AND CHALLENGES OF NORTH AMERICAN FREE TRADE: A CANADIAN PERSPECTIVE

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CHRONOLOGY LEADING TO THE NAFTA NEGOTIATIONS

June 10, 1990
Presidents Bush and Salinas announced they had instructed their officials to undertake consultations preparatory to negotiations on a comprehensive Free Trade Agreement. This agreement would include: the gradual and comprehensive elimination of trade barriers; protection for intellectual property rights; establishment of a dispute settlement procedure; and means to expand the flow of goods, services and investment.

August 8, 1990
Mexican Trade Minister, Jaime Serra Puche, and U.S. Trade Representative, Carla Hills, recommended to the U.S. and Mexican presidents that the two countries proceed to negotiations on a Free Trade Agreement.

August 21, 1990
In a letter to President Bush, President Salinas formally proposed initiation of negotiations for a Free Trade Agreement between the United States and Mexico.

September 24, 1990
International Trade Minister, John C. Crosbie, announced the Government of Canada's decision to participate in preliminary discussions with Mexico and the United States to establish the basis for subsequent negotiations on a trilateral Free Trade Agreement.

September 26, 1990
President Bush informed the Senate Finance Committee and the House Ways and Means Committee of Mexico's request for negotiations aimed at the establishment of a Free Trade Agreement. This notification served to start the clock on the "fast track" authorization process. The House and Senate committees have 60 legislative days to approve the fast track process. If granted, the negotiated trade agreement must be approved or rejected by Congress without amendment.

At the same time, President Bush informed the House and Senate committees that Canada had expressed a desire to enter into exploratory discussions with the U.S. and Mexico on a North American Free Trade Agreement (NAFTA).

February 5, 1991
Prime Minister Mulroney and Presidents Bush and Salinas announced their decision to pursue a NAFTA which would progressively eliminate obstacles to the flow of goods, services and investment, provide intellectual property rights protection, and establish a fair and expeditious dispute settlement mechanism.

President Bush notified the House Ways and Means Committee and the Senate Finance Committee of Canada's request to become a party to trilateral NAFTA negotiations. This notification initiated a separate 60-day fast track authorization process.

EXECUTIVE SUMMARY

This report presents detailed trade and investment data germane to a better understanding of the opportunities and challenges of a North American Free Trade Agreement (NAFTA). It also provides insight into a number of key questions that are often raised about the yet-to-be-defined Agreement.

One of the most fundamental of these questions is whether a free trade agreement can at the same time be a "fair" trade agreement when two of the proposed partners (the United States and Canada) are highly advanced countries, while the third partner (Mexico) is very much a developing country. The analysis begins, therefore, with a review of why free trade is in Canada's interests.

Origin of trade and investment opportunities with Mexico

Many Canadians are concerned that free trade with Mexico will benefit Mexican workers at the expense of Canadian workers. Mexican wages are approximately one-tenth of Canadian wages. However, most of Canada's imports from Mexico already enter duty-free, or at relatively low duties. Canada, in fact, imports a great deal from low-wage, developing countries, to the benefit of Canadian consumers and without dire consequences for Canadian industry. On the contrary, such trade facilitates lower production costs and helps Canada to be more competitive in high-skill, high-wage jobs.

Mexico, following the example of the "seven tigers"[1] in the Asia-Pacific Region, has adopted outward-looking, market-based policies. Since the mid-1980s, Mexico has been dismantling the protectionist policies of former governments. Its desire for a free trade agreement with the United States and Canada is a dramatic conclusion to a series of radical, unilateral measures designed to propel Mexico into the competitive international marketplace. As a result, Mexico is poised to experience rapid growth.

Changes in the world economy are not a zero-sum game--one country's gain is not usually at the expense of another's. Mexico appears to have the most to gain from free trade with the United States and Canada primarily because it is so far down the income scale and has such vast unused (or under-utilized) resources. It will begin to approximate living standards in the rest of North America only if it specializes in its areas of comparative advantage and relies on imports for many of its industrial and consumer requirements. Mexico's imports, in fact, will grow rapidly--more rapidly than its exports. It will need a considerable increase in foreign investment and capital, both to assist in the strengthening of its economy and to balance its current-account deficit.

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[1] Hong Kong, Indonesia, Malaysia, Singapore, South Korea, Taiwan and Thailand.

This, then, is the origin of the trade and investment opportunities for Canada (and the United States) following freer trade with Mexico. We mustn't be blindsided by low wages. Mexico's wages are low because Mexican productivity compares very unfavourably to our own. Our challenge is to ensure that our own productivity stays among the highest in the world. A NAFTA will contribute towards this goal, perhaps modestly at first, but increasingly as our ties with Mexico grow.

Potential benefits for Canada

The contribution to productivity will reflect economies of scale and other benefits, as Canadian firms organize themselves to serve a market of 360 million people. Following the implementation of a NAFTA, Canada will concentrate more on high-skill, high-wage jobs, where we enjoy a comparative advantage. Mexico, with its abundance of low-skill labour, will concentrate more on labour-intensive activities. In all three countries, business will operate more efficiently and consumers will benefit from greater choice and more competitively priced goods and services.

Since these benefits can be realized only by industrial restructuring, some entrepreneurs and employees in the United States, Canada and Mexico will face difficult adjustments. Winners and losers at the individual level are inevitable. The losses, however, can be minimized by transition arrangements and by special provisions in the Agreement itself. This is an important reason for being at the negotiating table with Mexico and the United States: Canada must promote its interests just as our southern neighbours will promote theirs.

There is a lot of hard work ahead, both in negotiating a trilateral agreement and in preparing for its implementation. Canadians must recognize that, due to the limited trade between the two countries, the immediate prospect of free trade with Mexico may not be all that compelling, but the long-term opportunities are immense. Mexico could well become the North American equivalent of South Korea or Thailand. These opportunities, however, will be realized only if Canadians develop the same business connections that have made commerce with the United States so profitable. Given the cultural differences and geographic distance, all the more effort will be needed in nurturing ties with Mexico.

As a first step in this process, Canadian business must assemble and digest information about the trade and investment linkages among Mexico, Canada and the United States. It is important that data be gathered on a highly disaggregated basis, to help individual firms recognize and appreciate the stakes.

To this end, Investment Canada has undertaken a comprehensive analysis of both Canadian and Mexican exports to the United States, and Mexican exports to Canada. The analysis is sufficiently detailed to allow businesses to identify the trade competition in their areas of interest. This level of analysis also permits some insight into the investment implications of North American free trade, which is vital, given the growing complementarity between trade and foreign investment.

Sensitive areas: potential market overlaps

Investment Canada's analysis focuses particular attention on Canadian and Mexican competition for the U.S. market, for it is here that Canadian interests will initially be most at stake–whether or not Canada participates in the negotiations.

Detailed analysis presented in the report indicates that almost all Canadian exports to the United States can be characterized as:

- not having any Mexican equivalent (e.g. aluminum);
- having a Mexican equivalent, but with a very low U.S. duty rate already in place against the imported goods from Mexico; or
- having a Mexican equivalent and a U.S. duty rate that is roughly the same for both Canadian and Mexican exports.

Thus, for a large part of Canadian exports to the United States, the added competition that would result from a North American Free Trade Agreement will be less severe than anticipated.

Nevertheless, Canada and Mexico will compete in several U.S. markets. In some important sectors (automotive, steel, and textile and apparel industries), the competition is already intense and will increase as a result of free trade. Even where markets overlap, however, a NAFTA will simply formalize trends that are already occurring.

"Maquiladora" operations[2] as forerunners of free trade

Increasingly during more than two decades, American and other foreign firms (including some Canadian firms) have invested heavily in maquiladora operations in Mexico. This has allowed such firms to employ Mexican workers in assembly operations and to avoid having to pay duties on imported goods. The maquiladora operations, in fact, are the forerunners of free trade in North America.

[2] "Maquiladora" generally refers to assembly operations involved in export-manufacturing or secondary assemblage. The maquiladora (or "in-bond") industry was established in 1965 as part of Mexico's Border Industrialization Program. Designed to attract foreign manufacturing facilities, maquiladora operations exempt businesses in Mexico from paying duties on imported goods used in assembly processes for exports.

Two aspects of these practices warrant particular mention. The first is that investment in a maquiladora operation reflects expected gains from better use of labour. Instead of conducting all operations in a high-wage setting, Canadian and U.S. firms are increasingly trying to separate high-skill jobs from low-skill jobs. This endeavour is common to all high-wage countries. Japan, in particular, has been highly successful in this endeavour. Unless North America follows suit, other countries will simply usurp our traditional markets.

The second aspect of maquiladora operations that warrants comment is their contribution to intra-corporate trade. Some 20 percent of U.S.-Mexican trade is of an intra-corporate nature, and this share is expected to grow rapidly. In the case of U.S.-Canadian trade, about half is of an intra-corporate nature. This points to the desirability–if not the necessity–of having corporate connections on both sides of the border, something that is woefully lacking between Mexico and Canada. Indeed, one of the central conclusions of this analysis is that Canadian direct investment in Mexico will be necessary if Canada hopes to capture the export potential of a rapidly growing Mexican economy.

Mexico's foreign investment regulations

Because international investment is such a strong complement to trade, the report presents a thorough discussion of Mexico's foreign investment regulations. Since 1985, these regulations have been greatly liberalized. There is now considerable scope for foreign participation in the Mexican economy. In fact, Mexico is seeking a North American free trade accord primarily to spur foreign investment. The trade negotiations may lead to yet further investment liberalization, because— as illustrated in the report— Mexican provisions are at present far less open than those of either Canada or the United States.

Concern about Mexican imports largely unwarranted

The report also provides detailed information about Canadian imports from Mexico. Canada imports motor vehicle parts and engines; TV, radio, sound, and telecommunications equipment and parts; office and digital processing equipment; precious metals, alloys, and other metal ores; and crude oil. Most of these imports, which account for more that two-thirds of total imports from Mexico, enter with duty rates of zero or near-zero. These imports will be largely unaffected by a free trade agreement.

The remaining third of imports from Mexico, however, could be considerably affected. Import and tariff data demonstrate that there is a broad range of Mexican imports that bear high effective Canadian duties. For example, Mexican imports of textiles, garments and footwear are subject to duties in excess of 20 percent. Free trade with Mexico in these and a number of other commodities could lead to greater competition with domestic production or imports from third countries (i.e. from countries not part of the trilateral free trade agreement).

However, a number of factors minimize the risk for Canada. First, Canadian production that competes with Mexican imports subject to high tariffs represents only about five percent of Canada's gross domestic product. Further, similar imports from third countries are 16 times the magnitude of high-tariff imports from Mexico. Finally, the free trade agreement can be expected to include provisions for a lengthy implementation and adjustment period. It would be to Canada's considerable disadvantage if risk-avoidance persuaded us to opt out of the opportunities and challenges of North American free trade.

Concluding comments

The report concludes by noting that North American free trade requires investing in Canada's future. Expansion of Canada's exports to Mexico, and greater openness to Mexican exports both in Canada and the United States, will be accompanied by greater trilateral investment. To realize new productivity and job opportunities, Canadians must be prepared to invest more heavily, both at home and abroad. A trade strategy that taps into the possibilities in Latin America must be supported by an investment strategy.

INTRODUCTION

Canada, the United States and Mexico are expected to commence formal negotiations in the spring of 1991 that will lead to a North American Free Trade Agreement (NAFTA). Working groups and consultations are already well under way so as to expedite the process. It is hoped by the governments involved that the negotiations will proceed quickly. Some optimists have predicted that a comprehensive free trade agreement could be reached in principle by as early as the end of 1991.

What is meant by a comprehensive agreement? First and foremost, a comprehensive NAFTA is not a simple extension or expansion of the Canada-U.S. Free Trade Agreement (FTA). The FTA is hand-tailored to fit the special relationships and interests prevailing between Canada and the United States. The principles behind the FTA, though, are expected to help guide the NAFTA negotiations. The NAFTA and the FTA must be complementary in many important respects—including rules of origin and dispute settlement provisions. Every effort must be made to avoid the so-called hub-and-spoke approach, whereby bilateral arrangements between the United States and Canada, and between the United States and Mexico, would result in an overall net advantage for the United States.

Mexico presents another set of special relationships and interests. Trilateral free trade among the three countries must be governed by the developing status of Mexico and the market-based economic structure that has proved so successful in Canada and the United States. Clearly, Mexican-U.S. economic ties are much stronger than those between Mexico and Canada. Nonetheless, it is in the interests of all three countries to create the largest market in the world (360 million people compared with 320 million in the European Community). Benefits for Canada of being part of a NAFTA include the expanded export opportunities associated with a rapidly growing Mexican economy.

And yet this reference to tremendous growth prospects for Mexico sends shivers down the spines of many Canadians. Some see this rapid growth as occurring at the expense of Canadian jobs. Indeed, critics of the proposed NAFTA see Canada being swamped by Mexican products, and our markets in the United States being similarly overwhelmed. The alleged spoiler, of course, is the low-wage situation in Mexico.

Change upsets long-standing practices; hence, those who feel least able to respond to these changes, or those who claim to speak on their behalf, resist change itself. Others in Canada and the United States have confidence that, even though global competitive forces are extremely demanding, their firms can match or excel those in other countries. Canada and the United States have overall productivity levels superior to those found anywhere else in the world.

However, the merits of a free trade agreement between a low-wage, developing country and two industrialized, high-wage countries have little to do with head-to-head competition. The zero-sum perspective, whereby the growth of one country is assumed to take place at the expense of another country, is founded on a faulty understanding of how the global economic system works. Progressive liberalization of the world trading system since the Second World War has led to growing benefits for all participants in this liberalization.

Since the mid-1980s, Mexico has been opening up and deregulating its economy. Mexico has joined the General Agreement on Tariffs and Trade (GATT), reduced its tariffs significantly, abolished official prices and removed most import licensing requirements. By the end of 1990, Mexico had privatized or dismantled 722 of its 1,155 state-owned firms, and restrictions on foreign investment had been greatly relaxed. Foreign investment, in fact, is one of the prime, sought-after prizes of a free trade agreement. Mexico's development strategy is now based on export promotion rather than import substitution.

These reforms open up the possibility of enormous growth for Mexico—similar to that experienced by South Korea and a number of other Asian countries. Mexico, after all, has per capita incomes that are one-tenth or less than those of either the United States or Canada. The improvement of living standards in what is now a Third World country will not jeopardize those in the rest of North America. On the contrary, just as technology leads to improved productivity and job quality, so too improved resource use in Mexico will lead to further opportunities for specialization, trade and investment in the United States and Canada. Because of global developments and the apparent determination of the United States and Mexico to proceed with trade liberalization, sectoral adjustments are inevitable regardless of whether or not Canada participates in free trade. By helping to forge the conditions by which trilateral free trade is introduced, Canadian concerns respecting sectoral impacts can be taken into account. The phasing of tariff reductions, exceptions for certain sectors, rules of origin, "grandfathering" of industrial support programs and other components of a NAFTA can be designed to ease sectoral adjustments. It is very much in the interests of Canada to be at the negotiating table.

This statement is based on more than a leap of faith. It is based on facts about the three countries, including their respective skill levels and natural resource endowments. It is also based on a solid understanding of trade and investment flows, and what affects these flows over the long term. The implications of trade liberalization are well understood by economists and business leaders who, with few exceptions, have strongly endorsed the formation of a NAFTA. A recent survey by the Canadian Manufacturers' Association indicates that 90 percent of its members favour Canadian participation in the trilateral negotiations, and almost half anticipate business opportunities for their companies. A NAFTA will not result in a zero-sum outcome. On the contrary, all three countries stand to benefit substantially.

Mexico will no doubt benefit the most, if for no other reason than it has so far to go before it begins to enjoy the living standards commonplace in Canada and the United States. A NAFTA will greatly assist Mexico in making the transition from a developing country to a developed country, and from a low-wage country to a high-wage country. In making this transition, Mexican imports will grow more rapidly than its exports. As one of the world's leading trading nations, and as a member of the trade agreement, Canada will have an inside track on a rapidly growing export market. By the end of the century, Mexico will be home to more than 100 million avid consumers.

A different perspective of the Canada-U.S.-Mexico trade negotiations is gained by considering the north-south dichotomy and, more generally, the globalization of world economies. Mexico is a poor country struggling to overcome a heavy external debt load and a rapidly growing population. After many years of extensive state intervention and unsuccessful economic policies, including severe restrictions on foreign investment, Mexico has emerged in recent years with a fresh approach to development. It has demonstrated its willingness to implement the tough structural adjustment measures long advocated by the International Monetary Fund (IMF) and the World Bank.

Mexico's success is vital, both for its domestic well-being and as proof that structural adjustment measures work. The success of Singapore, South Korea, Taiwan, Hong Kong, Thailand, Malaysia and, most prominently, Japan has stood in stark contrast to the stagnation or reversals suffered by socialist or protectionist countries (e.g. Vietnam, and the Eastern Bloc generally). Despite the success of the former countries, however, a number of Third World countries are in a highly confused state concerning solutions to age-old development problems. Unfairly, their unsatisfactory economic performance is often attributed to unworkable IMF/World Bank prescriptions. Mexico, like Indonesia and a small number of emerging "newly industrializing countries" (NICs), is a model of those same prescriptions applied successfully.

Canada, along with the United States and other Group of Seven (G7) industrialized countries, has a lot at stake in nurturing Mexico's fledgling success. Part of this stake is purely self-interest, based on improved economic prospects for all three members of a NAFTA. But there are other dimensions to self-interest, and other arguments than pure self-interest. Canada's official development assistance, for example, is approximately $2.5 billion annually; until living conditions in Third World countries improve, Canada will be called upon to contribute even more. Furthermore, extreme poverty in Latin America and elsewhere in the world compounds the refugee problem. Even North America's drug problem is believed to be linked with north-south disparities. In these regards, Canada's interests in trilateral free trade with the United States and Mexico cannot be quantified.

PULLING TOGETHER THE FACTS: BASIC ECONOMIC DATA

What are the facts that should inform us about the implications of free trade among Canada, the United States and Mexico? The temptation, of course, is to immediately refer to trade and investment data, or wage data. It is instructive, however, to put the proposed NAFTA into some context. What follows, then, is a brief summary of some key facts about the three countries.

Demographic information is a good place to start, since population levels and rates of growth play an important role in determining the potential for commerce between nations. From this perspective, Canada is a small country. With a population of only 26 million, compared with 250 million in the United States and 85 million in Mexico, our stature derives not from a head count but from our economic clout. Canada's gross domestic product (GDP), in fact, is almost three times that of Mexico's. As members of the G7, Canada and the United States play influential roles in shaping the world economy.

Clearly, in light of the population and GDP data, Mexico's standard of living is very much below that of Canada and the United States. While GDP per capita in Canada and the United States is about US$21,000, in Mexico it is less than US$2,000. It is this gaping difference that, even if only partially closed, promises such opportunity for wealth and trade creation for all parties to a NAFTA. In fact, per capita GDP comparisons understate the potential; the concentration of wealth in Mexico means that the average family income is considerably less than one-tenth the average in either Canada or the United States.

Mexico's importance is sure to grow. During the 1960s and 1970s, its population increased at the rate of about three percent per year. As a consequence, Mexico's population is much younger than the rest of North America's. This population growth rate moderated considerably during the 1980s, reaching about two percent per year by the end of the decade. Still, this is twice the rate for Canada and the United States. Canadians are startled by the fact that more than 20 million people live in Mexico City alone.

While Mexico's population growth rate is twice that of Canada and the United States, its economic growth rate between 1980 and 1987 was only 0.5 percent annually, compared with rates of about 3 percent in the rest of North America. Since the economic reforms of the mid-1980s, industrial production has strengthened considerably in Mexico. The collapse of world oil prices in 1986, however, and the difficulties of adopting market disciplines, has caused overall growth to continue to be disappointing. Inflation is in the 30 percent range, which contrasts very unfavourably to the low inflation targets set by the Bank of Canada and the U.S. Federal Reserve. Slow growth in Mexico is at least in part due to the destabilizing effects that inflation—and hyperinflation—have had on the economy; 1990 was the first time in over a decade that Mexico's GDP grew faster than its population.

Despite these problems, there is every reason to believe that Mexico's economic growth rate will accelerate rapidly in the future. Structural policies now in place are conducive to free enterprise, including business investment by foreigners. The accumulated value of foreign investment in Mexico has increased almost four fold during the past decade. A NAFTA will no doubt greatly increase foreign interest in Mexico, if for no other reason than the conclusion of such an agreement will help consolidate the reforms already introduced by the de la Madrid and Salinas governments. Mexico's external debt, which was US$93 billion in 1990, no longer hangs over the economy like the sword of Damocles; the external debts of Canada and the United States dwarf that of Mexico. As one indicator of Mexico's potential, value-added by industries under the maquiladora program increased from $772 million in 1980 to $2.3 billion in 1988. The customs value of U.S. imports under the maquiladora program has been growing at a compound annual rate of almost 20 percent. Table 1 indicates the value-added by sector, and the overall value of maquiladora exports between 1986 and 1989.

"Maquila," or "maquiladora," generally refers to an assembly operation involved in export-manufacturing or secondary assemblage. The maquiladora, or "in-bond industry," was established in 1965 as part of Mexico's Border Industrialization Program. This program, which exempts businesses in Mexico from paying duties on imported goods used in assembly processes for exports, was designed to attract foreign manufacturing facilities. Originally restricted to a 20-kilometre strip along the Mexico-U.S. border, the program now applies throughout most of the interior of Mexico. The U.S. government has a complementary program, under which no U.S. duty is applied to the value of U.S.-made components incorporated in imports from Mexico. In effect, duty is paid only on value-added in Mexico—which tends to be low because of low wages. Currently, over half the more than 2,000 maquiladoras are Mexican subsidiaries of U.S. firms. Many of these U.S. firms specialize in the production of electric and electronic goods, transportation equipment and textiles and apparel. So far, only nine Canadian companies have maquiladora operations.

Reference to the maquiladora is interesting because it is a forerunner of North American free trade. It is also interesting because of the controversy concerning the low labour costs and, in combination with proximity to the U.S. market, the advantage that these appear to give to maquiladora producers over Canadian and American producers. This is the most persistent worry raised by opponents to negotiations with Mexico. It is also, for the most part, ill-founded. An explanation is in order.

Mexican unskilled labour is generally paid little more than $.60 an hour, while those who work in maquiladora or in-bond industry may earn in the order of $2.00 an hour—depending on how long they stay with a firm (considerable bonuses are paid to

Table 1
Maquiladora Exports

Total Value of Exports				Industry	Value-Added in Exports			
1986	1987	1988	1989		1986	1987	1988	1989
US$ millions					US$ millions			
43	44	57	70	Foodstuffs Processing	11	16	23	32
360	410	468	567	Textiles, Apparel	84	101	128	183
67	78	102	160	Shoes, Leather Goods	17	20	28	46
145	255	414	573	Furniture Parts, Wood, Metal	55	78	127	156
6	18	38	55	Chemical Products	4	10	18	22
1,622	2,086	2,850	3,389	Transport Equipment	307	381	596	725
73	116	169	184	Equipment, Tools, Non-electric	25	28	37	47
1,265	1,309	1,694	2,096	Electrical, Electronic, Materials, Equip.	270	283	382	477
1,397	1,847	2,877	3,492	Electrical, Electronic, Materials, Acess.	315	393	586	765
135	152	264	336	Toys, Sporting Goods	41	44	66	100
450	681	1,087	1,369	Other Manufacturing Sectors	117	191	283	407
82	111	127	204	Services	49	51	63	88
5,645	7,107	10,147	12,495	Total	1,294	1,596	2,337	3,048
11.1	25.9	42.8	23.1	Growth Rate (%)	2	23	46	30

Source: Bank of Mexico.

workers who stay with a firm, in an attempt to overcome high turnover rates and training costs). Not surprisingly, comparisons with Canadian or U.S. wage rates suggest to the non-economist a serious competitive problem; the average industrial wage in Canada's manufacturing sector is $15 an hour. The Canada/Mexico wage differential is similar to the Germany/Portugal wage differential.

As will be elaborated upon in a subsequent section of this paper, the effective duty rate on Canadian imports from Mexico is, on average, only 2.4 percent. Thus duties or tariffs on imports from Mexico only marginally narrow the wage rate differential between the two countries—by $.02 at the low-end of the scale and by $.05 at the high-end of the scale. Clearly, existing Canadian tariffs provide little protection; high tariffs apply to less than a third of Canadian imports from Mexico. Moving to zero tariffs, then, will have relatively little effect on the competitive position between Canada and Mexico; this also applies to competition for the U.S. market. Reduction of non-tariff barriers, such as marketing regulations and quotas, could have important implications in certain sectors (e.g. alcoholic beverages) but, generally speaking, trade liberalization would have only a marginal impact in the short to medium term on Canada's competitive position.

Commentators on free trade frequently overlook two key variables that allow wealthy, high-wage countries to trade profitably with poor, low-wage countries. The first variable is the exchange rate, which is the mechanism that equilibrates imports and exports:

> What matters in international competition is not how much local labour is paid in terms of purchasing power. What matters is how unit costs of production compare internationally at the going exchange rates.
>
> Richard Lipsey, *Canada at the U.S.-Mexico Free Trade Dance.* Commentary, C.D. Howe Institute, August 1990.

The second key variable is productivity or output per worker. Wages (and incomes) are high in Canada and the United States because overall productivity is the highest in the world; in sharp contrast, wages (and incomes) are low in Mexico because the productivity of Mexican workers is low. Their low productivity is the result of a combination of factors, including low skill levels, poor plant and machinery with which to work, and poor social infrastructure such as roads, telecommunications, etc. It should also be noted that labour costs represent less than 45 percent of value-added in the manufacturing sector in Canada.

At the going exchange rates between the Mexican peso and the Canadian and U.S. dollars, unit labour costs (which are the product of hourly wage rates and the number of hours of labour needed to produce a unit of output) are more or less comparable among the three countries. In those industries where Mexico has an advantage, its production and exports will increase. Where Canada and/or the United

States have an advantage, their production and exports will increase. Because Mexico has a labour surplus and a relatively unskilled labour force, it will tend to gain in the lower-value-added, lower-wage industries. Canada and the United States will tend to gain in the higher-value-added, higher-wage industries. A NAFTA will provide a strategic fit between countries with different resource capabilities:

> It would constitute combining the labour abundant and capital scarce region of Mexico with the technologically advanced industry and demographically aging population of Canada and the U.S.
>
> Dr. Edward Neufeld, Executive Vice-President, Royal Bank of Canada
> Remarks to the National Economists Club, Washington, February 1991.

Increasingly, the quality of the labour force is determining the competitive ability of a country. On this score, Canada and the United States— as indicated above— are far ahead of Mexico. And while Mexico is investing heavily in the education and training of its labour force, it will be a long time before it begins to match the skills and adaptability evident in its northern competitors. This is not to dismiss, though, the challenge for Canada and the United States to maintain their levels of high-quality jobs and complementary lower-paid support jobs. In the face of intensified competition from a low-wage country like Mexico, adjustment will be required. Canada will have to realign somewhat its industrial base in keeping with its areas of comparative advantage.

All three countries, in fact, will experience adjustment costs— an unavoidable fact if gains from liberalized trade are to be realized. Adjustment is an ongoing process, however, and stems from a wide variety of factors, including shifting consumer demand, technological advances and the adaptation of business to the pressures of globalization. Each year, approximately one-third of the Canadian labour force shifts in or out of jobs— some to enter the labour force, some to retire, and most to seek a step-up in their employment prospects. Just as accommodating the FTA has had only a marginal effect on labour adjustment in Canada, so too accommodation of a NAFTA would have only a marginal effect. In some sectors the effect may be more than marginal— both in a positive and in a negative sense.

There are, of course, resources other than human resources that bear upon trade between nations. Almost a third of the economically active population in Mexico is still dependent on agriculture and related rural occupations. This is much higher than in the case of either Canada or the United States, both of which have much larger and better acreage devoted to agriculture. While irrigation is increasing the potential of agriculture in Mexico, water supplies are limited. Further, Mexico may have to rely more on imports to supply basic foodstuffs to satisfy its growing population, increasing urbanization and increased consumer demand as incomes rise. Mexico imports wheat, corn and other agricultural products from Canada and the United States. To be sure, Mexico provides stiff competition in vegetables; but for the most part only during the nine months when domestic produce is not available in Canada. In short, there is a degree of complementarity among the three countries regarding their agricultural resources.

Petroleum reserves are also complementary. Mexico, with proven crude oil reserves in excess of 56 billion barrels, has become the fifth-largest oil exporter in the world. Indeed, with the disruption of Iraq's oil production due to the Gulf war, Mexico now ranks fourth in the world (after Saudi Arabia, the Soviet Union and Iran). Canada, with six billion barrels of proven reserves (not including the potential of the oil sands), is an exporter to the U.S. market, but Central and Eastern Canada are partially dependent on offshore oil. Mexico and Canada serve different portions of the U.S. market and free trade would have little if any impact on energy exports. The United States has 26 billion barrels of proven reserves, but these are rapidly being depleted. Other non-renewable resources include mineral resources and, again, all three countries have rich and extensive deposits. Like Canada, Mexico is a major producer of copper, lead, gold, silver and zinc. Unlike Mexico, Canada is a major producer of aluminum and nickel. Mineral prices are established on world commodity exchanges and Canada is considered to be competitive internationally. Iron and steel production is being rationalized in many countries, including Canada, reflecting more efficient use of materials in final consumption. Mexico and Canada compete for different segments of the U.S. steel market, in part a reflection of transportation costs.

Renewable resources other than agriculture include forestry and tourism. Mexico provides little or no competition to Canada respecting lumber or pulp and paper. A NAFTA would open up markets in Mexico for Canada, possibly at the expense of Scandinavian producers. Tourism is a major industry for all three countries and a NAFTA could be expected to generate even more intra-regional travel than is now the case. Bilateral tourism agreements already exist between Mexico and the United States, and between Mexico and Canada. In 1989, 550,000 Canadians visited Mexico, either for business or a holiday. In the same year, 75,000 Mexicans visited Canada.

The above economic data have omitted reference to the manufacturing and service sectors, which are addressed in the section on trade that follows. It should be apparent even at this stage, however, that there is little to fear respecting free trade between two rich, high-wage countries and a relatively poor, low-wage country.

PULLING TOGETHER THE FACTS: TRADE DATA

Trade regimes are broadly similar between Canada and the United States, but there are significant differences when compared with Mexico. In part because of their long-standing membership in the GATT, both Canada and the United States have transparent trade regimes and low tariff barriers. Just prior to the implementation of the FTA, the average Canadian tariff on dutiable goods stood at 10.1 percent, compared with an average tariff of about 5 percent in the United States. Customs duties amounted to only 3.6 percent of total Canadian imports. As a result of the FTA, all tariffs between Canada and the United States will be eliminated by January 1, 1998. This is being carried out in three phases; generally, tariffs in respect to agriculture and the non-durable, labour-intensive industries are being phased out at a different rate than those related to the durable manufacturing industries. Tariff elimination can be accelerated and so far there have been 430 Canadian requests, covering 2,200 tariff items. American requests have been equally high. The first round of accelerated tariff elimination, implemented on April 1, 1990, covered 400 goods and $6 billion worth of bilateral trade. A second round of accelerated tariff elimination is expected to be implemented July 1, 1991.

It is worthwhile reflecting on this experience with implementation of the FTA. Accelerated tariff elimination is probably the single best indicator of how quickly the business sector can adapt to new trade realities. Despite this evidence, some critics attribute the recent economic recession in Canada (and the United States) to the FTA. Indeed, according to some polls, a majority of Canadians perceive the FTA to be against their best interests. Few seem to understand that the recession was a logical consequence of an overheated economy in the latter half of the 1980s, and other imbalances. The fact that many other advanced industrialized countries have experienced similar difficulties should defuse the FTA/recession argument, but time may be needed to do so.

Mexico's trade regime is still in transition—from a policy of import substitution and protectionism to a policy of investment and export promotion. The old policy, which prevailed up to the mid 1980s, favoured a generally inefficient industrial sector at the expense of the development of the natural resource sectors. An executive decree in July 1985, however, introduced major trade reforms. The first significant step was the removal of import license requirements from over 2,000 categories on Mexico's tariff schedule. Mexico joined the GATT in 1986, accelerating the removal of import license requirements, tariff reductions and the phasing out of official import reference prices. Maximum tariff rates have been reduced from 100 percent to 20 percent and Mexico's average tariff rate is now only six percent. Import licensing requirements have been eliminated for 95 percent of imports. More liberal provisions apply if imports are intended as inputs for exports (as in the case of the maquiladora), or if they satisfy local-content requirements. For example, producers may import computer components duty-free if the end-product satisfies a 30 percent local-content requirement.

Canada, the United States and Mexico have non-tariff barriers that impede the free flow of goods and services and these barriers will, no doubt, figure in the NAFTA negotiations. Non-tariff barriers include voluntary restraints, quotas, product standards, procurement policies, performance requirements respecting direct investments, countervail and anti-dumping measures and national security provisions. Other factors, such as environmental regulations (or non-regulation), also influence trade flows and the NAFTA negotiations can be expected to address these concerns. Security of market access was an important motivation for Canada in negotiating the FTA. This motivation is also important for Mexico, although its prime objective appears to be the creation of a positive climate for new foreign direct investment and the return of flight capital by Mexicans.

Throughout the NAFTA negotiations, business representatives from each of the three countries involved can be expected to draw attention to at least four sets of trade data:

- the trade flows among the three countries;
- the official and effective tariff rates imposed by the three countries;
- the commodity-by-commodity overlap of exports in each of the three countries, particularly for Mexico and Canada concerning the U.S. market; and
- trade with third countries.

The first three sets of data will assist in determining the degree of trade creation or adjustment likely to follow implementation of a NAFTA, while the fourth set will assist in judging the degree of trade diversion to North America at the expense of the European Community, Japan and other countries. Appendix B outlines the theory of trade and investment creation and diversion.

It is not possible in this paper to present data covering all the above points. What follows, instead, is a summary of preliminary research conducted by Investment Canada.[3] Since this paper presents a Canadian perspective on the business challenges and opportunities associated with a trilateral free trade agreement, the data presented relate particularly to Canadian-Mexican competition. At least during the implementation period, it is competition for the U.S. market that is likely to give rise to the most

[3] Including material prepared under contract for Investment Canada by R.D. Hood Economics Inc.

adjustment. Trilateral free trade will also mean increased penetration of the Canadian market by Mexican goods— displacing some domestic and rest-of-the-world production. As the data will show, however, most Mexican imports already enter Canada duty-free (because they are embodied in U.S. goods covered by the FTA), or at low tariff rates. There will also be trade gains for Canada in the Mexican market. Canadian firms may displace American producers, other producers outside North America, or inefficient Mexican producers. Because Mexico still has relatively high tariffs, a NAFTA would give Canada and the United States favoured access to the Mexican market. More positively, as Mexico's standard of living improves and as domestic consumption increases, there will be new business opportunities for firms worldwide.

By way of providing an overview of what is at stake regarding the negotiation of a NAFTA, Chart 1 sets out (in U.S.-dollar terms) the trade flows among Canada, the United States, Mexico and the rest of the world. Clearly, the United States is the overwhelming export market for both Canada and Mexico. In 1989, Canada's total exports were US$121 billion, US$85 billion or 70 percent of which were to the United States. Mexico's total exports were US$34 billion, US$28 billion or 82 percent of which were to the United States. Trade between Canada and the United States is three times that between Mexico and the United States. But it is also evident from the chart that trade between the United States and Mexico is many times greater than it is between Canada and Mexico. This general overview should be kept in mind when reviewing the more detailed data that follow.

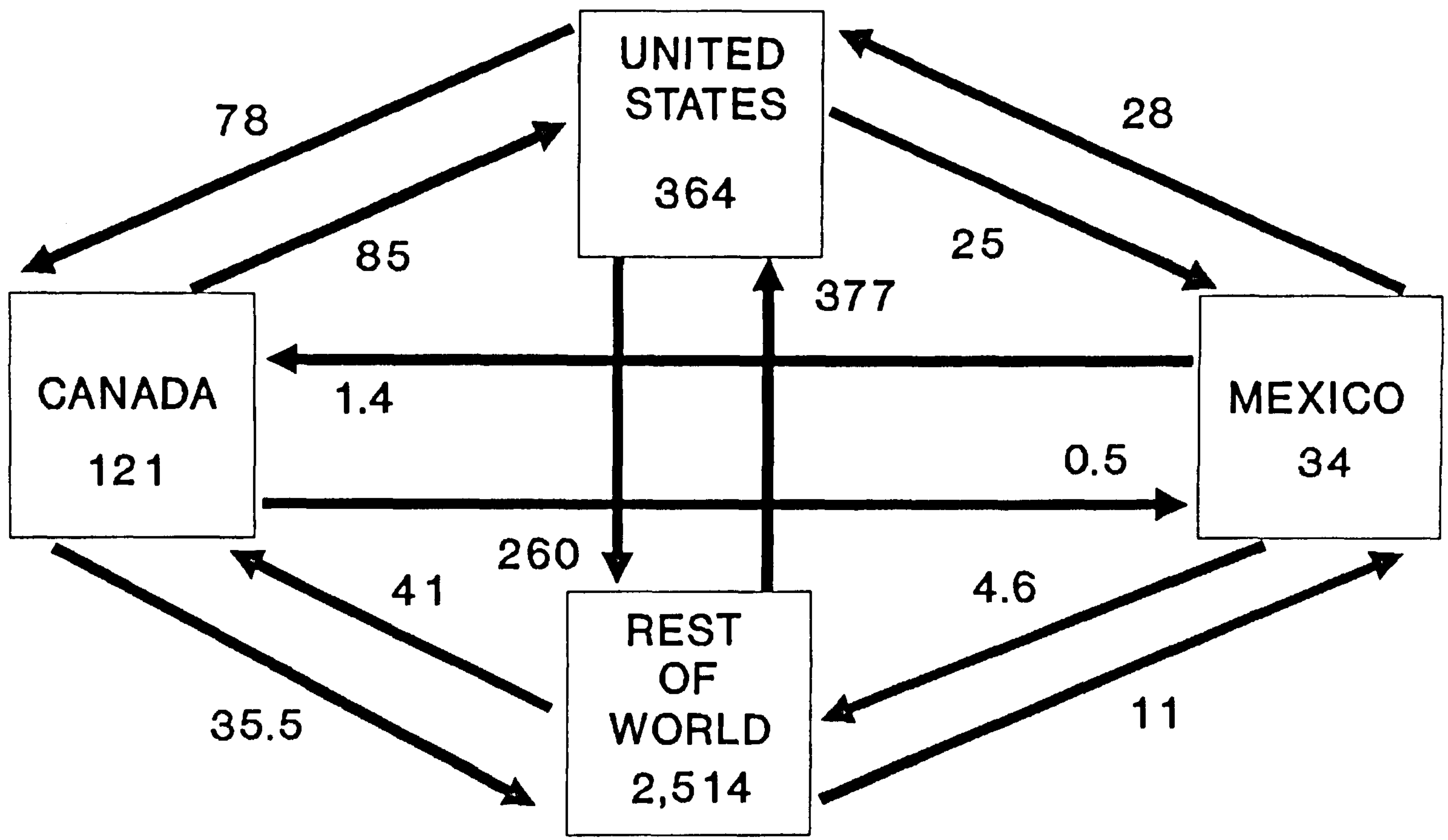
Trade Data Concerning Canadian-Mexican Competition for the U.S. Market

Tables 2 and 3 provide detailed information on the composition of Canadian and Mexican exports to the United States in 1989.[4] Table 2 ranks Canadian exports by order of importance, showing the comparable level of Mexican exports (shown at the six-digit Harmonized System level). Table 3 ranks Mexican exports to the United States by order of importance, showing the comparable level of Canadian exports. These tables, then, provide a ready way of comparing the degree to, and manner by which Canada and Mexico compete against each other in the United States. Since the tables also indicate the degree to which other countries are providing goods and services to the United States, some insight is given of the potential for trade diversion. Where third countries currently account for a significant volume of a U.S. import item, there is greater scope for both Canada and Mexico to increase their exports to the United States as tariffs against them are eliminated.

[4] See Appendix A for explanatory notes on Tables 2 to 6.

Chart 1

1989 Exports (US$ Billions)
Canada - U.S.- Mexico - Rest of the World



Note: Total exports for country/region shown in box.
Source: Investment Canada compilations from
Direction of Trade Statistics, IMF.

Table 2
U.S. Imports and Market Shares from Canada, Mexico and the Rest of the World, by Commodity, 1989.

(ranked by Canadian import value)

Commodity Description	Cdn. Share of Imports	Mexican Share of Imports of Commodity	Rest-of-World Share of Imports of Commodity	% of All Cdn. Imports	Cumulative % of All Cdn. Imports	% of All Mexican Imports	% of All Rest of World Imports
870323 Automobiles (piston engines >1500-3000 cc)	22.75	3.38	73.87	10.21	10.21	5.02	8.24
870431 Trucks (gas powered, GVW ≤ 5 tonnes)	63.84	1.63	34.53	5.28	15.49	0.45	0.71
480100 Newsprint, in rolls or sheets	97.67	0.03	2.30	4.98	20.47	0.01	0.03
870899 Motor vehicle parts nes	56.05	5.01	38.93	4.19	24.66	1.24	0.73
870324 Automobiles (piston engines >3000 cc)	55.78	6.13	38.09	3.86	28.52	1.40	0.65
270900 Petroleum oils, crude	8.94	11.41	79.65	3.56	32.08	15.06	7.90
440710 Lumber, coniferous (softwood)	98.85	0.61	0.53	3.23	35.31	0.07	0.00
980100 Products of U.S returned after being export, nesoi	31.73	10.79	57.49	3.15	38.46	3.55	1.42
470321 Chemical wood pulp (soda or sulphate, coniferous, bleached or semibleached, nes)	96.58	0.04	3.37	2.24	40.70	0.00	0.02
271121 Natural gas, in gaseous state	99.55	0.00	0.45	1.79	42.49	0.00	0.00
271000 Petroleum oils, other than crude	12.16	0.95	86.90	1.77	44.26	0.46	3.13
847330 Parts & accessories of data processing machines	14.93	3.79	81.28	1.24	45.50	1.04	1.68
760120 Aluminum unwrought, alloyed	85.31	0.16	14.53	1.04	46.54	0.01	0.04
710812 Gold in unwrought forms, non-monetary	63.96	7.32	28.72	0.99	47.53	0.37	0.11
854211 Monolithic integrated circuits, digital	9.01	1.44	89.55	0.95	48.48	0.50	2.35
750210 Nickel unwrought, not alloyed	70.50	0.00	29.50	0.92	49.40	0.00	0.10
880330 Aircraft parts nes	30.58	0.66	68.76	0.86	50.26	0.06	0.49

• Where several subgroups have been aggregated to the 6-digit level, the description of one of the subgroups is applied to the whole.
Source: Compilations by Investment Canada and R.D. Hood Economics Inc. from U.S. Department of Commerce data.

Table 3
U.S. Imports and Market Shares from Canada, Mexico and the Rest of the World, by Commodity, 1989

* (ranked by Mexican import value)

Commodity Description	Mexican Share of Imports of Commodity	Cdn. Share of Imports of Commodity	Rest-of-World Share of Imports of Commodity	% of All Mexican Imports	Cumulative % of All Mexican Imports	% of All Canadian Imports	% of All Rest-of-World Imports
270900 Petroleum oils, crude	11.41	8.94	79.65	15.06	15.06	3.56	7.90
870323 Automobiles (piston engines > 1500-3000 cc)	3.38	22.75	73.87	5.02	20.08	10.21	8.24
854430 Ignition wiring sets used in vehicles, aircraft, etc.	70.66	5.74	23.59	3.96	24.04	0.10	0.10
980100 Products of U.S. returned after being export, nesoi	10.79	31.73	57.49	3.55	27.59	3.15	1.42
852810 Television receivers, video monitors and projectors	35.55	3.18	61.27	2.89	30.48	0.08	0.36
852990 Parts for television receivers and video monitors	34.87	5.18	59.95	2.35	32.83	0.11	0.29
090111 Coffee, not roasted, not decaffeinated	21.32	0.02	78.67	1.63	34.46	0.00	0.45
870324 Automobiles (piston engines >3000 cc)	6.13	55.78	38.09	1.40	35.86	3.86	0.65
870821 Safety seat belts for motor vehicles	71.80	12.57	15.63	1.37	37.23	0.07	0.02
710691 Silver in unwrought forms	55.67	35.90	8.43	1.27	38.50	0.25	0.01
840734 Engines, spark-ignition (displacing > 1000 cc)	22.04	46.17	31.79	1.24	39.74	0.79	0.13
870899 Motor vehicle parts nes	5.01	56.05	38.93	1.24	40.98	4.19	0.73
852721 Radio receivers for motor vehicles	24.72	7.41	67.87	1.20	42.18	0.11	0.25
010290 Bovine, live except pure-bred breeding	43.17	56.73	0.10	1.07	43.25	0.42	0.00
030613 Shrimps and prawns, frozen, in shell or not	17.33	0.45	82.22	1.05	44.30	0.01	0.37
847330 Parts & accessories of data processing machines	3.79	14.93	81.28	1.04	45.34	1.24	1.68
854451 Electric conductors (voltage of >80 but ≤ 1000)	51.57	4.37	44.06	0.91	46.25	0.02	0.05

* Where several subgroups have been aggregated to the 6-digit level, the description of one of the subgroups is applied to the whole.
Source: Compilations by Investment Canada and R.D. Hood Economics Inc. from U.S. Department of Commerce data.

Tables 2 and 3 indicate that a large number of Canadian exports to the United States currently experience little or no competition from Mexico. Newsprint, pulp, lumber, natural gas, certain petroleum products, aluminum and nickel are among the more important Canadian exports to the United States; Mexican competition respecting these exports is minimal. The top 17 Canadian export items account for 50 percent of total Canadian exports to the United States. About 30 percent of these face virtually no competition from Mexico. There is considerable overlap respecting a number of goods and services but, in many cases, the actual head-to-head competition is limited; the reasons for this include product specialization and differing geographic markets.

The key areas where Canadian and Mexican exports do compete vigorously in the U.S. market are passenger vehicles and trucks, engines and parts, certain petroleum products, data processing machines and zinc. There is a whole range of other items where competition is already stiff, but each of the items accounts for less than one-third of one percent of total Canadian exports to the United States.

Table 3 tells much the same story, but from a Mexican perspective. Key Mexican exports to the United States that Canada also provides in significant volumes include, in addition to those already noted above, VCRs, television tuners, car stereos, insulated wire and connectors, digital processing equipment and a variety of electrical and electronic equipment.

Tables 4 and 5 show U.S. tariffs in 1989 on imports from Canada and Mexico. Actual duty paid is shown both as a percentage of total imports of the category in question and as a percentage of imports within that category actually subject to duty. As is the case with Tables 2 and 3, Table 4 presents the data from a Canadian perspective while Table 5 presents the data from a Mexican perspective. (Note that Tables 2-5, inclusive, cover only the top 50 percent of Canadian and Mexican exports to the United States. Complete coverage results in tables that are more than 300 pages long; complete information in either hard copy or diskette form is available upon request.)

The tables show that tariffs on most items imported by the United States from either Canada or Mexico are already negligible. Canada's top export is passenger vehicles, which account for over 10 percent of total Canadian exports to the United States. There is no duty payable on these exports. Mexican auto exporters, even though not part of an auto pact or free trade arrangement with the United States, face an effective duty of only 2.5 percent (see the second row and second column of Table 5). For trucks, there is again no duty on Canadian exports to the United States, while for Mexican exports the effective duty is 0.16 percent.

These examples illustrate a general pattern. Mexican exporters that compete against Canadian exporters in the U.S. market face low duties. In fact, among the commodities accounting for the top 50 percent of Mexican exports to the United States

Table 4
Canadian Exports to the U.S. and Duty Rates, 1989

(ranked by export value)

Commodity Description	Value of Imports from Canada by Commodity (US$ millions)	Cdn. Duty Paid as % of Dutiable Imports	Cdn. Duty Paid as % of Total Imports	Mex. Duty Paid as % of Dutiable Imports	Mex. Duty Paid as % of Total Imports
870323 Automobiles (piston engines >1500-3000 cc)	8,979.66	0.00	0.00	2.50	2.50
870431 Trucks (gas powered, GVW ≤ 5 tonnes)	4,645.63	0.00	0.00	0.16	0.16
480100 Newsprint, in rolls or sheets •	4,382.85	0.00	0.00	0.00	0.00
870899 Motor vehicle parts nes	3,690.16	2.67	0.24	3.09	2.83
870324 Automobiles (piston engines >3000 cc)	3,392.48	0.00	0.00	2.50	2.50
270900 Petroleum oils, crude	3,132.63	0.42	0.42	0.45	0.45
440710 Lumber, coniferous (softwood)	2,839.02	0.00	0.00	0.00	0.00
980100 Products of U.S returned after being export, nesoi	2,770.70	0.00	0.00	0.00	0.00
470321 Chemical wood pulp (soda or sulphate, coniferous, bleached or semibleached, nes)	1,972.81	0.00	0.00	0.00	0.00
271121 Natural gas, in gaseous state	1,576.06	0.00	0.00	0.00	0.00
271000 Petroleum oils, other than crude	1,555.96	0.84	0.83	1.16	1.15
847330 Parts & accessories of data processing machines	1,089.81	0.00	0.00	3.90	0.08
760120 Aluminum unwrought, alloyed	918.15	0.00	0.00	0.00	0.00
710812 Gold in unwrought forms, non-monetary	868.03	0.00	0.00	0.00	0.00
854211 Monolithic integrated circuits, digital	835.60	0.00	0.00	0.00	0.00
750210 Nickel unwrought, not alloyed	809.44	0.00	0.00	0.00	0.00
880330 Aircraft parts nes	759.98	0.00	0.00	0.00	0.00
760110 Aluminum unwrought, not alloyed	733.24	0.00	0.00	0.00	0.00

• Where several subgroups have been aggregated to the 6-digit level, the description of one of the subgroups is applied to the whole.
Source: Compilations by Investment Canada and R.D. Hood Economics Inc. from U.S. Department of Commerce data.

Table 5
Mexican Exports to the U.S. and Duty Rates, 1989

(ranked by export value)

Commodity Description*	Value of Imports from Mexico, by Commodity (US$ millions)	Mex. Duty Paid as % of Dutiable Imports	Mex. Duty Paid as % of Total Imports	Cdn Duty Paid as % of Dutiable Imports	Cdn Duty Paid as % of Total Imports
270900 Petroleum oils, crude	3,999.14	0.45	0.45	0.42	0.42
870323 Automobiles (piston engines > 1500-3000 cc)	1,334.28	2.50	2.50	0.00	0.00
854430 Ignition wiring sets used in vehicles, aircraft, etc.	1,051.80	5.00	4.97	4.50	0.85
980100 Products of U.S. returned after being export, nesoi	942.25	0.00	0.00	0.00	0.00
852810 Television receivers, video monitors and projectors	768.24	5.00	5.00	4.50	4.50
852990 Parts for television receivers and video monitors	625.34	4.66	4.58	4.28	2.50
090111 Coffee, not roasted, not decaffeinated	434.18	0.00	0.00	0.00	0.00
870324 Automobiles (piston engines >3000 cc)	372.55	2.50	2.50	0.00	0.00
870821 Safety seat belts for motor vehicles	363.71	3.10	3.10	2.70	0.28
710691 Silver in unwrought forms	337.94	0.00	0.00	4.80	0.00
840734 Engines, spark-ignition (displacing > 1000 cc)	330.38	3.10	3.10	2.62	0.12
870899 Motor vehicle parts nes	329.99	3.09	2.83	2.67	0.24
852721 Radio receivers for motor vehicles	318.41	3.71	3.71	2.90	0.15
010290 Bovine, live except pure-bred breeding	284.23	1.23	1.23	1.28	1.25
030613 Shrimps and prawns, frozen, in shell or not	280.00	0.00	0.00	0.00	0.00
847330 Parts & accessories of data processing machines	276.52	3.90	0.08	0.00	0.00
854451 Electric conductors (voltage of >80 but ≤ 1000)	241.56	5.30	5.27	4.70	3.87
070200 Tomatoes, fresh or chilled	222.32	6.91	6.91	3.07	3.07

* Where several subgroups have been aggregated to the 6-digit level, the description of one of the subgroups is applied to the whole.
Source: Compilations by Investment Canada and R.D. Hood Economics Inc. from U.S. Department of Commerce data.

in 1989, there was only one case where the duty rate was above four percent; tomatoes were subject to a duty of 6.4 percent. Among the top 80 percent of Mexican exports to the United States, there were only two categories with duty rates above 10 percent. Most rates were in the two to three percent range. Even in the case of Mexican exports to the United States with a high degree of U.S. content, duties (i.e., U.S. tariff codes 806 and 807) against the value-added in Mexico were low.

What conclusions can be drawn from these data? First of all, there is a degree of overlap between Canada and Mexico respecting competition for the U.S. market. The current rates of duty, however, are already so low that free access for both countries to the U.S. market is likely to have only a marginal effect on Canadian exports to the United States. Second, almost all Canadian exports to the United States can be characterized as:

- not having a Mexican equivalent (e.g. aluminum);

- having a Mexican equivalent and a low U.S. duty rate against the Mexican export; and

- having a Mexican equivalent and a U.S. duty rate that is roughly the same for both Canadian and Mexican exports.

These conclusions, however, are not intended to gloss over the sectoral impacts of trilateral free trade. To illustrate some of the challenges that both Canada and the United States may face, supplementary information is given below about the automotive, steel, textile and apparel industries.[5]

The elimination of the U.S. tariff on automotive products would not in itself provide major benefits to Mexican exporters. In effect, de facto free trade already exists within North America for automotive products because of the combined effects of the Auto Pact provisions, the maquiladora industrialization program and U.S. trade regulations. As a result, Canadian parts producers and exporters currently face competitive pressures from Mexican producers. The automotive industry accounts for a large share of both investment and trade flows between Mexico and the United States. U.S. imports of Mexican motor vehicles and parts were $4.9 billion in 1989. Mexico has unilaterally eased its restrictions on automotive trade and investment, making it easier for vehicle assemblers in Mexico to achieve higher levels of quality through the use of imported parts. A NAFTA would simply formalize trends already occurring in the industry: the growth of the Mexican automotive parts industry; increased sourcing of

[5] This information is drawn from a report prepared by Industry, Science and Technology Canada. North American Trade Liberalization: Sector Impact Analysis, September 1990.

labour-intensive, low-technology Mexican automotive parts by North American companies; further foreign investment in automotive parts facilities in Mexico; and increased competition from Mexican-manufactured vehicles.

In regard to the steel industry, the 1989 Steel Trade Liberalization Program limits U.S. imports from Mexico. This voluntary restraint program is expected to expire in March 1992. Free access to the U.S. market could lead to a substantial increase in Mexican exports. These would largely displace other countries' exports to the U.S. market, since Canada and Mexico serve quite different market segments. Canada focuses on the northwest and midwest U.S. states, whereas Mexico focuses on the southern U.S. states. Transportation costs and quality factors make it unlikely that Mexican steel will make inroads in the near future into Canada's major steel markets in the United States.

The textiles and apparel sectors in Canada and the United States are subject to intense competitive pressures from developing countries, including Mexico. Currently, the United States imports almost $800 million of textile and apparel products from Mexico. About three-quarters of this is apparel and roughly 90 percent is the result of maquiladora production. The United States maintains quantitative restrictions on Mexican imports, through a bilateral agreement negotiated under the Multifiber Arrangement (MFA). The most recent agreement came into effect January 1, 1988, and included significantly increased quotas in several major categories. Further changes were introduced in January 1990 that allow for greater access of products assembled from U.S. fabric and Mexican textiles and apparel. Industry members suggest that a NAFTA would encourage Asian producers to locate in Mexico, creating greater demand for U.S. fabrics. Clearly, a NAFTA would add to the existing pressures for Canadian and U.S. textile and apparel manufacturers to re-structure. Over the long-term, Canadian manufacturers and foreign investors might consider diverting planned investments from Canada to Mexico.

These sector examples illustrate that, even in the case of industries believed to be vulnerable to free trade, the outlook is far from an immediate or wholesale displacement of Canadian exporters in the U.S. market. As the following data will indicate, nor is it likely that a NAFTA will result in Mexican imports overwhelming the Canadian market at the expense of domestic producers.

Trade Data Concerning Canadian Imports From Mexico

Canadian imports from Mexico are not large, amounting to only $1.7 billion in 1989. This represents less than two percent of Canada's total imports, despite low barriers to trade with Mexico. The effective duty rate averaged 2.4 percent, and Mexico is not constrained from the Canadian market by quotas on key commodities such as textiles. Imports from Mexico have been growing rapidly in recent years, particularly in 1989, when they increased by almost 30 percent.

Table 6 shows imports from Mexico in some detail; Statistics Canada's 600 input-output commodity grouping was used to classify the imports. As can be seen from the table, imports from Mexico are concentrated in a few categories. Indeed, the first five categories of imports account for two-thirds of total imports from Mexico. The major imports are motor vehicle parts and engines, TV, radio, sound and telecommunications equipment and parts, office and digital processing equipment, precious metals and alloys, other metal ores and crude oil.

Table 6 also shows the effective duty rates paid on Mexican imports. Clearly, the bulk of imports enter under low duty rates. For example, automotive products and accessories are subject to an effective duty rate of only 0.1 percent. Tariff reductions respecting Mexican imports to Canada, following implementation of a NAFTA, would have only a marginal impact on those items that currently account for most of the trade.

Free trade with Mexico may, however, result in a considerable increase in new import items, or a surge of imports currently subject to high tariffs. Table 7 indicates that there are many items still subject to high Canadian tariffs. In contrast to Table 6, where Mexican imports are ranked according to their importance, Table 7 ranks the import categories according to the size of the tariff (stopping at eight percent so as to avoid a long list). As can be seen from Table 7, there is a broad range of Mexican imports that bears high effective duties. While less than six percent of Mexican imports are subject to effective duties of eight percent or more, the importance of these categories could increase substantially as tariffs are phased out under a NAFTA. The table also shows imports of these same categories from other countries, and the level of Canadian production. This gives some indication of the potential for Mexican imports to displace domestic production and third-country imports.

The most obvious cases are textiles, garments and footwear. Canadian imports of these products from Mexico generally bear effective duties in excess of 20 percent. There is significant Canadian and other offshore supply that might be displaced by Mexican products once free trade is fully implemented. Other categories that might be subject to intense Mexican competition are luggage, office stationery and supplies, paints, leather handbags and wallets, plated silverware and cutlery, tiles, brooms, brushes and mops, toys, plastic pipes, fittings and sheets, tires and tubes, bicycles, batteries, builder's hardware, radar equipment, papermaker's felts, radio and TV broadcasting equipment, fuses, wire and cable.

While this is a "risk list" for Canada, there are a number of considerations that will likely modify the impact of free trade. Imports from Mexico that were subject to tariffs of eight percent or more amounted to only $93 million in 1989, compared with Canadian production of goods in these categories totalling $37 billion. Further, imports of goods in these categories from third countries amounted to $16 billion. Some of these articles will become available duty-free from U.S. sources as a result of the FTA. This will put

Table 6
Canadian Imports from Mexico, and Canadian Production, by Value, 1987 and 1989

Input-Output Commodity Classifications		Canadian Production	Total Imports	Imports from Mexico	Effective Duty Rate on Mexican Imports
		1987	1987	1989	1989
		C$ millions			percent
34100	Motor Vehicle Engines and Parts	2,902	3,351	249	0.1
34300	Motor Veh. Access, Parts & Assem.	8,099	12,726	244	0.1
25900	Precious Metal & Alloys Prime Fo.	5	109	183	0.0
32900	Office Machines and Equipment	2,015	5,777	145	2.5
35700	T.V., Radio, Record Players	625	2,183	138	3.0
34200	Auxiliary Electric Equipment	335	830	97	0.0
33400	Passenger Automobiles & Chassi.	0	13,083	73	1.4
3800	Crude Mineral Oils	13,048	3,552	49	0.0
32100	Pkg. Mach, Lub. Eq & Oth. Misc. Mach.	740	493	39	1.0
1400	Vegetables, Fresh	1,143	760	39	2.5
59200	Green Coffee	0	369	26	0.0
32600	Refrig & Air Con. Eq, excl. Household	424	873	22	2.0
15600	Yarns, Silk, Fibreglass	873	501	20	7.6
36200	Electronic Equipment Component	1,118	1,759	19	3.2
36800	Elec. Equip. Industrial, nes.	949	574	18	3.6
26300	Scrap & Waste Materials nes.	64	485	16	0.0
50900	Toys and Game Sets	7	491	15	11.3
4800	Crude Mineral nes.	50	136	14	0.0
59300	Tropical Fruit	0	515	14	0.0
1300	Fruits, Fresh, excl. Tropical	349	586	12	0.0
11600	Alcoholic Beverages, Distilled	728	338	11	75.5
17000	Carpeting & Fabric Rugs, Mats, etc.	991	281	10	3.9
36900	Batteries	300	186	9	10.0
36100	Elec.Tubes & Semi-Conductors etc.	0	623	9	4.0
20400	Household Furn. incl. Camp & Lawn	1941	499	9	1.6
59400	Unallocated Imports & Exports	0	12067	8	0.7
37400	Electric Lighting Fixtures etc.	558	318	7	1.6
36700	Transformers & Converters excl. T&T	664	133	7	5.9
18400	Clothing	3,936	1556	6	23.7
24000	Steel Plates, Not Fabricated	556	167	6	7.6
46400	Organic Chemicals, nes.	0	69	6	3.0
35300	Small Elec. Appliances, Domestic	366	559	6	7.1
7600	Fruit, Berries, Dried, Crystalize	680	438	5	5.2

Table 6
Canadian Imports from Mexico, and Canadian Production, by Value, 1987 and 1989

Input-Output Commodity Classifications		Canadian Production	Total Imports	Imports from Mexico	Effective Duty Rate on Mexican Imports
		1987	1987	1989	1989
		C$ millions			percent
39000	Glass, Plate, Sheet, Wool	558	389	5	0.3
31900	Ind. Trucks, Tractors, Trailers etc.	270	414	5	3.1
38200	Plumb. Eq., Vitreous China, & etc.	125	190	5	4.3
21300	Tissue & Sanitary Paper	184	46	5	4.0
11900	Ale Beer, Stout & Porter	2,328	46	4	18.1
14000	Footwear excl. Rubber & Plastic	680	804	4	22.7
7800	Veget. Frozen, Dried & Preserved	508	98	4	18.6
40400	Plastic Resins & Mat., Not shaped	2,345	1146	4	7.1
37000	Wire and Cable, Insulated	1,335	178	4	8.4
36600	Engines, Marine, Electric Turbin	733	1039	4	5.3
50300	Photographic Equip & Suppl.Incl.Fil.	51	1272	4	0.6
35900	Radio& TV Broadcasting & Trans Equip.	759	156	4	8.8
4300	Gypsum	87	6	3	0.0
25500	Lead, Primary Forms	113	12	3	0.0
4400	Salt	225	28	3	0.0
22600	Office and Stationery Supplies	696	304	3	12.6
32300	Mach. Ind. Specified & Special Pur.	4,802	6243	3	3.4
50600	Brooms, Brushes, Mops & Oth. Clean.	99	58	3	11.6
15200	Fabrics, Broadwoven, Wool, Hair & M.	0	164	3	6.9
36300	Interior Signal, Alarm & Clock Sy.	63	56	3	0.3
7500	Fish Products	2,510	617	2	0.5
28000	Steel Sheet & Strip Coated or Fa.	757	296	2	6.5
37200	Enclosed Safety Switches etc.	568	234	2	8.5
32400	Power-Driven Hand Tools	70	213	2	6.3
1800	Oil Seeds, Nuts and Kernels	1,064	146	2	0.0
13500	Plastic Pipe Fittings & Sheet	2,530	1133	2	11.0
29200	Bolts, Nuts, Screws, Washers etc.	738	428	2	0.4
49900	Misc. Measure & Control Instruments	597	401	2	7.2
15800	Fabric, Woven, Textile Fibres	355	479	2	24.4
35800	Tel & Teleg. Line Apparatus & Equip.	619	722	2	6.7
27600	Beams and Other Struct. Steel	819	134	2	6.8
30700	Valves	277	280	2	7.1
37300	Elec. Light Bulbs & Tubes, etc.	0	181	2	7.4

Table 6
Canadian Imports from Mexico, and Canadian Production, by Value, 1987 and 1989

Input-Output Commodity Classifications		Canadian Production	Total Imports	Imports from Mexico	Effective Duty Rate on Mexican Imports
		1987	1987	1989	1989
		C$ millions			percent
50800	Sporting, Fishing & Hunting Equip.	415	415	2	7.9
18500	Apparel Accessories & Other Misc.	309	160	1	10.3
50000	Medical & Related Instruments etc.	583	1074	1	3.4
14700	Fabrics, Broad Woven of Cotton	31	339	1	15.8
34400	Automotive Hardware, excl. Spring	155	320	1	0.0
52100	Household Ornamental Objects & A.	1,265	430	1	6.2
26400	Aluminum & Aluminum Alloys, Cast	1,564	791	1	1.3
39200	Glass Tablewre & Housewre, End & nec.	3	101	1	8.2
27400	Power Boilers	0	25	1	12.5
29300	Builders' Hardware	270	221	1	9.9
25000	Steel Pipes & Tubes nes.	426	208	1	4.8
26100	Aluminum Fluorides & Sodium Alum.	0	2	1	0.0
50400	Jewelry, Findings, Met. & Gem Stones	385	363	1	9.6
48000	Phthalic Anhydride	0	8	1	8.1
26600	Copper Alloy Prod. Cast, Roll, ex.	210	107	1	1.3
1700	Nursery Stock & Related Mat.	458	161	1	8.7
18200	Fabrics, Knitted, nes.	456	113	1	20.7
44900	Alcohols and Their Derivatives.	0	69	1	7.6
33500	Trucks, Chassis, Tractors, Com.	8,575	3,378	1	0.0
10500	Nitrogen Function Compounds nec.	0	322	1	0.3
36000	Radar Equip. & Related Devices	796	120	1	9.4
28700	Wire & Wire Rope, of Steel	571	164	1	7.1
38400	Natural Stone Basic Prod, Struc.	3	58	1	1.0
46300	Organo-Inorganic Compounds etc.	0	289	1	6.0
11000	Coffee, Roasted, Ground, Prepared	736	103	1	0.9
52000	Phono Records and Artist Mater.	128	230	1	7.4
	Total of Above	87,670	93,871	1,665	
	Grand Total	852,768	139,867	1,694	2.4 †

* This table lists the 75 highest dollar value imports of Statistics Canada's 608 I-O commodity groups. Grand total refers to the total of all 608 I-O commodity groups.

† Average duty rate of all 608 I-O commodity groups.

Source: Compilations by Investment Canada and R.D. Hood Economics Inc. from Statistics Canada data.

Table 7
Canadian Imports from Mexico, and Canadian Production, by Duty Rate. 1987 and 1989.

Input-Output Commodity Classifications		Canadian Production	Total Imports	Imports from Mexico	Effective Duty rate on Mexican Imports
		1987	1987	1989	1989
		C$ millions			percent
11600	Alcoholic Beverages Distilled	728	338	10.9	75.5
17500	Textile Containers	0	13	0.0	25.0
18300	Knitted Wear	1,002	972	0.8	25.0
18000	Hosiery	316	39	0.3	24.9
17700	Misc. Textile Fab. Mat. Inc. Rags	85	49	0.1	24.7
15800	Fabric, Woven, Textile Fibres	355	479	1.9	24.4
15900	Fabrics, Broad Woven, Mix & Blends	25	321	0.4	24.2
18400	Clothing	3,936	1,556	6.4	23.7
51000	Fabrics, Impreg. Ex. Rubber-coate	9	192	0.1	23.7
18100	Fabrics, Knitted & Netted, Elastic	0	14	0.2	22.8
14000	Footwear ex. Rubber & Plastic	680	804	4.2	22.7
50200	Watches, Clocks, Chronometers etc.	61	189	0.0	22.4
18200	Fabrics, Knitted, nes.	456	113	1.0	20.7
16700	Narrow Fabrics	103	59	0.0	20.0
15000	Blankets, Bedsheets, Towels & Cloth	176	93	0.3	19.2
7800	Veget. Frozen, Dried & Preserved	508	98	4.0	18.6
11900	Ale Beer, Stout & Porter	2,328	46	4.5	18.1
16800	Lace Fabrics, Bobbinet & Net	7	38	0.0	17.3
17900	Laces and Textile Prod. N.E.S.	198	110	0.0	17.1
30900	Gas Meters and Water Meters	0	12	0.0	16.7
14700	Fabrics, Broad Woven of Cotton	31	339	1.4	15.8
9900	Other Confectionery	425	96	0.0	15.5
17400	Tarpaulins & Other Covers	102	6	0.0	15.2
14300	Luggage	51	98	0.4	14.4
29800	Scissors, Razor Blades, ind. Cutlery	9	46	0.0	14.2
12100	Tobacco Processed, unmanufact.	243	5	0.0	14.0
15700	Tire Yarns	0	17	0.2	13.5
48800	Printing and Other Inks	246	32	0.0	13.0
8200	Pickles, Relishes, Other Sauces	450	41	0.0	12.9
22600	Office and Stationery Supplies	696	304	3.0	12.6
17800	Household Textiles, nes.	352	105	0.5	12.6

Table 7
Canadian Imports from Mexico, and Canadian Production, by Duty Rate. 1987 and 1989.

Input-Output Commodity Classifications		Canadian Production	Total Imports	Imports from Mexico	Effective Duty rate on Mexican Imports
		1987	1987	1989	1989
		C$ millions			percent
27400	Power Boilers	0	25	1.1	12.5
40900	Paints & Related Products	1,495	321	0.0	12.5
40500	Film & Sheet, Cellulosic Plastic	0	56	0.0	12.5
33700	Military Motor veh., Motorcycle	266	412	0.3	12.5
47200	Additives for Mineral Oils, nes.	209	112	0.1	12.4
14400	Leather Handbags, Wallets etc.	87	87	0.4	12.4
41500	Toilet Preparations & Cosmetic	1,198	210	0.0	12.0
50500	Plated & Silverware, Cutlery, etc.	15	56	0.1	11.9
47700	Ammunition & Ordnance, Military	0	64	0.0	11.7
38000	Bricks and Tiles, Clay	0	175	0.5	11.6
50600	Brooms, Brushes,Mops & Other Clean.	99	58	2.7	11.6
35600	Gas Ranges & Elec. Stoves, Domestic	243	68	0.1	11.4
50900	Toys and Game Sets	7	491	14.7	11.3
14200	Leather Belting, Shoe Stock	0	19	0.4	11.0
13500	Plastic Pipe Fittings & Sheet	2,530	1,133	2.1	11.0
12600	Tires & Tubes, Trucks & Buses	428	374	0.1	10.7
30100	Heating eq, Warm air ex. Pipes	173	80	0.0	10.5
50700	Bicycles, Children's eh. & Parts	189	149	0.2	10.4
21600	Bldg. Paper	577	55	0.0	10.4
18500	Apparel Accessories & Other Misc.	309	160	1.5	10.3
30400	Com. Appliances, Cook & Warming fo.	67	24	0.2	10.3
38600	Plasters & Oth. Gypsum Basic Prod.	515	18	0.1	10.1
29400	Fittings, Furn. Cabinets & Caskets	2	43	0.0	10.1
25200	Cast & Wrought Iron Pipe & Fitting	142	130	0.6	10.1
21700	Towels, Napkins & Toilet Paper	593	15	0.0	10.0
36900	Batteries	300	186	9.4	10.0
23900	Steel Bars and Rods	1,894	258	0.0	9.9
30600	Forgings of Carbon & Alloy Steel	0	26	0.0	9.9
30800	Pipe Fittings, not Iron & Steel	413	254	0.0	9.9
29300	Builders' Hardware	270	221	1.1	9.9
22400	Facial Tissues, & Sanitary Napkins	419	21	0.0	9.9

Table 7
Canadian Imports from Mexico, and Canadian Production, by Duty Rate. 1987 and 1989.

Input-Output Commodity Classifications		Canadian Production	Total Imports	Imports from Mexico	Effective Duty rate on Mexican Imports
		1987	1987	1989	1989
		C$ millions			percent
22500	Paper Containers, nes.	130	35	0.0	9.8
29900	Domestic Equipment, nes.	356	505	0.2	9.8
50400	Jewelry, Findings, met. & Gem Stone	385	363	1.1	9.6
30200	Unit & Water Tank Heaters, Non-electric	27	16	0.2	9.5
20600	Special-Purpose Furniture	594	53	0.0	9.4
36000	Radar Equip. & Related Devices	796	120	0.9	9.4
23800	Steel Castings	177	30	0.0	9.2
35500	Refrig., Freezers & Comb., Domestic	357	73	0.2	9.2
39300	Abrasive Basic Products	286	134	0.5	9.2
15300	Papermakers' Felts	83	14	0.2	9.2
31800	Conveyors, Escal., Elev. & Hoist mac.	598	440	0.1	9.2
31000	Fire Fight. & Traffic Control Equip.	5	77	0.0	9.1
51100	Tiling, Rubber, Plastic	0	111	0.2	9.0
12300	Tobacco Mfg. ex. Cigarettes	163	19	0.0	8.9
35900	Radio & TV Broadcasting & Trans Equip.	759	156	3.9	8.8
22700	Paper End Products	17	92	0.1	8.8
1700	Nursery Stock & Related Mat.	458	161	1.0	8.7
39100	Glass Containers	0	55	0.8	8.6
13100	Rubber Sheeting, Shoe Stock etc.	318	179	0.4	8.5
33900	Oth.Trailers & Semi-Trailers, com.	484	117	0.0	8.5
40800	Pharmaceuticals	2,715	811	0.0	8.5
37200	Enclosed Safety Switches etc.	568	234	2.4	8.5
37000	Wire and Cable, Insulated	1,335	178	4.0	8.4
49700	Aircraft & Nautical Instruments	0	90	0.0	8.3
20700	Misc. Furniture and Fixtures	599	49	0.1	8.3
	Total of Above	37,228	16,037	93	
	Grand Total*	852,768	139,867	1,694	2.4†

* This table lists the 75 highest duty rates of Statistics Canada's 608 I-O commodity groups. Grand total refers to the total of all 608 classifications.

† Average duty rate of all 608 commodity groups.

Source: Compilations by Investment Canada and R.D. Hood Economics Inc. from Statistics Canada data pressure on Canadian and offshore suppliers regardless of whether trilateral free trade with Mexico is concluded. In any event, a NAFTA can be expected to include provisions for a lengthy implementation period; tariff elimination under the FTA, for example, is being phased in over a ten-year period.

Trade Data Concerning Canadian Exports To Mexico

Canadian exports to Mexico were $603 million in 1989, less than one percent of total exports. This low share reflects the fact that Mexico, until the mid-1980s, had a largely closed economy. As indicated earlier in this paper, Mexico has implemented far-reaching reforms and it is now pursuing a policy of export promotion rather than import substitution. In fact, greater access to imports is seen by the Salinas Government as being vital to Mexico's development strategy. Tariffs, therefore, have been reduced substantially and most import license requirements abolished. Canadian firms have been responding to the new market opportunities in Mexico, as evidenced by the 23 percent increase in Canadian exports to that country in 1989. Major exports to Mexico include motor vehicle and engine parts, oilseed, dairy products, wheat, sulphur, wood pulp, steel plate, sheet and strip, telecommunications equipment and parts, and potash.

At the time of writing, detailed material on Canada's exports to Mexico, including data on duties paid and the degree of Mexican and third country competition, was not complete. Research on opportunities in Mexico is vital, for the response to these opportunities will importantly determine the benefits for Canada of a NAFTA. In terms of two-way trade between Canada and Mexico, it would appear that Canada has slightly more to gain from the elimination of tariffs. Mexico's tariffs are still considerably higher than Canada's and, in any case, most Mexican goods enter Canada duty-free. It should be noted that a bilateral U.S.-Mexico free trade agreement would put Canada at a competitive disadvantage; the United States would gain preferential access to Mexico's markets at the expense of third countries—including Canada. Furthermore, Canada would be excluded from the gains expected from a better integration of North American production and the enhanced ability thereby to compete in overseas markets. A NAFTA may become a forerunner of free trade in Central and South America. It is very much in Canada's interests to have Mexico as a stepping stone to other Latin American markets.

External Affairs and International Trade Canada, in its press kit (February 5, 1991) announcing Canada's formal participation in the trilateral negotiations, gives the following examples of Canadian successes in exporting to Mexico:

- In 1988, Northern Telecom's telephone equipment sales to Mexico were worth $4 million. In 1989, sales were $27 million. Sales for 1990 were estimated at over $60 million and anticipated 1991 sales are greater than $100 million.

- A Mexican company has awarded Spar Aerospace a $16 million contract for communications systems used in earth stations and satellite dishes.

- Air transport equipment sales are expanding rapidly (e.g. Challenger jet aircraft).

- Canadian exports of dairy breeding cattle are increasing and Canadian farmers anticipate further sales of other dairy and grain products.

There is considerable export potential in some areas. To illustrate, over the next five years it is estimated that Mexico will spend $10 billion on telephone equipment. As the magazine *Canadian Business* recently noted, "For Canadian firms with engineering strengths, the opportunities in Mexico appear boundless. Beyond telecommunications and transportation, there is water irrigation, agriculture, the environment and utilities."

Data Concerning Intra-Corporate Trade

A NAFTA will reinforce what is already a well-established trend globally—the growing importance of intra-corporate trade. One-third of world trade in manufactured goods is estimated to be intra-corporate trade.

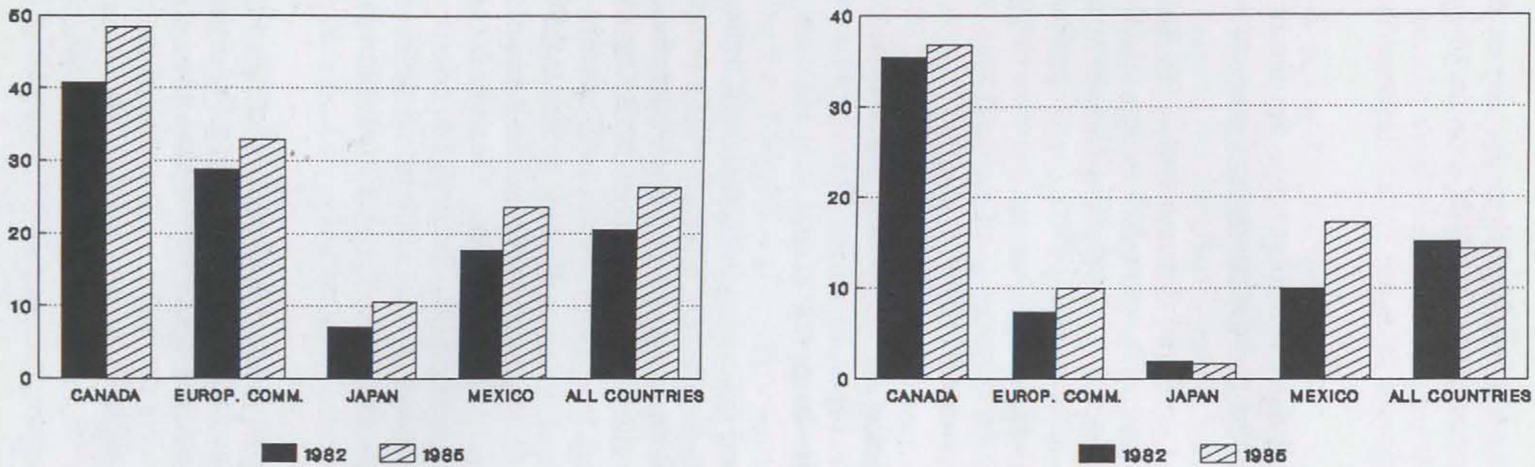
Unfortunately, data on intra-corporate trade are limited. The United States has good information, while that for Canada, and especially for Mexico, is weaker. Chart 2 illustrates the U.S. data on intra-corporate trade. Nearly half of total U.S. exports to Canada and more than one-third of U.S. imports from Canada are attributable to intra-corporate trade between U.S. parent firms and their majority-owned Canadian affiliates. Trade between minority-owned foreign affiliates is also significant. This form of trade explains a smaller share of U.S.-Mexico trade, but it is nonetheless important. Most of this is associated with maquiladora operations. General Motors, Ford and Chrysler have established some 42 maquiladora plants. Table 8 provides more detailed information about the sales and employment levels of affiliates of American companies operating in Canada and Mexico. Clearly, the scale of these operations is considerable in both countries.

Table 8 also gives some indication of the differing rates of return. According to the Table, Canadian affiliates of U.S. manufacturing firms yield net incomes per employee that are three and a half times higher than the corresponding figures for Mexican affiliates. This reflects the higher skill levels of the Canadian work force and the use of more-advanced, capital-intensive production technologies.

Chart 2

U.S. Merchandise Trade Between U.S. Parent Companies and Majority-Owned Foreign Affiliates as a Proportion of Total U.S. Merchandise Trade Selected Countries/Regions

Affiliated Exports (Percent Share) Affiliated Imports



Source: Investment Canada compilation from U.S. Department of Commerce data.

Table 8
Operations of U.S. Affiliates Abroad, 1987

Canada							Industry	Mexico						
Sales	Net Income	Employ.	Wages	Assets	Wage/ Employ.	Net Inc. Employ.		Sales	Net Income	Employ.	Wages	Assets	Wage/ Employ.	Net Inc. Employ.
US$ millions		thousands	US$ millions		US$ thousands			US$ millions		thousands	US$ millions		US$ thousands	
20,704	1,320	35.7	1,446	29,550	40.5	37.0	Petroleum	165	-7	2.4	28	197	11.7	-2.9
81,180	3,624	470.9	12,894	54,697	27.4	7.7	Manufacturing	14,925	829	380.3	1,762	13,334	4.6	2.2
5,407	449	32.9	831	4,494	25.3	13.6	Food	1,596	50	48.5	167	1,083	3.4	1.0
12,362	806	65.5	1,921	10,407	29.3	12.3	Chemicals	3,660	272	65.3	390	3,673	6.0	4.2
4,713	429	39.3	899	5,868	22.9	10.9	Primary and Fabricated Metals	729	45	22.4	99	798	4.4	2.0
6,171	368	40.9	1,299	4,589	31.8	9.0	Machinery excl. Electrical	644	0	18	107	778	5.9	0.0
5,267	228	51	1,261	3,707	24.7	4.5	Electrical and Electronic	1,148	-17	83.7	247	961	3.0	-0.2
34,593	444	133.5	3,964	15,583	29.7	3.3	Transportation Equipment	4,245	213	73.7	383	3,153	5.2	2.9
12,667	900	107.8	2,719	10,049	25.2	8.3	Other Manufacturing	2,903	266	68.7	369	2,888	5.4	3.9
12,689	368	54.4	1,359	8,221	25.0	6.8	Wholesale Trade	1,182	29	9.4	123	834	13.1	3.1
8,872	1,188	30.8	913	40,937	29.6	38.6	Finance, excl. Banks, Ins, Real Estate	124	9	0.5	12	424	24.0	18.0
3,294	193	60.8	839	4,297	13.8	3.2	Services	450	35	14.7	121	354	8.2	2.4
18,476	605	259.7	3,846	13,360	14.8	2.3	Other Industries	1,020	118	34.4	95	1,153	2.8	3.4
145,215	7,298	912.3	21,297	151,062	23.3	8.0	Total/Average	17,866	1,013	441.7	2,141	16,296	4.8	2.3

Source: Compilation by Investment Canada based on U.S. Department of Commerce data.

Businesses in Canada well appreciate how vital intra-corporate linkages are in meeting the pressures of globalization. A research paper by Investment Canada[6] indicates that more than 1,100 Canadian companies have direct investments abroad, and another 366 foreign-controlled firms based in Canada also have direct investments abroad. (The data are for 1986, the latest year available.) Mergers and acquisitions are a growing component of this investment. Between 1987 and 1990, Canadian firms made a total of 438 acquisitions abroad, of which 307 were in the United States. As a final note, the paper outlines further research required to better understand the motivations for these acquisitions, and their geographic distribution. This research is highly relevant to preparing for North American free trade, since the benefits to Canada of a trilateral agreement will undoubtedly depend to some degree on the investment response.

PULLING TOGETHER THE FACTS: INVESTMENT DATA

In a manner parallel to trade, the United States is the largest foreign investor in both Canada and Mexico. It accounts for US$68 billion or almost 70 percent of the stock of foreign direct investment in Canada. The United States accounts for US$17 billion or 63 percent of the stock in Mexico. The stock of Canadian direct investment in the United States is also significant. With direct investment of US$32 billion in the United States, Canada ranks as the fourth largest foreign investor, after the U.K., Japan and the Netherlands. While Mexican investment in the United States is much lower (US$1 billion), it represents a significant economic link between the two countries. At present, investment ties between Canada and Mexico are modest; in 1989, Canada's stock of direct investment in Mexico was US$372 million. Chart 3 provides an overview of the investment relationships among Canada, the United States and Mexico, in much the same manner as Chart 1 provides an overview of the trade relationships.

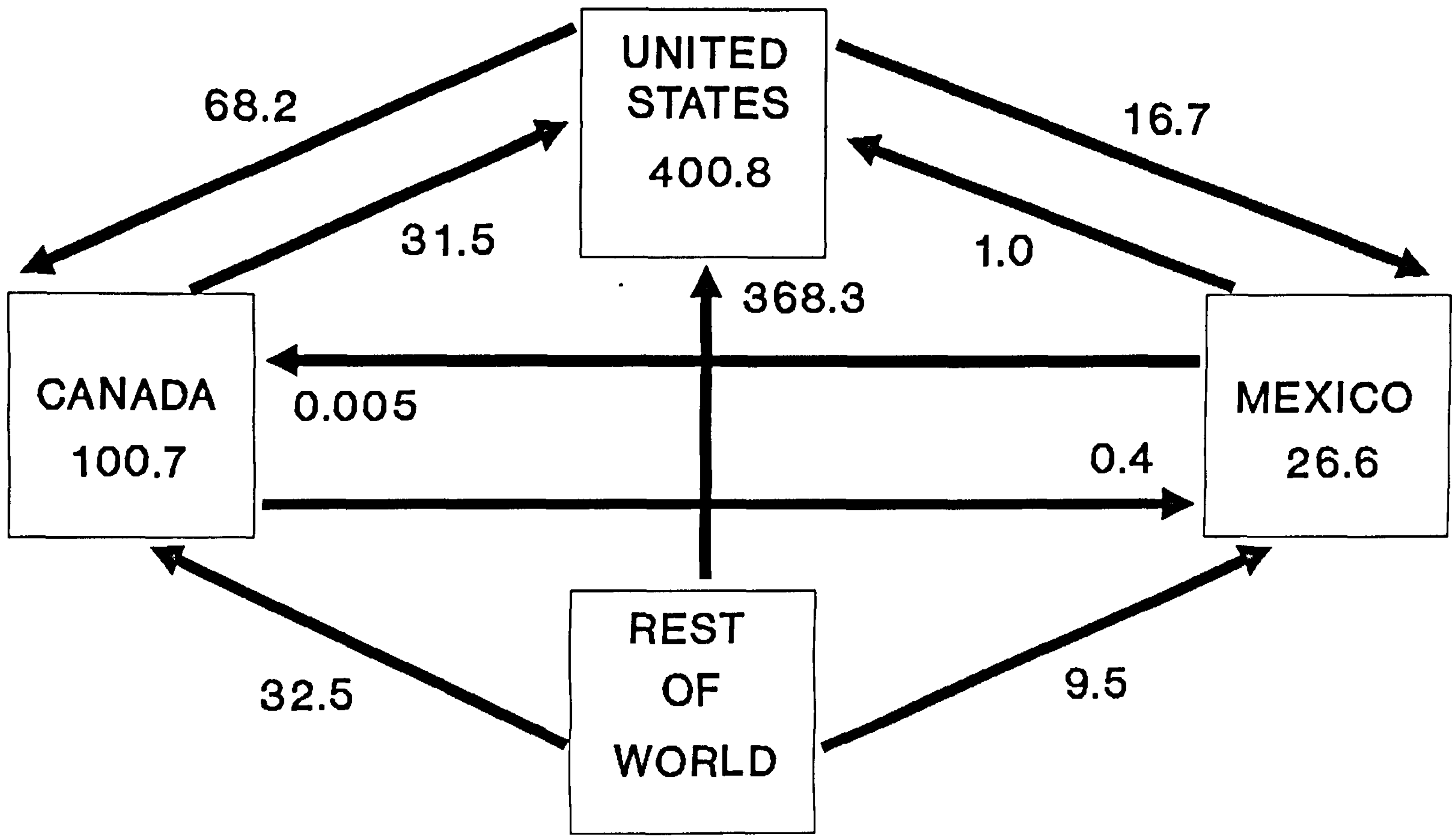
Direct investment from abroad (which entails some degree of foreign control) helps to facilitate access to markets, technology transfer, improved opportunities and returns for skilled workers, and the sharing of advanced management techniques. For Canada, foreign direct investment has always been a vital component of the economy. Recently, too, the United States has experienced a surge in foreign direct investment. Until the mid-1980s, Mexico had tight restrictions concerning foreign investment, but now these measures are being relaxed. Since foreign investment policy is likely to be one of the agenda items during the NAFTA negotiations, and because there is such a strong link between investment and trade opportunities, it is useful to briefly compare the policies of

[6] John Knubley, William Krause and Zulfi Sadeque. Canadian Acquisitions Abroad: Patterns and Motivations. Investment Canada, January 1991.

Chart 3

Foreign Direct Investment Stocks, 1989 (US$ Billions)

Canada - U.S.- Mexico - Rest of the World



Note: Stock of FDI for Country/Region shown in box.

Source: Investment Canada compilation using data from Statistics Canada, U.S. Department of Commerce, and the Mexican National Commission on Foreign Investment (NCFI)

Canada, the United States and Mexico.[7] Information about Mexico's foreign investment policy is emphasized, on the assumption that the Canadian and U.S. provisions are better known by most readers of this paper. Further, many Canadian business representatives are interested in the possibility of investments in Mexico, as a complement to their investments in Canada and the United States. Hence the data presented highlight foreign investment activity in Mexico. A brief summary is also given of the investment provisions contained in the Canada/U.S. Free Trade Agreement, as these must be integrated with the NAFTA provisions.

Mexican Foreign Investment Policy

Prior to 1989, foreign investment was either prohibited completely or permitted only on a minority position basis. Now, majority-owned foreign investments of up to US$100 million are permitted, with minimum regulation in sectors accounting for approximately two-thirds of the Mexican economy. Also, in sectors where the government retains the right to extensively review and/or restrict foreign investment, the degree of foreign ownership permitted has been increased substantially. Even in telecommunications and banking, which were previously off-limits to foreign investors, the new regulations permit foreign ownership of up to 49 percent and 30 percent, respectively.

The Mexican National Commission on Foreign Investment (NCFI) is vested with the authority to review and oversee foreign investment in Mexico. The NCFI is composed of the heads of seven ministries and is served by a secretariat with a staff of 120.

Foreign investment proposals that satisfy specified criteria are granted automatic approval. The most important criteria require that:

- the investment is made in an "unclassified activity" (now included in the unclassified sector are the previously restricted glass, cement, iron, steel and cellulose industries);
- the investment does not exceed US$100 million;
- financing, either debt or equity, is foreign-sourced;
- industrial projects are located outside of highly populated areas; and

[7] Two other reports relevant to this comparison are:
- Canada-U.S.-Mexico Free Trade Negotiations: The Rationale and the Investment Dimension. Investment Canada, August 1990.
- Foreign Investment in Mexico, the United States and Canada. Investment Canada, November 1990.

- a balanced foreign exchange position is maintained during the first three years of operation.

Regular financial plans must be submitted by foreign investors, comparing current operations with the initial financial plans. If difficulties are encountered with the investment, the NCFI may intervene to establish a new basis for the investment.

Foreign investments subject to closer scrutiny include the following:

- investments not meeting all the criteria for the automatic approval process;

- investments involving foreign ownership above specified levels in classified sectors of the economy; there are 141 classified industries, 58 of which are open to majority foreign ownership with prior NCFI approval; ownership limits for other classified industries range from 34 to 49 percent; and

- proposed investments of a politically sensitive nature.

In 1990, approximately 300 foreign investment applications were received by the NCFI. Since May 1989, when the regulations came into effect, the NCFI has not refused any applications. Decisions on foreign investment applications must be given within 45 days. Follow-up and remedies apply respecting all approved applications.

Appendix C provides a much more detailed account of the foreign investment regulations in Mexico, including a listing of all industries and their treatment under the regulations.

Foreign Direct Investment In Mexico

Among the Latin-American countries, Mexico has the second largest amount of foreign direct investment (FDI), and is exceeded only by Brazil. Despite a significant growth of foreign direct investment in Mexico over the past several years, however, it constituted less than 10 percent of total gross fixed investment during the 1980s, and its share of Mexico's GDP was less than five percent.

As shown in Table 9, the estimated amount of accumulated FDI in 1989 was US$26.5 billion. The United States continues to be the largest direct investor in Mexico, although its share had declined from 69 percent in 1980 to 63 percent by the end of the 1980s. The United Kingdom has doubled its share of FDI in Mexico, replacing West Germany as the second-largest foreign investor. The respective positions of other foreign investors in Mexico, including Japan, have not changed substantially.

Table 9
Foreign Direct Investment in Mexico: Cumulative Value of FDI in Millions of U.S. Dollars

Years / Country	1980	1984	1985	1986	1987	1988	1989	Jan/Nov 1990	Average Annual Growth		
									1980-85	1985-89	1980-89
U.S. % of FDI	5,836.6 69.0	8,513.4 66.0	9,840.2 67.3	11,046.6 64.8	13,716.2 65.5	14,957.8 62.1	16,748.0 63.0	18,650.9 62.8	11.0	14.2	12.4
FRG % of FDI	676.7 8.0	1,125.4 8.7	1,180.8 8.1	1,399.4 8.2	1,446.3 6.9	1,583.0 6.6	1,675.0 6.3	1,830.8 6.2	11.8	9.1	10.6
Japan % of FDI	499.1 5.9	816.0 6.3	895.3 6.1	1,037.5 6.1	1,170.3 5.6	1,319.1 5.5	1,356.0 5.1	1,455.5 4.9	12.4	10.9	11.7
Switzerland % of FDI	473.7 5.6	647.7 5.0	788.9 5.4	823.0 4.8	918.2 4.4	1,004.5 4.2	1,170.0 4.4	1,341.3 4.5	10.7	10.3	10.6
Spain % of FDI	203.0 2.4	369.6 2.9	383.6 2.6	477.3 2.8	603.1 2.9	637.2 2.6	691.0 2.6	691.9 2.3	13.6	15.9	14.6
U.K. % of FDI	253.7 3.0	395.5 3.1	451.9 3.1	556.2 3.3	987.1 4.7	1,754.7 7.3	1,781.0 6.7	1,901.1 6.4	12.2	40.9	24.2
France % of FDI	101.5 1.2	237.3 1.8	248.0 1.7	564.9 3.3	596.1 2.8	748.5 3.1	798.0 3.0	942.4 3.2	19.6	33.9	25.7
Sweden % of FDI	126.9 1.5	230.4 1.8	235.9 1.6	260.5 1.5	297.2 1.4	329.7 1.3	346.0 1.3	349.9 1.2	13.2	10.0	11.8
Canada % of FDI	126.9 1.5	194.8 1.5	229.7 1.6	270.3 1.6	289.6 1.4	323.5 1.3	372.0 1.4	410.4 1.4	12.6	12.8	12.7
Others % of FDI	160.7 1.9	369.8 2.9	374.6 2.6	614.1 3.6	905.9 4.3	1426.1 5.9	1,648.0 6.2	2,109.9 7.1	33.4	65.1	46.7
Total Cumulative FDI	8,458.8	12,899.9	14,628.9	17,053.1	20,930.3	24,087.4	26,587.1	29,684.1	11.6	16.1	13.6

* Revised figures for "Total Cumulative FDI" are incorporated in this table, even though details of the country revisions were not available. Components may not add to totals because of revised totals, and because of rounding errors.

Source: Executive Secretariat of the National Foreign Investment Commission, Mexico.

In 1989, Canada's accumulated direct investment in Mexico was US$361 million; this represents almost a threefold increase over the 1980 level. Canada's share of FDI in Mexico, however, continues to be less than 1.5 percent.

Table 10 indicates that new foreign investment projects authorized by the NCFI were expected to total US$3.1 billion in 1990, compared with US$2.5 billion in 1989 and US$3.2 billion in 1988. More than 60 percent of the inflow in recent years is due to U.S. and U.K. investment; France, Germany and Japan have each accounted for approximately five percent of the total. Canadian firms invested an estimated US$37 million and US$50 million in 1989 and 1990, respectively.

Some 9,000 foreign firms have investments in Mexico, an increase of about 2,000 over the number five years ago. As expected, the largest representation is from the United States. Table 11 shows the major foreign firms with operations in Mexico. Currently, there are 214 Mexican companies with Canadian capital, of which 154 are minority-owned and 60 are majority-owned. Table 12 lists some of the major Canadian firms with either minority- or majority-ownership in Mexican enterprises.

Most (two-thirds) of FDI in Mexico is concentrated in the manufacturing sector, predominantly in the maquiladoras. The next largest concentration is in the service sector (25 percent), followed by commerce (7 percent) and mining (1.5 percent).

Mexico's foreign ownership restrictions do not apply to investments in maquiladora operations. As pointed out earlier in this paper, and as reflected in Table 1, maquiladoras are a major factor in Mexico's economy. Exports from the maquiladoras totalled US$12.5 billion in 1989; US$3 billion of this was as a result of value-added in Mexico. By industry, electronic machinery and equipment and other accessories accounted for about 40 percent of the value-added, followed by transportation (26 percent), textiles (9 percent), furniture (5 percent) and food (1.3 percent).

In summary, Mexico has considerably liberalized its foreign investment policy, and foreign direct investment is being actively encouraged. Mexico anticipates that a NAFTA will act as a strong stimulant. Although foreign investors have been responding positively to developments in Mexico, the level of foreign investment is still well below the targets set by the Mexican government. Canadian participation to date has been marginal.

U.S. Foreign Investment Policy

The U.S. Administration continues to advocate an "open door" policy towards international investment. Current U.S. restrictions on foreign investment are for the most part based on national security concerns: the Exon-Florio review process and the restrictions on foreign ownership in certain sectors, such as coastal shipping, fall into this category. In other sectors the national security concern is less clear. In still other

Table 10
Foreign Direct Investment in Mexico by Country of Origin

Country of Origin	New FDI - 1990	
	Value (US$ millions)	% of Total
U.S.A.	1,879.2	60.7
U.K.	101.7	3.3
Germany	163.1	5.3
Japan	120.7	3.9
Switzerland	142.4	4.6
France	177.4	5.7
Spain	10.7	0.4
Sweden	13.3	0.4
Canada	49.5	1.6
Holland	125.1	4.0
Italy	4.6	0.1
Others*	309.3	10.0
Total	3,097.0	100.0

* Includes: Bahamas, Virgin Islands, Cayman Islands, Colombia, Peru, Panama, Venezuela, Lichtenstein, Luxembourg, Belgium, Liberia, Korea, Australia.

Source: Direccion General de Inversion Extranjera (Department General of Foreign Investment) Direccion de Estudios Economicos (Department of Economic Studies), Mexico.

Table 11
Major Foreign Investments in Mexico, 1987

Name of Enterprise	Rank*	Type of Investment	Origin of Capital	Percent Foreign Owned
Chrysler de Mexico	2	Automotive	U.S.A.	99.9
General Motors	3	Automotive	U.S.A.	100.0
Ford Motor Company	5	Automotive	U.S.A.	100.0
Volkswagen de Mexico	8	Automotive	FRG	100.0
Celanese Mexicana	10	Artificial Fibers	U.S.A.	40.0
Kimberly-Clark	12	Paper & Cellulose	U.S.A.	45.0
IBM	14	Electronics	U.S.A.	100.0
Industrias Resistol	17	Petrochemicals	U.S.A.	39.2
Compania Nestle	13	Food	Switzerland	100.0
American Express	22	Financial Services	U.S.A.	100.0
Spicer	29	Auto Parts	U.S.A.	33.0
Ericcson (Mexico)	33	Electronics	Sweden	73.0

* "500 Largest Enterprises in Mexico 1987," Expansion Magazine. August 17, 1990.

Table 12
Main Canadian Companies in Mexico, 1990

Canadian Investor	Mexican Company	Sector
NEI Canada Ltd.	Transformadores Parsons	Industrial
Chempharm Ltd.	Farmaceuticos Lakeside, S.A.	Industrial
Diversey Worlds Holding Inc.	Diversey Mexico, S.A. de C.V.	Industrial
Pharma Investment Ltd.	Cafes Industrializados de Veracruz, S.A. de C.V.	Industrial
Caminco Ltd.	Minera Maria, S.A. de C.V.	Industrial
Moore Corporation Ltd.	Moore Business Forms de Mexico, S.A. de C.V.	Services
Canada Wire and Cable International Ltd Corp.	Industrias Axa, S.A.	Industrial
Philips Trans-America Holdings Corp.	Philips Mexicana, S.A. de C.V.	Industrial
Sapac Corporation Ltd.	Roche Mexicana de Farmacos S.A. de C.V.	Industrial
Noranda Inc.	Grupo Industrial Premenal, S.A. de C.V.	Industrial

Source: Direcion General de Inversion Extranjera, Mexico.

sectors, foreign investment is subject to the principle of reciprocity (e.g. designation as a primary dealer for government securities, and rights-of-way for oil and gas pipelines). The Exon-Florio provisions contained in the 1988 Omnibus Trade Bill give the President the power to disallow foreign takeovers of American-based firms that "threaten to impair national security." A formal screening process has been established under the direction of the Committee on Foreign Investment in the United States (CFIUS). Because ambiguity surrounds the meaning of "national security," up to half of foreign investors feel obliged to register their investment proposals with the CFIUS. To date, one foreign takeover has been reversed as a result of the application of the Exon-Florio provisions. In addition, several acquisitions investigated by CFIUS have resulted in what essentially amount to performance requirements being agreed to.

A number of other legislative proposals have been presented to Congress, including proposals that would: require disclosure of more information about foreign-controlled businesses; introduce a minimum tax on foreign subsidiaries; add new restrictions on foreign ownership in broadcasting; require reciprocity for foreign investments from certain countries; and limit foreign subsidiaries' participation in the political process. These legislative proposals are based on concerns about foreign influence on the U.S. economy, and alleged unfair trade and investment practices by other countries. They represent a trend which the U.S. Administration has, thus far, kept in check.

The state governments have an array of incentives, restrictions and regulations that affect foreign investment in a variety of ways, and for a variety of purposes. For example, while 36 states maintain trade and investment promotion offices in Japan, 42 states also have anti-takeover legislation.

Foreign Investment in the United States

Because there are many excellent accounts of foreign direct investment in the United States, what follows is brief.[8] The stock of FDI in the United States was US$400 billion at the end of 1989. By a variety of measures, the share of U.S. assets, employment and production accounted for by U.S. affiliates of foreign firms has increased by a factor of between two and three during the past decade. As a percentage of the total value of non-financial assets, the stock of FDI increased from 3.5 percent in 1980 to over 9 percent in 1989.

The United States is now the largest host country for foreign investment in the world. It accounts for over 25 percent of total international direct investment, in contrast

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[8] See, for example, Edward Graham and Paul Krugman. Foreign Direct Investment in the United States. Institute for International Economics. Washington, 1989.

to less than 10 percent two decades ago. Foreign investments in the United States are frequently large. In 1988, for example, there were nine acquisitions each worth more than US$1 billion.

By source country, the United Kingdom accounts for 30 percent of the stock of FDI in the United States; Japan accounts for 17.5 percent, the Netherlands for 15 percent and Canada for 8 percent. In terms of flows of FDI, during the last four years Japan was the source country for the largest number of transactions. In value terms, Japan was tied with the United Kingdom. Canada was third in both number and value of transactions. More than 50 percent of the transactions, and an even higher percentage by value, involved the manufacturing sector.

Investment by the United States in Canada and Mexico

Table 13 summarizes U.S. direct investment in Canada and Mexico. The accumulated level of U.S. investment in Canada is almost ten times that in Mexico. During most of the 1980s, the stock of U.S. direct investment in Canada grew at a faster rate than the stock of U.S. direct investment in Mexico. Both Canada and Mexico experienced a slight decline in the share of total U.S. direct investment abroad. Canada's share at the end of 1989 was just under 18 percent, while Mexico's was just under 2 percent. Other Latin American countries have gained, as has Europe and Asia.

Cross-border investment flows have shifted more dramatically than the stock of FDI. Between 1985 and 1989, Canada accounted for only 12 percent of U.S. cross-border direct investment. Reinvested earnings of Canadian affiliates continue to be the major source of U.S. direct investment in Canada. Mexico accounted for only 1 percent of U.S. cross-border direct investment in 1987, but for 3.6 and 4.3 percent in 1988 and 1989, respectively. By coincidence, Canada and Mexico were equal recipients of U.S. cross-border direct investment in 1989.

Canadian Foreign Investment Policy

Canada has long experienced the highest degree of foreign ownership and control of any industrialized county, a situation that has caused previous Canadian governments to introduce rigorous regulations for screening foreign investment. Since the mid 1980s, however, Canada has significantly liberalized its foreign investment policy.

The establishment of Investment Canada in June 1985 represented a major change from the former regulatory agency, the Foreign Investment Review Agency (FIRA). FIRA reviewed all foreign investments, including new investments and takeovers, regardless of size. In contrast, Investment Canada reviews only major foreign takeovers:

Table 13
U.S. Direct Investment Position in Canada and Mexico, 1984 and 1989

Canada		Mexico		Industry	Canada		Mexico	
1984	1989	1984	1989		1984	1989	1984	1989
percent					US$ millions			
23.9	16.3	1.5	1.0	Petroleum	11,156	10,912	71	68
44.9	48.4	79.4	82.5	Manufacturing:	20,985	32,324	3,650	5,838
3.5	3.3	9.0	6.6	Food	1,634	2,175	414	466
10.2	9.8	16.2	21.3	Chemicals	4,777	6,580	746	1,505
3.6	3.6	7.2	3.8	Primary and Fabricated Metals	1,672	2,437	332	269
5.3	5.0	4.4	4.5	Machinery, excl. Electrical	2,491	3,316	202	321
3.4	3.3	9.8	6.4	Electrical and Electronic	1,594	2,173	450	451
9.3	11.5	11.0	21.4	Transportation Equipment	4,337	7,673	505	1,518
9.6	11.9	21.8	18.5	Other Manufacturing	4,480	7,970	1,001	1,308
5.2	5.9	9.6	5.6	Wholesale Trade	2,439	3,917	443	395
1.1	1.4	-0.1	0.0	Banking	521	945	-3	0
13.1	17.5	4.2	1.8	Finance, excl. Banks, Ins./ Real Est.	6,139	11,680	195	130
1.5	2.1	-0.6	1.9	Services	705	1,385	-26	138
10.2	8.5	5.8	7.2	Other Industries	4,785	5,684	268	510
100.0	100.0	100.0	100.0	Total	46,730	66,847	4,598	7,079

Source: Compilations by Investment Canada from U.S. Department of Commerce data.

- direct acquisitions of Canadian businesses with assets of $5 million or more;
- indirect acquisitions of Canadian businesses with assets of $50 million or more; and
- acquisitions or new business in areas related to Canada's cultural heritage or national identity, which may be reviewed on the basis of ministerial discretion.

As will be explained more fully later, under the FTA higher review thresholds apply to U.S. investors.

Reviewable transactions are assessed to determine their "net benefit" to Canada, using six criteria: the general effect on economic activity in Canada; Canadian participation; effect on productivity and technological development; effect of the investment on competition within any industry or industries in Canada; compatibility with national and provincial policies; and the effect on competitiveness. The Minister responsible for Investment Canada must make a decision within 45 days from the receipt of a complete application, with provision for a 30 day extension.

From the inauguration of Investment Canada up to the end of 1990, 5,266 foreign investment proposals had been received. Three-quarters of these were not subject to review, and the 25 percent that were have all been approved. In some 11 percent of these latter cases, approval was subject to meeting specified performance requirements. Most of these requirements pertain to R&D undertakings in high-technology sectors, Canadian participation in the oil and gas sector, and product mandating and production levels in the manufacturing sector. As in most other countries, Canada restricts foreign ownership in certain sectors: for example, airlines, banking, book publishing and distribution, broadcasting, film distribution, the production of oil and gas, and uranium.

Foreign Investment in Canada

As in the case of the United States, foreign investment in Canada is described at length in other documents.[9] Some highlights respecting foreign direct investment in Canada include the following:

[9] The following is available upon request from Investment Canada: International Investment: Canadian Developments in a Global Context. Investment Canada Working Paper 6, January 1991.

- the stock of FDI at the end of 1989 was $119 billion;

- foreign control of total non-financial corporate assets in Canada is currently about 25 percent, compared with 37 percent in 1971; foreign control of the manufacturing sector is about 45 percent;

- cross-border direct investment in Canada doubled during the period 1985-89, compared with the first half of the 1980s; reinvested earnings by foreign-controlled firms in Canada continue to account for the lion's share of foreign direct investment;

- the importance of the United States has declined considerably relative to Asia and Europe as sources of foreign direct investment in Canada; Mexican investment in Canada is negligible; and

- the importance of foreign acquisitions relative to new or "greenfield" investments has grown significantly in recent years.

It should also be pointed out that investment is a two-way street. There has been a growing participation by Canadians in investment abroad. The stock of Canadian direct investment abroad was $74 billion at the end of 1989, 65 percent of which was in the United States.

Chart 4 summarizes the country distribution of both FDI in Canada, and Canadian direct investment abroad (information for 1987 is the most recent available).

Investment Provisions of the Canada-U.S. Free Trade Agreement

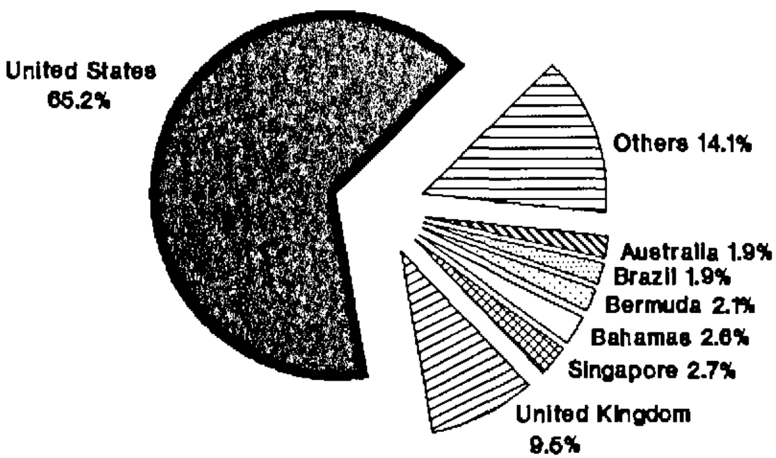
The investment provisions in Chapter 16 of the FTA set out the obligations that the two countries have towards each other's investors.

The national treatment clause ensures that Canada and the United States will provide to investors of the other country treatment no less favourable than the treatment they provide to their own investors. This obligation extends to provincial, state and local governments as well. Existing measures that do not conform to the national treatment obligation are "grandfathered" under the FTA–including the *Investment Canada Act*. Canada, however, agrees to increase the review thresholds for U.S. investors in four annual steps over the period 1989-92; for direct acquisitions the review thresholds will be raised to $150 million and the review of indirect acquisitions will be eliminated. Sectors excluded from the national treatment clause are banking, government procurement, culture and transportation.

Chart 4

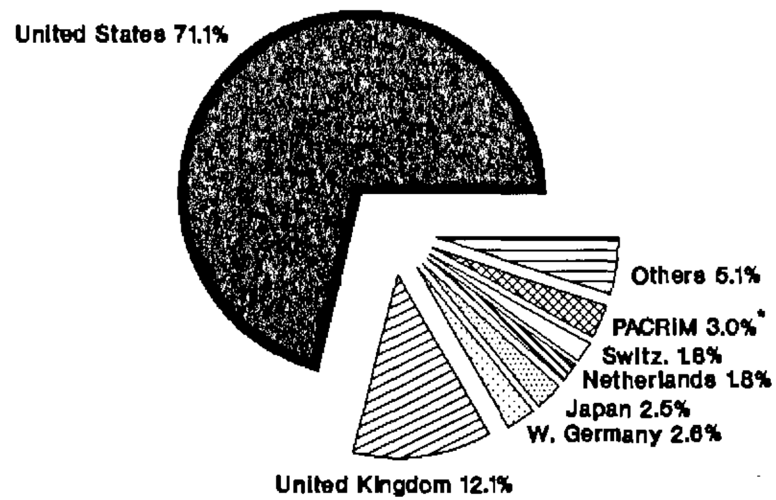
Distribution of Canadian Direct Investment Abroad (CDIA) and Foreign Direct Investment in Canada (FDI), by Country

1987



Book Value (Stock) of CDIA

1987 Total: $66.1 Billion



Book Value (Stock) of FDI

1987 Total: $101.5 Billion

* The PACRIM includes Japan, Hong Kong, Australia, S. Korea, Singapore, Taiwan, Malaysia, & other Pacrim countries.

Source: Statistics Canada

Canada and the United States also agree not to impose the following four performance requirements on investors of the other country: export performance; import substitution; local content; and domestic sourcing requirements. Other provisions ensure fair treatment in the event of nationalization, and the right of investors to transfer funds out of the other country. The investment chapter also ensures that new subsidies and tax measures will not be used to arbitrarily discriminate against investors of the other country.

Summary of Foreign Investment Policies

All three countries have a liberal and welcoming approach towards foreign investment, although there are considerable differences in the degree of openness. All three actively promote foreign investment and are significant host countries to foreign investment. Canada and the United States are also major sources of foreign investment funds. Nevertheless, all three countries maintain restrictions on foreign ownership in strategic sectors for economic, cultural and national security reasons, and all three countries have a mechanism to formally review and approve foreign takeovers. Since the late 1980s, Mexico has dramatically liberalized its foreign investment policy. Since 1985, Canada has also considerably liberalized its foreign investment policy; the high level of foreign ownership and control of the economy attests to the importance that foreign investment has always played. While the U.S. administration is facing protectionist sentiments as a result of the recent rise in foreign investment, so far the "open door" policy has been largely maintained.

Note that this discussion has primarily addressed formal provisions respecting foreign investment policy. Unfortunately, while formal barriers have generally been liberalized, informal barriers remain. These include anti-takeover or anti-trust legislation, state ownership, private concentration of share holdings, banking/commercial linkages that limit foreign participation, and intercorporate relationships. "Strategic" policies, such as assistance to joint ventures or consortia, may also influence investment decisions. Informal investment barriers may be included in the NAFTA negotiations.

The Business Investment Implications of Globalization and Free Trade

Globalization refers to the growing interdependence of national economies—and involves consumers, producers, suppliers and governments in different countries.[10] Boundaries between domestic and international markets are becoming less relevant as businesses increase their profiles abroad. As the previous section has demonstrated, nations—especially small nations like Canada and Mexico—are having to reconsider many

[10] See The Business Implications of Globalization. Investment Canada, Working Paper Number 5, May 1990.

of their domestic policies, including those regarding foreign investment. Also, many industries are having to become global in structure. A global industry is one whose competitive position in one country is significantly influenced by its position in other countries. The industry is not merely a collection of domestic firms; on the contrary, firms follow integrated international strategies, exploiting benefits gained in one market for use in another. Global industries include commercial aircraft, television, semiconductor and automobile production—all of which figure in North America.

The increasing penetration of local markets by foreign firms, and the growing need for domestic firms to pursue global strategies is raising the question, "Who is us?" The growing cost and importance of research and development is forcing alliances among what were once staunch competitors. Joint ventures, mergers, acquisitions and other forms of strategic alliances are breaking down the distinction between domestic and foreign firms. Even the dichotomy between high-technology and low-technology industries is diminishing. Most significantly, a purely domestic focus is no longer a viable business strategy in many industries. Foreign investment is rapidly becoming the strategic instrument by which firms are assuring themselves of access to overseas markets, new technology and skilled human resources. In order to remain competitive, domestic firms must gain a greater understanding and knowledge of foreign markets and competitors. In regard to trilateral free trade in North America, these requirements bear importantly on Canadian and Mexican businesses.

Following implementation of a NAFTA, and even in anticipation of it, opposing forces will emerge concerning the placement of investment within the participating countries. Mexico, as a consequence of a long period of trade protectionism, over-invested in capital-intensive industries. Many of these are inefficient, as implied by the fact that some 77,000 Mexican firms have ceased operation since Mexico joined the GATT in 1986. Mexico's comparative advantage is in more labour-intensive industries. With free trade, a realignment of capital-intensive investment in favour of Canada and the United States can be expected.

On the other hand, the growing tendency among industries to decouple or disintegrate unskilled production tasks from skilled production tasks poses a challenge for Canada and the United States, and an opportunity for Mexico. Increasingly, components manufacturing entails many suppliers in several countries. Components that require only unskilled labour are being manufactured in low-wage countries such as Mexico, which creates problems for unskilled labour in advanced countries like Canada and the United States. Trade liberalization accelerates this process. Firms will attempt to segment their vertically integrated production processes by factor intensity. By shifting some low-skill operations to Mexico, firms in Canada and the United States will be able to lower their costs and enhance their ability to compete internationally.

These developments are already happening, not only in North America but elsewhere in the Triad. Japanese investment in Korea, and more recently in Thailand, illustrates the success of parcelling out production components on the basis of comparative advantage at the factor input level. Businesses in Canada and the United States are having to incorporate the concept of production disaggregation into their investment strategies. If Canadian and American firms fail to identify the opportunities for rationalizing their operations as between low-wage and high-wage situations, so as to match required skill levels, then firms from overseas will simply usurp the market.

The challenge for advanced countries like Canada and the United States is to continue to build on their comparative advantage in human capital. There will always be a reasonable demand for low-skilled workers in advanced societies, but the emphasis must be on narrowing this demand and enhancing the demand for upscale jobs. This challenge is largely a private sector responsibility, but government support for education, training, other forms of labour force enrichment and research and development is vital. Investing in a country's future is critical to productivity and the ultimate competitiveness and standard of living of a country. For a small and open country like Canada, these dictates are particularly relevant.

SUMMARY AND CONCLUSIONS

This paper has endeavoured to highlight some of the challenges and opportunities associated with trilateral free trade among Canada, the United States and Mexico. Written from a Canadian perspective, the focus has been on intensified competition for U.S. markets following extension to Mexico of the free and assured access to the United States that Canada enjoys as a result of the FTA. Data have also been given about Canada-Mexico trade, and the likely trade creation and trade diversion following implementation of a NAFTA. Since trade and investment are so closely linked, a considerable portion of the paper deals with investment-related data.

There are no pretensions that the paper is self-contained or exhaustive. A great deal more work is needed to fully appreciate the risks and benefits for Canada of participating in the NAFTA negotiations. Nonetheless, several conclusions are justifiable at this juncture:

General Economic Impact

- a NAFTA will not be a simple extension of the FTA, either in form or in terms of the economic implications for Canada;

- the wage differential between Mexico and Canada reflects productivity differences between the two countries; trilateral trade liberalization will not result in Mexico overwhelming Canada and the United States with a rush of low-cost products;

- Mexico has extremely low incomes, at least in part because of past policies that emphasized trade protectionism and various subsidy and regulatory means for industrialization; sweeping reforms introduced since the mid-1980s should enable Mexico to experience rapid growth, in the same manner as enjoyed by South Korea, Thailand and a number of other countries;

- Mexico's improved economic performance, together with a population that will reach 100 million by the end of the century, offers a major new export market for Canada; being part of a NAFTA will help ensure that Canadian businesses are active in this new market;

- the differing resource endowments of Canada, the United States and Mexico, including differing skill levels, are broadly complementary; by rationalizing production and distribution within North America, each of the participating countries in a NAFTA will be better able to compete internationally;

- adjustments will be required but, for the most part, these will be marginal relative to the ongoing adjustments associated with globalization, technological advancement, changing consumer demands, and the normal rotation of the labour force; and

- adjustment assistance is recognized in the considerable number of labour force and industry adjustment programs provided by the federal and provincial governments in Canada; adjustment assistance to smooth the implementation of trilateral free trade can be expected through the phasing of tariff elimination, the rules of origin provisions, possible exemptions for certain sectors and the"grandfathering" of existing support policies.

Trade Implications of Canadian and Mexican Competition for the U.S. Market

- the United States is the major export market for both Canada and Mexico; there is some degree of overlap between Canada and Mexico in terms of their exports to the United States; there is also a large percentage of Canadian exports to the United States that have no Mexican competitor;

- only a small percentage of Canadian exports to the United States enjoy a considerable tariff advantage over Mexican exports; equal access for Canada and Mexico to the U.S. market will not materially affect Canada's export prospects; and

- in the case of some sectors (e.g. automotive products, steel, and textiles and apparel industries), intensified competition as a result of Mexico's free access to U.S. markets will pose adjustment challenges; wholesale displacement by Mexican producers in selective sectors is most unlikely, even in the long run.

Trade Implications of Canadian Imports from Mexico

- almost 80 percent of Mexican imports already enter Canada duty-free; the average overall effective duty is only 2.4 percent; nor is Mexico currently excluded from the Canadian market by quotas on key commodities such as textiles; there are significant non-tariff barriers (e.g. marketing regulations) in some sectors that, if removed, could result in increased imports;

- major imports from Mexico are automotive parts and engines, TV, radio, sound and telecommunications equipment, precious metals and alloys and crude oil; and

- some six percent of Canadian imports from Mexico are subject to effective duties of eight percent or more; the importance of this category of goods could increase substantially following implementation of trilateral free trade; the total value of such imports from Mexico in 1989 was $93 million, compared with Canadian production of these same categories of goods of $37 billion and third-country imports of $16 billion; some trade diversion can be expected, and the phasing of tariff elimination respecting this category of goods will be important.

Trade Implications of Canadian Exports to Mexico

- while exports to Mexico account for less than one percent of total Canadian exports, this percentage could grow considerably following implementation of trilateral free trade;

- this expansion of exports will derive from the sharp increase in imports required by Mexico to satisfy growing consumer demand, and to provide the machinery and equipment and other inputs necessary for a developing country; also, Canada and the United States, as a result of a NAFTA, will enjoy favoured access, relative to third countries, to Mexican markets;

- more research is required concerning effective duty rates facing Canadian exporters to the Mexican market, and the steps needed to ensure that Canada responds aggressively to the new export opportunities; in terms of take-up of new export opportunities, a NAFTA is fundamentally different than the FTA; and

- the FTA basically consolidated long-established trade and investment relationships between Canada and the United States; a NAFTA presents a whole new market to Canada; the appropriate network of trade and investment relationships has yet to be established.

Implications of Intra-Corporate Trade

- intra-corporate trade accounts for a large share of Canada-U.S. trade, and a rapidly growing share of U.S.-Mexico trade; and

- trade liberalization can be expected to accelerate this trend; more research is required to ascertain the implications of this trend for Canadian businesses endeavouring to expand their trade links with Mexico.

Investment Implications

- as in the case of trade, the investment ties between Canada and the United States, and between the United States and Mexico, are strong;

- direct investment abroad has become a key strategic instrument for access to markets, new technology and skilled human resources; it can be expected that direct investment among Canada, the United States and Mexico will figure importantly in how the benefits of trilateral free trade are distributed;

- strong investment ties must be established between Canada and Mexico; Canadian direct investment abroad has grown considerably over the past two decades (more rapidly than foreign direct investment in Canada), but most of this has been concentrated in the United States; Canadian direct investment in Latin America, particularly Mexico, is vital if Canada is to benefit from hemispheric free trade; currently, Canadian investment in Latin America is— with the exception of Chile and Brazil— minimal;

- Mexico's foreign investment policy has been greatly liberalized in recent years; it is now possible for a high degree of foreign participation in the Mexican economy; foreign investment in maquiladora operations has been extensive, but so far Canadian participation is limited; Canada accounts for only 1.5 percent of foreign direct investment in Mexico;

- the foreign investment policy of the United States has always been relatively open, and Canada and the U.S. have well-established investment ties; these ties will be extremely important in helping to respond to new export opportunities in Mexico;

- Canada's foreign investment policy is also open and, increasingly, emphasis is being given to joint ventures and other forms of strategic alliances; with the prospect of free trade with Mexico, attention must be given to strategic alliances with Latin American businesses;

- Canadian businesses are having to rationalize their investments so as to concentrate more effectively on comparative advantages; in some cases this means decoupling low-skill activities from high-skill activities, with the former being relocated in low-wage countries such as Mexico; this rationalization is unavoidable, given intense competition from other countries;

- Canada must endeavour to concentrate on upscale jobs; this is largely the responsibility of the private sector, but government support for education, training, other forms of labour force enrichment and research and development is vital; and

- North American free trade requires investing in Canada's future.

APPENDIX A

NOTES TO TABLES AND DATA SOURCES

Notes to tables

1. The brief descriptions of import categories in Tables 2-5, inclusive, are subject to possible misinterpretation because the U.S. tariff classifications at the 6-digit level may contain several sub-groups. Where this is the case, the description of one of the sub-groups is applied to the whole category. For example, the description of U.S. tariff classification code # 870323 indicates station wagons with engines of 1,500-3,000 cc.; in fact, this code includes all passenger vehicles with engines of 1,500-3,000 cc. Because this category is so prominent, we have indicated the more descriptive title (i.e. passenger vehicles) in the tables. In other cases, however, no adjustment has been made.

2. In Table 6, the Canadian production of certain goods is indicated as zero, even though there may be considerable production. This is because of confidentiality restrictions.

3. For purposes of presentation, the tables stop short of giving information for all import categories. Complete tables run to 300 or more pages each. Tables showing complete trade, duty, production and other information are available in hard copy and on diskette.

Data Sources

Investment Data

Data on U.S. direct investment abroad are available from the *U.S. Survey of Current Business*. These data show the net investment position as well as net capital outflows by country and by industrial sector for at least the last 10 years. Rates of return on investment in host countries are also indicated.

Mexican data on FDI come from the Central Bank of Mexico and the National Foreign Investment Commission of Mexico. The former source provides no breakdown by country of origin and the latter data are based on approvals rather than actual flows. The latter is the most useful, however, as it shows not only the country of origin but the sector (with maquiladora investment shown separately).

Canadian data on direct investment in the United States line up reasonable well with the U.S. data on FDI, although the sectoral breakdowns are different and there are differences in the distinction between short- and long-term flows. Detailed sectoral breakdowns are available. No data on rates of return are available, and none can be easily constructed. There are no comprehensive Canadian data on Canadian direct investment in Mexico.

The U.S. Department of Commerce produces a publication entitled *U.S. Direct Investment Abroad: Operations of U.S. Parent Companies and their Foreign Affiliates*. The publication includes basic income and balance sheet information, from which various rates of return, profitability and productivity based on assets, net income, employment, employee compensation and sales can be constructed. The data provide a useful comparison between the relative performance of U.S. affiliates in Canada and Mexico. The data are available by sector, but confidentiality rules limit the conclusions that can be drawn. Moreover, the financial information may reflect transfer pricing practices.

Trade Data

U.S. imports by country are available on CD-ROMs from the U.S. Department of Commerce. Investment Canada acquired these data and, in collaboration with R.D. Hood Economics Inc., extracted the figures for Canada, Mexico and the rest of the world. The data base shows individual import shipments classified at the 8-digit Harmonized System (HS) level. The fields in each record show:

- the HS number;
- the special 4-digit U.S. extension code;
- the text description of the commodity;
- the Standard Industrial Classification (SIC) number for the industry producing the commodity;
- the import value;
- the import units (kg, m, etc.);
- the import volume;
- the calculated duty;
- the duty rate;
- the point of unlading; and
- the country of origin.

The calculated duty is not necessarily the same as the duty rate. The reasons for this are not clear, but the calculated duty reflects special exemptions, the Generalized System of Preferences (GSP) and similar items. For some reason the actual duties paid are not shown in the customs entry forms, so the calculated duty is an effort to estimate the duty using other information. In any event, this is the only information on duty-by-commodity that is available.

It was hoped that the "point of unlading" information would offer some opportunity for checking the geographic distribution of imports within the United States.

The point of unlading, however, is not the same as the point of consumption; most unlading, in fact, is at major sea ports, and hence this information gives little indication of the geographic distribution of consumption.

Data on Canadian imports and duties from the United States, Mexico and the rest of the world were obtained by a special tabulation from Statistics Canada. They show the following information:

- the 8-digit HS number;
- the import value;
- the duty paid;
- the duty-bearing portion;
- the duty-free portion; and
- the country of origin.

Statistics Canada was also commissioned to map these data on to the 608 Canadian input-output (I-O) commodity groups. The data were compared with the I-O production data to give an indication of the level of competition that Canada experiences from Mexican imports.

All the production, trade and consumption data for Canada will be available on the Harmonized System in the near future. This will facilitate research in a number of important areas that were previously thwarted by the lack of conformity of data sets.

APPENDIX B

THEORY OF TRADE AND INVESTMENT DIVERSION AND CREATION

by R.D. Hood Economics Inc. under contract for Investment Canada

Existing economic theory is much better suited to analyzing the effects of trade agreements on trade patterns than on investment patterns. Much of the theory of trade takes the international distribution of capital to be fixed. When capital is assumed to be mobile, usually no distinction is made between direct and portfolio flows.

Trade, domestic investment and cross-border capital flows are closely linked. Indeed, a considerable amount of North American trade is intra-company trade. Regulations on the trade in finished goods and intermediate inputs affect plant location decisions. Whereas trade barriers result in inefficiencies, free trade allows for the full realization of economies of scale and other benefits of specialization.

Free trade also allows companies to decouple low-skill production processes from high-skill production processes, and to situate each in those countries offering the best rates of return on invested capital. Such specialization can lead to an increase in trade and cross-border investment. An understanding of industry-specific economies of scale, technology transfer issues, patterns of vertical integration and the potential for segmenting production processes by factor intensity is needed to assess fully the investment implications of a free trade agreement. Such detail is usually missing from most econometric models used to analyze the effects of trade liberalization. Nonetheless, such models provide some useful insights.

Partial Equilibrium Models

A partial equilibrium model is frequently used to estimate the effects of tariff changes on the pattern and volume of trade. Estimates of the supply and demand elasticities of traded goods are made for the members of the trade agreement and for third countries. The generally expected result of trade liberalization is that trade among the members to the agreement will increase and trade with third countries will fall. Trade diversion is said to have occurred to the extent that a member to the agreement simply shifts its imports in favour of other members of the agreement, at the expense of third countries. Trade creation exists to the extent that the increase in imports from other members of the agreement exceeds the reduction in imports from third countries.

In general, the creation of a free trade area implies gains for its members, since their trade opportunities are expanded. There are possible exceptions, depending on certain substitutability conditions, where a member can experience losses.

The partial equilibrium model is most often used to assess the impact of a customs union on members and non-members. It can easily be adapted to cover the situation where an existing union is expanded. In this latter case, the new element to consider is the gains or losses that existing members experience when a new member is included. Provided that estimates of all relevant supply and demand elasticities can be made, shifts in the pattern of trade and the welfare effects on various members can be calculated.

Such results could be used to make inferences about investment needed to sustain the new pattern of production. Typically, however, partial equilibrium models fail to adequately reflect the underlying production processes. If the trade-investment link is inadequately described, the models cannot be used to say anything precise about investment. Analysis of the investment implications depends on explicit modelling and estimation of the profit-maximizing behaviour of firms in each industry.

The concepts of investment creation and diversion are analogous to trade creation and diversion, but care is needed in defining terms. The focus should be on changes in the rates of investment in countries affected by the trade agreement, rather than on trans-border flows of capital. For instance, the Free Trade Agreement between Canada and the United States may have induced some European firms to shift production to North America, instead of exporting from European factories. This shift would involve an increase in investment in North America, and a reduction in Europe; as such, this is considered to be investment diversion. The Canada-U.S. agreement could also lead to rationalization of production within Canada and the United States, with more specialized plants producing on either side of the border. This may lead to lower unit costs and higher overall capacity and output. Investment creation occurs to the extent that increases in investment in Canada and the United States exceed the reductions elsewhere.

Two observations are in order:

- In order for there to be investment creation there must be a net increase in world investment and world savings. The simple fixed capital stock models of trade creation and diversion do not normally allow for this.

- The emergence of investment diversion or investment creation does not necessarily bear any particular relationship to changes in the pattern of international capital flows. These flows result from a gap between investment and savings. Investment creation in North America might be financed by increased savings in North America or by increased savings in the rest of the world. In the first case international capital flows would not increase, whereas in the latter case they would.

So too in the case of investment diversion. In fact, depending on expectations and the management of monetary and public debt matters, international capital flows could run counter to the direction expected as a result of investment diversion or creation. Further, the capital flow could be either direct or portfolio investment.

General Equilibrium Models

The general equilibrium approach takes more explicit account of the production side, since production functions are specified for a range of products. These may differ across countries, reflecting differing endowments of factors used in production. Demand patterns are fully accounted for and the principles of profit and utility maximization drive consumption, production and trade. In general, a country specializes in the production of goods and services that require intensive use of factors in relative abundance. A country tends to export those goods and services in which it has a comparative advantage, and to import other goods and services. Trade liberalization tends to increase the demand, within a country, for abundant factors and to lessen the demand for scarce factors. Overall, there is a tendency for relative factor prices to converge across trading partners. Capital/labour cost ratios will tend to equalize among the member countries, provided that relative factor endowments (including those related to technology) are not too different.

A general equilibrium model can be used to predict the gains and losses that would result from extending a free trade agreement. The net benefits to existing members differ; the member most similar to the new member tends to benefit least. In special circumstances, in fact, an existing member could be a net loser from the inclusion of a new member with similar demand and factor endowment characteristics. The new member has the effect of worsening the terms of trade for the existing member.

In the case of trilateral trade liberalization in North America, the existing members—Canada and the United States—are similar in terms of technology, factor endowments and relative factor prices. Mexico— the new member— is sharply different from both existing members. Given this situation, a general equilibrium model is unlikely to show significant impacts for either Canada or the United States as a result of including Mexico in a free trade agreement. The theory suggests that, if existing members of a free trade agreement trade little with the rest of the world prior to extension of the agreement to other members, welfare gains will normally accrue to all existing members, provided that the new member is sufficiently different.

The significance of trade with the rest of the world prior to extension of a free trade agreement is that trade diversion can result in losses for existing members. For instance, Canada might have bought textiles from India as the lowest cost source prior to extension of the trade agreement. If these goods bore a tariff, the extension of the agreement might cause Canada to switch to (now tariff-free) Mexican sources. But if Mexico is a higher-cost producer than India, Canada effectively loses real income because it now pays a higher price to the Mexicans than it paid to the Indians. (The income effect of the loss of tariff revenue is nil from the Canadian perspective because these were amounts paid by Canadians to Canadians.) The real income loss associated with diversion of trade from India to Mexico is equal to the difference in Mexican and Indian costs times the amount diverted.

The loss may be offset to some degree by trade creation—that is, the amount by which imports from Mexico exceed the amount previously imported from India. This gain is a consumer surplus related to the partial elimination of trade distortions. The gain is not as large as it would have been had the tariffs been also eliminated on Indian imports, nor is the amount of trade creation as great.

Again, however, these results derive from general equilibrium models that normally omit investment dynamics. Typically, the stocks of capital and labour are taken as fixed. No account is taken of the impact on savings and capital accumulation, and capital is not assumed to be mobile internationally. To judge the impact on investment, these assumptions must be altered.

Capital will shift to the country where it earns the highest return. Factor prices can be brought into alignment by trade and specialization. Factor returns can be equalized directly by capital flows as well as indirectly by goods flows. But, while trade in goods equalizes relative factor prices, trade in factors equalizes absolute factor prices. For instance, free trade in goods alone between Mexico and the United States would tend to equalize the labour/capital cost ratio between the two countries. Nonetheless, the returns to both factors might be lower in Mexico. Opening up the Mexico-U.S. border to capital movements would involve flows of capital from Mexico to the United States.

This pattern does not fit recent events. There were large inflows of financial capital to Mexico well before the recent liberalization of trade. Real interest rates are now higher in Mexico than in the United States as a result of sharp shifts in world commodity prices, the debt crisis and the need for stabilization measures. If anything, it is probably more accurate to characterize events as starting with the free movement of financial capital followed by freer movement of goods, rather than the other way around. This formation accords better with the facts in that it allows for initial movements of capital into Mexico (the capital-poor country), rather than having exports of Mexican capital, as predicted by the reverse order of current and capital account liberalization. Neither formulation accurately describes reality. Some trade in both goods and capital occurs, but neither of these flows is perfectly free. Consequently, prices are not equalized in relative or absolute terms. In this context, the challenge is to estimate the incremental effect on domestic investment in each country as a result of Mexico's inclusion in some form of trade and investment agreement with its two northern neighbours. More particularly, the challenge is to estimate the impact for Canada, since it is an existing member of the Canada-U.S. FTA.

In principle, this analysis could be handled by a general equilibrium model. The changes to rules governing FDI in Mexico, and the removal of the trade limiting effects of threatened U.S. countervail and voluntary restraint measures would be difficult to factor in but, in theory at least, one could generate a set of predicted changes to domestic investment in the three countries. Such an effort is beyond the scope of this paper.

APPENDIX C

THE REGULATION OF FOREIGN INVESTMENT IN MEXICO

by Rosemary D. MacDonald, Investment Canada

Mexico has exhibited a long history of economic nationalism, a policy based upon its distrust and resentment first of European, and then of U.S., economic colonization of the country. As a result, for the past 70 years Mexico has enforced laws restricting foreign investment. Since the mid-1970s, the framework and climate for foreign investment was set by three laws designed to "Mexicanize" the economy by stimulating domestic private investment and restricting foreign investment: the 1973 Law for the Promotion of Mexican Investment and the Regulation of Foreign Investment; the 1973 Technology Transfer Law (revised January ll, 1982); and the 1976 Law on Patents and Trademarks (modified in 1986).

Since 1986, however, under the direction of President Miguel de la Madrid Hurtado and, more particularly, under his successor, Carlos Salinas de Gortari, Mexico has undergone a dramatic change with respect to its economic policies. The new policy direction involves nothing less than a fundamental restructuring of the Mexican economy, and a sweeping change with respect to attitudes toward foreign investment.

This Appendix reviews the important changes that have been made in the laws regulating foreign investment in Mexico. An understanding of current regulations is highly pertinent, since a key U.S., and possibly Canadian, objective in free trade negotiations with Mexico is to secure the progress made in trade and investment liberalization to date. An international accord would better ensure that future governments in Mexico adhere to the trade and investment liberalization already established by President Salinas.

Investment Canada's assessment of Mexico's investment regulations is based upon documentation provided by Mexican officials, other written material and interviews with public and private sector representatives in Mexico. A full appreciation of Mexico's foreign investment policy and regulatory process will require further research. It is clear that some degree of discretion remains in the interpretation and application of the Mexican investment regime. Under the circumstances, any liberalization achieved or intended by the Mexican government will be revealed by the treatment of foreign direct investment.

Law for the Promotion of Mexican Investment and the Regulation of Foreign Investment

Former Foreign Investment Restrictions

The 1973 Law on Foreign Investment limited foreigners to minority ownership. The law applied to both new, or greenfield, investment as well as to acquisitions. Foreigners could not acquire more than 25 percent of the shares or 49 percent of the fixed assets of a Mexican company without prior authorization from the National Commission on Foreign Investment (NCFI).[11] Authorization of ownership in excess of these levels was approved or rejected based on the NCFI's judgement as to whether a higher level of foreign investment would be beneficial to the economy. Seventeen criteria, or General Resolutions, were considered in making such a decision. Permission for foreign ownership in excess of the regulatory levels was given increasingly frequently, especially in later years, and particularly in industries regulated under Sector Development Programs. However, decisions reportedly took from 8 to 16 months, and were made on a fairly discretionary basis. Foreign investors lacked clear, neutral and fixed guidelines. Prior approval was also required by foreign investors for all increases in existing investment, including the undertaking of new activities, the introduction of new product lines, as well as for expansions and relocations.

Recent Reforms: May 16, 1989: Regulations of the Law to Promote Mexican Investment and to Regulate Foreign Investment

In May 1989, the Mexican Government announced a comprehensive reform of the law regulating foreign investment. The changes substantially liberalized regulations governing foreign direct investment, facilitated procedures for making new foreign investments and opened many new areas for majority foreign ownership. The revised rules provide a neutral and standard framework for all investment projects. Case-by-case authorizations are now limited to explicitly designated cases (see below).

The changes have the specific intent of attracting foreign investment, which the Salinas government recognizes as essential in achieving the economic growth required to complete the transformation of Mexico into a modern, industrial economy.

The liberalization focuses primarily on new, or greenfield, investment in that the measures have been introduced without any time restriction. Procedures regulating

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[9] The NCFI is a semi-autonomous agency within the Ministry of Commerce and Industrial Development (SECOFI). It is vested with the authority to review and oversee foreign investment in Mexico and is composed of the Ministers of: the Interior; Foreign Affairs; Finance and Public Credit; Programming and Budget; Energy, Mines and Parastate Industry; Labour; and SECOFI. The NCFI is served by a secretariat with a professional staff of 120.

foreign acquisitions of existing companies have also been liberalized, but a time limit of three years (terminating May 16, 1992) has been placed on the applicability of liberalized acquisition provisions.

Investment Canada staff interviewed senior officials in the Mexican public and private sectors to try to ascertain if the greater openness indicated by recent changes in Mexican legislation, regulations and policies was fully reflected at the administrative level. Interview results indicated that policy liberalization has been effectively communicated to the administrative level of government. Three of the private firms interviewed specifically mentioned the attitude of accommodation exhibited to foreign investors by the NCFI.

Legal status. The government's new policy approach has yet to be fully enshrined in legislation. For example, the new FDI regulations, which were implemented through presidential decree, revise the administration of the 1973 law, which remains the fundamental legal framework governing foreign investment in Mexico.

Furthermore, although greatly liberalized, FDI in Mexico is still extensively regulated. The regulatory system also continues to allow a fair amount of discretion to the NCFI, whose decision is final. There is no provision allowing foreign investors recourse to the courts in cases of disputed decisions.

The administrative process. Approvals of foreign investment proposals are handled in three different ways:

- Investments qualifying for "automatic" approval are recorded by the National Registry of Foreign Investment, a sister organization of the NCFI, and also within the Ministry of Commerce and Industrial Development (SECOFI).

- Most investments requiring review and approval are handled by a Committee of Representatives of the ministries comprising the NCFI. This committee meets once a month.

- Reviewable investments of a politically sensitive nature are reviewed by Ministers, who meet once every two months or upon request.

"Automatic" approval of foreign majority ownership in unclassified activities. The regulations now permit up to 100 percent foreign ownership of new corporations in "unclassified" sectors of the economy. Unclassified sectors have been substantially broadened to include the previously restricted glass, cement, iron, steel and cellulose industries. As a result, unclassified sectors now cover approximately two-thirds of Mexico's gross domestic product.

Authorization of up to 100 percent foreign ownership is "automatic" provided that the following conditions are satisfied:

- the investment is registered with the NCFI;
- the investment is made in an unclassified activity;
- the investment does not exceed $100 million;
- financing, either debt or equity, is accomplished with foreign-sourced funds; foreign investors already established in Mexico may use funds they already possess in Mexico; at the end of the pre-operating stage, shareholders' equity must be equal to a minimum of 20 percent of the investment in fixed assets;
- the investment is located some place other than in the highly populated areas of Mexico City, Monterey, Guadalajara or certain municipalities of the states of Hidalgo and Mexico; this provision applies only to industrial projects;
- the company maintains, on a cumulative basis, a balanced foreign exchange position during the first three years of operation;
- the investment creates permanent employment for Mexican workers and provides continuing training and educational programs to upgrade employee skills; and
- the investment incorporates technology that satisfies existing environmental requirements.

The foreign investor is deemed to have accepted these conditions through the act of implementing the investment.

Within 60 working days of establishing an investment, foreign investors qualifying for the automatic approval process must file information with the NCFI detailing the following: the size of the investment; sources of financing; the firm's projected foreign exchange position for each of the first three years; the location; anticipated employment levels; and information on technology to be used. Of these factors, the NCFI places greatest emphasis on financing, projected foreign exchange balances and location.

Foreign investors must submit annual financial statements to the NCFI, which compares the initial financial plan to the current year's actual performance. If actual results fall below projections filed at the time of registration, the foreign investor is called in for consultations with the NCFI. In cases where the investor is found to be incapable of satisfying the criteria, negotiations are undertaken to establish a new basis for the investment. The NCFI has indicated that its policy is to maximize the possibility for foreign investors to operate in Mexico, while properly administering the guidelines laid down by the May 1989 Regulations to the Law on Foreign Investment. In this context, foreign investors interviewed by Investment Canada indicated that the Mexican government was "bending over backwards" to help them establish businesses in Mexico.

The Authorization Process for Foreign Investments Not Qualifying for Automatic Approval. Included in this category are: all investments in excess of $100 million; investments involving foreign ownership above specified levels in "classified" sectors of the economy (see below for detailed description); and investments not meeting all the criteria for the automatic approval process. In 1990, an estimated 300 foreign investment applications were received by the NCFI. The NCFI has not refused any applications since the Regulations came into effect in May 1989.

One of the law firms interviewed indicated that it is common for foreign investors to conduct informal, exploratory talks with the NCFI prior to submitting official investment applications. According to that firm, a foreign investor might decide against proceeding with a project if, during consultations, it seemed that a satisfactory agreement could not be reached.

The NCFI must render decisions on foreign investment applications within 45 days. Day One begins when all information necessary to reviewing the case has been received. Applications which have received no response within the designated 45-day review period are deemed to have been approved. A fee is levied on each application. The fee is established by law and is set at some fraction of one percent of the total amount of the investment. The minimum fee is equivalent to roughly US$50.

Restrictions on Foreign Ownership. Restrictions on foreign investment apply in the case of 141 activities. These activities are listed in the "Classification" that forms part of the May 1989 Regulations to the Foreign Investment Law. The classification is subdivided into six categories (the detailed industry categories are shown at the end of this Appendix):

Category 1	Activities reserved exclusively to the Mexican state (11 activities).
Category 2	Activities reserved to Mexican nationals (33 activities).
Category 3	Activities that allow up to 34% foreign ownership (5 activities).
Category 4	Activities that allow up to 40% foreign ownership (8 activities).
Category 5	Activities that allow up to 49% foreign ownership (26 activities).
Category 6	Activities that require prior authorization for majority foreign ownership (58 activities).

Foreign investment below specified limits in categories 3 through 6 is automatically approved as long as it satisfies the criteria set out in the foregoing section.

Foreign investment above these limits is possible, but is subject to review and prior approval by the NCFI. In such cases, the NCFI must be satisfied that the investment will: serve as a complement, not as a replacement, to domestic investment; promote exports and contribute positively to the balance of payments; create jobs and improve the remuneration of employees; contribute to the development of less economically developed regions; and bring in technology and/or undertake research and development in Mexico.

Even though certain sectors remain restricted, noteworthy liberalization has taken place within sectors;

- in the telecommunications sector (formerly reserved exclusively to the state), foreign investment is now allowed up to 49 percent;

- in the petrochemical sector, 14 petrochemicals have been reclassified from "basic" (reserved exclusively to the state) to "secondary" (minority foreign participation permitted); 539 petrochemicals have been reclassified from "secondary" to "tertiary" (open to 100 percent foreign participation);

- in the insurance industry the permissible level of foreign investment has been raised from 15 percent 49 percent (see section on The Regulation of Foreign Investment in the Insurance Industry);

- banking, although remaining closed to foreign control, will now be open to foreign participation, up to a maximum of 30 percent (see section on The Regulation of Foreign Investment in Banking); and

- in the mining sector, some of the land previously reserved to the state is now open to foreign exploration and exploitation activity; in addition, 100 percent temporary foreign ownership through trusts is permitted in the case of category 5 minerals (see section on The Regulation of Foreign Investment in the Mining Sector).

Temporary Foreign Majority Ownership in Certain Classified Activities through the Medium of Special Trusts. Furthermore, foreign investors may now, through participation in special trust mechanisms, acquire temporary majority ownership in any of the classified activities that are subject to specific percentage limitations for foreign investment. Included under this provision are the important sectors of gas distribution and domestic air and maritime transportation (normally reserved for Mexican nationals) as well as mining[12], secondary petrochemicals, automotive parts, fishing and financial leasing (normally restricted to a maximum foreign ownership of 34 or 49 percent). Trusts may be established for up to a 20-year period. In the case of majority ownership through trusts, the following conditions must apply:

[12] New regulations affecting foreign direct investment in the mining sector became effective December 10, 1990. These regulations introduce new trust provisions that are specific to the mining sector.

- the company acquired is experiencing financial difficulties and/or has large foreign currency liabilities;
- the acquired company needs new capital to finance investment designed to upgrade technology, modernize operations, increase production, manufacture new products or increase exports;
- no interested Mexican investors could be identified;
- Mexican investors have waived any existing preferential stock acquisition rights; and
- the foreign investment will be in the form of cash, or a capitalization of the company's liabilities.

Special trusts also permit foreign investors to acquire temporary control over restricted coastal and border zone real estate. Under the 1973 *Foreign Investment Law*, real estate trusts of up to 30 years could be established. Under the 1989 revisions to the law, trusts can now be renewed for an additional 30 years, thereby enabling foreigners to fully realize long-term investment projects. Real estate trusts may be established for either tourism or industrial purposes.

In a trust mechanism, ownership is vested in the trustee (usually a Mexican bank), but all other proprietary rights are exercised by the investor, including the right to sell to others, to order transfer of the title to a qualified Mexican owner, or to build on land owned in trust.

Acquisition of existing corporations. Under the 1973 law, acquisition by foreigners of more than 25 percent of the shares, or 49 percent of the fixed assets, of any existing enterprise required authorization by the NCFI. As a result of the 1989 revisions, during a three year period ending on May 16, 1992, foreign investors may now —without prior authorization—acquire up to 100 percent of the stock of existing corporations engaged in an unclassified activity. The acquiring firm must undertake to satisfy the criteria for automatic approval of foreign investment in an unclassified activity, and to invest in additional fixed assets an amount equal to at least 30 percent of the acquired firm's current fixed assets. Acquisitions of firms engaged in restricted sectors of the economy continue to require approval from the NCFI.

Expansion of existing foreign investment. Under the 1973 law, authorization was required for relocation, expansion, new product lines and the undertaking of new activities. Under the 1989 revisions, these activities may be undertaken without authorization, where an enterprise undertakes to invest in additional fixed assets an amount equal to at least 10 percent of the net value of its current fixed assets, and to meet the requirements for new foreign investment in unclassified activities.

Registration of foreign companies. As previously, all corporations wholly or partially owned by foreign investors must register with the National Registry of Foreign

Investments, a sub-unit of the Ministry of Commerce and Industrial Development. Foreign firms must also obtain a permit from the Secretariat of Foreign Affairs to authorize the acquisition of property; this step is routine once approval (automatic or processed) of the investment has been granted by the NCFI.

Investment in Mexico's stock exchange. The May 1989 regulations allow foreigners to undertake portfolio investment in Mexican equities through the medium of special 30-year trust funds. These trust funds are empowered to acquire and hold specially designated "N" or neutral shares of Mexican corporations and to pass on to foreign investors the economic rights to such shares through the sale of trust "participation certificates."

NCFI Follow-up of Foreign Direct Investment

All foreign investors are required to submit annual performance reports. The balanced foreign exchange requirement is the condition that foreign investors generally find most difficult to meet (during the first three years of operation, companies are expected to maintain, on a cumulative average basis, a balanced foreign currency position). Interviews conducted in Mexico indicated that, in some cases, the NCFI has accepted undertakings by firms to reduce their foreign exchange requirements if a balance has been impossible to achieve.

Following completion of the first three years, foreign investors need no longer balance their foreign currency accounts. They must, however, continue to file annual performance reports, and these reports continue to be monitored by the NCFI.

Objectivity of the system. Investment Canada interviews with senior-level Mexican administrators in both the private and public sectors indicated that liberalization of foreign direct investment is both real and substantial. The NCFI, however, still has a degree of discretionary power over how foreign investors may be treated.

Remedies. In cases where foreign investors do not honour investment agreements, the law authorizes the NCFI to impose fines. The NCFI may also rescind its approval of the investment. NCFI officials indicated that remedies would be strictly enforced in cases where it appeared that the foreign investor had deliberately misled the NCFI in presenting its original investment application.

In cases where failure to meet initial expectations is the result of inaccurate projections, or of unforeseeable circumstances, the NCFI reconsiders the investment application.

NCFI decisions are final. There is, according to government officials, no possibility of an appeal to the courts if negotiations between the Commission and the foreign investor are not successful.

Lack of coordination of the legal framework. The rapid pace of change in laws and regulations governing the Mexican economy has created a situation where not all measures have been reconciled. For instance, laws affecting foreign investment in the banking and insurance sector have been changed, raising permissible foreign investment levels. These changes have not, however, been reflected in corresponding changes to The Classification of Economic Activities.

Regulation of Foreign Investment in the Banking Sector

On May 2, 1990, an amendment to the Mexican Constitution was approved, reversing the nationalization of the Mexican commercial banks and once again allowing private sector participation. Subsequently, on July 18, 1990, Congress approved a new *Law on Credit Institutions*, establishing administrative and prudential regulations, and laying out permissible ownership levels for various investor groups, including foreigners.

The new law provides for the issue of three categories of common stock: A, B and C shares. C shares may be purchased by foreigners, Mexican citizens, the federal government, various Mexican banking and insurance institutions, and other institutional investors authorized by the Ministry of Finance. C shares can equal up to 30 percent of bank capital.

Individual shareholdings, Mexican or foreign, are limited to 5 percent of the total capital stock of a commercial bank (10 percent with exceptional permission of the Ministry of Finance). The Mexican government wants thereby to assure widely held ownership of the large commercial banks. The higher 10 percent individual ownership level may be possible in the case of smaller commercial banks.

The Mexican government has announced its intention of selling 100 percent of the shares of the commercial banks, which were nationalized in 1982. It may retain some level of participation on a temporary basis, depending upon the speed at which the Mexican stock market is able to absorb the shares at prices judged to be reasonable. Sale of shares to foreigners will proceed separately, and will take place in 1991.

Foreign banks may now also hold a minority stake in holding companies of financial groups.

Regulation of Foreign Investment in the Insurance Industry

New investment by foreign corporations in the insurance sector had been prohibited since 1935. Foreign companies already established in the sector at that time were allowed to remain but were required to reduce their participation to below 50 percent; that level was later reduced to 15 percent. Reforms announced in January 1990 remove the ban on new foreign corporate investment, and raised the allowable level of foreign participation to 49 percent.

Regulation of Foreign Investment in the Mining Sector

New Mining Regulations

New administrative regulations dealing with Article 27 of the Constitution, which limits foreign participation in mining, entered into effect on December 10, 1990. These regulations are designed to attract: new technology, which has been especially lacking in small- and medium-sized firms; new capital for purposes of modernization, diversification and increased exploration; and badly needed marketing skills.

The following changes have reportedly been introduced. One million of the 3 million hectares of land previously reserved to the state are now open to foreign exploration and development. Foreign investment was formerly limited to participation of 34 percent and 49 percent, depending upon the category of mineral. The new regulations now allow temporary 100 percent foreign ownership in the 49 percent category, through the medium of a trust mechanism. The higher level applies in the case of both exploration and exploitation activities.

Law Regarding Maquiladoras

The maquiladora, (or "in-bond" industry,) is the most rapidly growing sector of the Mexican economy. Originally established in 1965 by agreement between the U.S. and Mexican governments, the program first started to come into its own during the mid-1970s, when increased competition from Asian countries forced U.S. manufacturers to seek methods of lowering production costs. The 1984 peso devaluation gave a further boost to the program, but the phenomenal expansion of this sector coincides with the implementation of the current economic reforms, which began in 1985. Growth in value-added soared to 24 percent in 1987, and to 46 and 30 percent in 1988 and 1989, respectively. At the end of 1989, there were 1,800 maquiladora plants, employing an estimated 500,000 Mexican workers. These plants produced an estimated US$13 billion in products, almost exclusively for export to the U.S. market. In 1989, this production created an estimated US$3 billion in value-added income for Mexico. After the petroleum industry, the maquiladora sector is Mexico's largest producer of foreign exchange.

Under the maquiladora program, foreign corporations can establish wholly-owned Mexican subsidiaries that operate under special customs treatment. The firms are allowed to import— duty-free and on a temporary "in bond" basis— machinery, equipment, parts, raw materials and other components used in the assembly or manufacture of semi-finished or finished products. The maquiladoras import semi-finished products from the U.S. for assembly or further manufacture in Mexico. Under U.S. tariff items 806.30 and 807.00, these products are then allowed to re-enter the U.S. market with duty levied only on components that are not of U.S. origin, and on the value-added during assembly or manufacture in Mexico.

Currently, 60 percent of existing maquiladoras are owned by U.S. firms. However, the maquiladora scheme is proving increasingly attractive to firms from other countries. Japan, West Germany, Canada, France, Sweden, South Korea, Hong Kong and Taiwan have all moved funds into Mexican maquiladora investments more recently.

Since 1983, certain industrial sectors have seen particularly strong expansion in the number of maquiladora factories: automotive accessories (+ 290 percent), electrical and electronics industries (+ 51 percent), and metal products (+ 44 percent). Based on the amount of value-added in 1988, the following were the most important sectors: electric and electronic goods (41 percent), transport equipment (26 percent), and textiles and apparel (6 percent).

The Mexican government is eager to encourage further investment of this nature. Regulations governing the maquiladora industry, already very liberal, were liberalized further by the government in December 1989. Major provisions regarding investment in this sector are as follows:

- 100 percent foreign ownership is permitted;
- investments may be made in any amount;
- approval for foreign investment is automatic and can be obtained in three working days from SECOFI;
- administrative procedures necessary to establish or expand a firm are now the sole responsibility of SECOFI; six different departments were formerly involved;
- maquiladoras now receive automatic authorization to locate plants in any area zoned for industrial development (Originally, plants were restricted to an area close to the U.S.-Mexico border. Since 1972, plants have been allowed to locate elsewhere, and firms are showing an increasing preference for interior, one-company-town sites, as labour behaviour in northern border plants is becoming increasingly unruly. As of 1988, 18 percent of maquiladora plants were located in interior areas; and that number is increasing);
- maquiladora licenses now carry open-ended terms; in-bond firms formerly had to seek pro-forma renewal of licenses every two years;
- under certain conditions, an in-bond firm may now sell locally an amount equal to

50 percent of additional value above their annual exports sales. Initially, the entire output of a maquiladora had to be exported. In 1983, regulations were relaxed to allow domestic sales equal to 20 percent of additional value above the previous year's exports;
- technology transfer is encouraged by: allowing the in-bond importation of computers and telecommunications equipment for administrative purposes; and by authorizing maquiladoras, under certain conditions, to transfer machinery, tools and equipment to another maquiladora, or to their domestic suppliers;
- under the new rules, Mexican companies that supply inputs to the maquiladoras are excused from paying value-added tax on the inputs supplied, thereby reducing the price of their products by as much as 15 percent; and
- maquiladoras may now enter into subcontracting agreements with domestic firms.

Technology Transfer Law

Technology Transfer Law, 1973 (revised January 11, 1982)

In 1973, the Mexican government passed a law governing technology transfer. The intent of the 1973 law was to establish ground rules that would secure better treatment for Mexican firms in contracts for technology with frequently more powerful foreign firms. To this end, the 1973 law established a National Registry of Technology to review and approve all royalty and licensing agreements. The Registry enjoyed discretionary powers and, although in recent years it permitted more generous contract terms, it enforced fairly restrictive terms through the greater part of the 1973 to mid-1980s period. In so doing, the law created a climate that discouraged foreign technology transfer. Advanced technology was withheld from the country, and was one factor that led to today's problem of inefficient, non-competitive industries.

Revision of the Technology Transfer Law, January 1990

The Mexican government is reforming its rules on technology transfer and intellectual property. In January 1990, it promulgated important changes to the existing technology transfer law. The changes provide for greater contract flexibility, greater confidentiality, a simplified administrative and reporting process, and some added protection against piracy for licensors of technology. Specifically, the January 1990 changes have the following effects:

- **Term of contract**: Technology transfer contracts were limited to 10 years. Terms are no longer regulated.

- **Royalties:** The earlier law contained no reference to any specific rate on royalties, license fees or other charges. However, the National Registry limited royalties to

3 percent for some time, although royalties of 5 - 7 percent were approved in more recent years. Royalties can now be freely negotiated.

- **Approval process:** The approval process was lengthy and complicated. Now contracts are virtually automatically approved upon registration. This removes from authorities the power to require supplementary undertakings, a practice that was fairly common.

- **Confidentiality:** Contract provisions granting protection to licensors against unauthorized use of their technology by licensees can now be extended beyond the contract's expiration date. This possibility applies as long as the original technology was upgraded during the term of the original contract.

- **Franchises:** Franchise procedures and requirements now encourage investment under this form.

- **Exports:** Export requirements or limitations were often applied on a case-by-case basis. Now uniform regulations are clearly defined.

These revisions are great improvements to the old law. Despite the many improvements, however, important gaps remain. The revised technology transfer law provides improved protection to licensors against infringements by licensees (confidentiality provision extension), but it does not protect against violations by third parties. This problem remains to be addressed by new legislation, which the government plans to bring forward in the area of patents, trademarks and trade secrets.

Patent and Trademark Law

In January 1990, the Mexican government announced that it was drafting new legislation, to be sent for approval to Congress around the end of 1990, to provide for intellectual property protection "similar to that which is given in advanced nations." Introduction of the bill to Congress is still awaited. The subsequent legislative process will also take some time. It is not clear when passage of the bill might be expected, although the government had originally said that it hoped for passage during the first part of 1991. As for the laws on technology transfer and foreign investment regulation, the government introduced desired changes by presidential decree, thanks to clauses in both laws giving the government discretionary powers to interpret and change those regulations.

Required improvements to the patent and trademark law include, first and foremost: extension of patent terms; extension of patent protection to products in such sectors as chemicals, pharmaceuticals and biotechnology; and further improvements in trade secret protection.

Nonetheless, on the basis of the Salinas government's clear intention to address these issues and the improvements already introduced to the *Technology Transfer Law*, the United States has removed Mexico from the U.S. Special 301 "Priority Watch List" of nations lacking adequate intellectual property protection.

Classification of Economic Activities with Respect to Foreign Investment Limits

The following classification of activities was published as part of the May 1989 Regulations of the Law to Promote Mexican Investment and to Regulate Foreign Investment. The classification defines the activities in which foreign investment is not permitted, is limited, or requires authorization to exceed 49 percent ownership. The law establishes the following six categories:

Category	Restriction
1	Activities reserved exclusively to the Mexican state.
2	Activities reserved to Mexican nationals or Mexican companies with an exclusion-of-foreigners clause.
3	Activities in which foreign participation is permitted up to 34 percent of the capital stock of the companies.
4	Activities in which foreign participation is permitted up to 40 percent of the capital stock of the companies.
5	Activities in which foreign participation is permitted up to 49 percent of the capital stock of the companies.
6	Activities in which majority foreign participation is possible with prior authorization from the NCFI.

Any activity not included in the classification is open to 100 percent foreign participation without prior authorization, provided that certain requirements described in the regulations are met. Foreign investment above stated limits in Categories 3,4 and 5 is possible, but is subject to prior review and approval by the NCFI.

Category 1: Activities reserved exclusively to the Mexican state

Oil and gas production
Mining and/or refining of uranium and radioactive minerals
Manufacture of basic petrochemical products
Oil refining
Treatment of uranium and nuclear fuels
Coin minting
Generation and transmission of electric energy
Supply of electric energy

Railroad transportation services
Telegraph services
Banking services
Financial trusts and funds

Category 2: Activities reserved to Mexican nationals

Forestry
Forest nursery business
Retailing of liquified gas
Building materials transportation services
Moving services by road
Other specialized cargo transportation services by road
General cargo transportation services by road
Bus transportation services (intercity)
Urban and suburban bus transportation services
Taxis
Fixed-route taxi services
Taxi stand services
School and tourism bus services
Coastal transportation
Coastal and high-seas towing
Passenger air transportation in aircraft with Mexican registry
Air taxi transportation
Credit unions
Public warehouses
Foreign exchange houses
Financial consulting and promotion
Nonbanking savings and loans institutions
Other credit institutions
Brokerage firms
Investment companies (1)
Stock market services
Bonding
Insurance
Independent pension fund management
Private transmission of radio programs
Transmission and repetition of television programs
Notary public services (2)
Customs brokers and representative services (2)
Management of sea, lake and river ports

Notes:

(1) Fixed-income investment companies and their management companies are not eligible for investment by foreign governments or their agencies, foreign financial entities, or other associations of foreign persons, whether individual or juridical.

(2) Companies may have a foreign investment participation to the extent authorized by the NCFI. Providers of professional services are subject to the Regulatory Law of the Third Constitutional Article, pertaining to professional practices, and should be Mexican nationals.

Category 3: Activities that allow up to 34 percent foreign ownership

Mining and refining of coal
Mining and/or refining of iron ore
Mining and/or refining of phosphoric rock
Mining of sulphur

Category 4: Activities that allow up to 40 percent foreign ownership

Manufacture of secondary petrochemical products
Manufacture of parts and accessories for automotive electrical systems
Manufacture and assembly of bodies and trailers for automobiles and trucks
Manufacture of automobile and truck motors and their parts
Manufacture of automobile and truck transmission parts
Manufacture of automobile and truck suspension system parts
Manufacture of parts and accessories for automobile and truck brake systems
Manufacture of other parts and accessories for automobiles and trucks

Category 5: Activities that allow up to 49 percent foreign ownership

Deep-water fishing*
Shallow-water fishing*
Fresh-water fishing*
Artificial fish-breeding*
Mining and/or refining of minerals containing gold, silver and other precious minerals and metals
Mining and/or refining of mercury and antimony
Mining and/or refining of industrial minerals with lead and zinc content
Mining and/or refining of minerals containing copper
Mining and/or refining of other nonferrous metallic minerals
Mining and/or refining of feldspar
Mining of gypsum
Mining and/or refining of barite
Mining and/or refining of fluorite

Mining of other minerals to obtain chemical products
Mining and/or refining of salt
Mining and/or refining of graphite
Mining and/or refining of other nonmetallic minerals
Manufacture of explosives and fireworks
Manufacture of firearms and cartridges
Retailing of firearms, cartridges and ammunition
River and lake transportation
Harbour transportation services
Telephone services
Other telecommunications services
Financial leasing

* Does not include exploitation of species reserved for fishing cooperatives.

Category 6: Activities that require prior authorization if a majority foreign ownership is desired

Agriculture
Stock breeding and hunting
Gathering of forestry products
Timber
Newspaper and magazine publishing (1)
Manufacture of coke and other coal products (2)
Residential or housing construction
Nonresidential construction
Construction of urban works
Construction of industrial plants
Construction of power generating plants
Construction and laying of power transmission networks and lines
Construction of oil and oil by-products pipelines
Concrete structure erection or installation
Steel structure erection or installation
Ocean and river works
Construction of streets and highways
Construction of railroad tracks
Hydraulic and sanitary systems for buildings
Electric systems for buildings
Telecommunications installations
Other special installations
Earth moving
Foundations
Excavations

Underwater works
Installation of traffic and protection signals
Demolitions
Construction of water treatment plants
Drilling of oil and gas wells
Drilling of water wells
Other construction works
High-seas transportation
Tourism ship chartering
Investment companies (3)
Management companies of investment companies (3)
Private pre-school or kindergarten services
Private primary school services
Private secondary school services
Private middle school services
Private university services
Private education services that combine kindergarten, primary, secondary, middle and university instruction
Private commercial and language school services
Private technical and handicrafts training school services
Private music, dance and other special private instruction services
Private special education services
Legal services (4)
Accounting and auditing services (4)
Management of passenger bus terminals and auxiliary services
Management of toll highways, international bridges and auxiliary services
Towing of vehicles
Other ground transportation services
Air navigation support services
Management of airports and heliports
Securities and investment consulting services
Insurance and bonding agency services
Pension consulting services
Representatives of foreign financial entities services
Other services related to financial, insurance and bonding institutions

Notes:

(1) Does not include printing of bank notes and postage stamps; activities that are reserved to the state.
(2) Does not include the production of oil; an activity that is reserved to the state.
(3) Fixed-income investment companies and their management companies are not eligible for investment by foreign governments or their agencies, foreign financial

entities or other associations of foreign persons, whether individual or juridical.

(4) Companies may have a foreign investment participation to the extent authorized by the NCFI. The providers of professional services are subject to the Regulatory Law of the Third Constitutional Article, pertaining to professional practices, and should be Mexican nationals.

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