G | M | F The German Marshall Fund of the United States
STRENGTHENING TRANSATLANTIC COOPERATION

OCP POLICY CENTER
THINK • STIMULATE • BRIDGE

Policy Brief

| *Wider Atlantic Program* |

Mexico's Strategic Comparative Advantage in International Trade: At the Crossroads of NAFTA, the Pacific Alliance, TPP, and TTIP

by Luis de la Calle

In Brief: This policy brief argues that Mexico's future agenda of negotiations should include three main priorities. Firstly, with the help of its NAFTA partners, Mexico should position itself as the export platform of North America to the world. Its structural changes, web of agreements, and strategic location pave the way for this. Secondly, it should insist on being invited to the negotiating table of the Transatlantic Trade and Investment Partnership (TTIP). If full participation is not possible, it should advocate for similar disciplines among members and the implementation of the cumulation of origin between NAFTA, TTIP, the EU-Mexico Free Trade Agreement, and EU-Canada Comprehensive Economic and Trade Agreement (CETA). Finally, at the international level, in order to support the multilateral trading system through the World Trade Organization (WTO), flexible accession clauses in TPP and TTIP and the guarantee that those agreements are not discriminatory to third countries should be strongly promoted.

The North American Free Trade Agreement (NAFTA), which came into force in 1994 between Canada, Mexico, and the United States, is no longer a preferential agreement for Mexico. Since NAFTA, the three members have opened their economies to other regions and countries to such an extent that the average applied import duties are now relatively low. Therefore, these low rates do not imply a significant preference for NAFTA members. However, the agreement has provided Mexico with the necessary tools and instigated the structural changes to propel it to the forefront of on-going international negotiations. It has now become clear that Mexico's size, the success of its export-oriented industries, and its location constitute a strategic comparative advantage that no other large emerging country can imitate. This allows Mexico to simultaneously be present in North America, transpacific, transatlantic, and Latin America international trade undertakings.

This policy brief argues that Mexico's future agenda of negotiations should include three main priorities. Firstly, with the help of its NAFTA partners, Mexico should position itself as the export platform of North America to the world. Its structural changes, web of agreements, and strategic location pave the way for this.

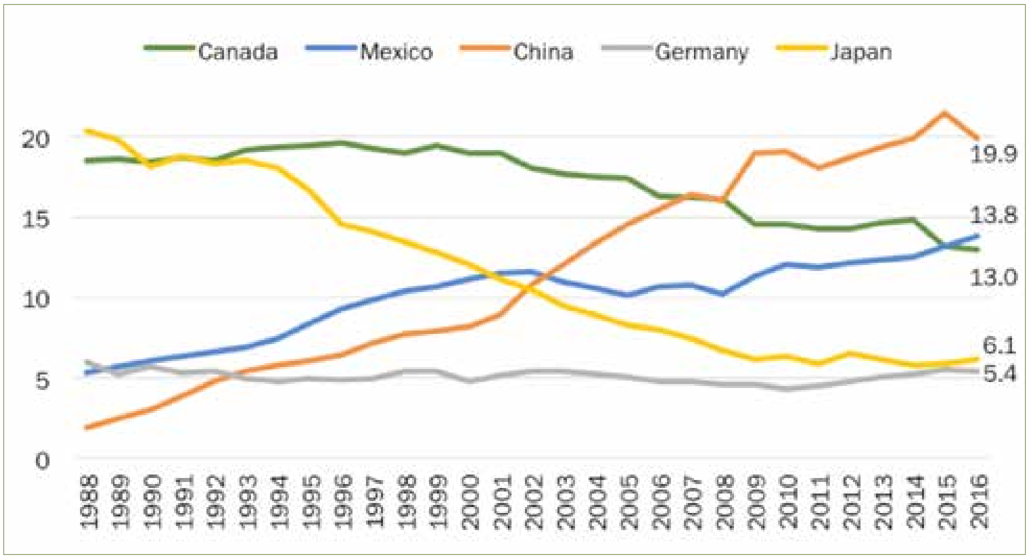
Secondly, it should insist on being invited to the negotiating table of the Transatlantic Trade and Investment Partnership (TTIP). If full participation is not possible, it should advocate for similar disciplines among members and the implementation of the cumulation of origin between NAFTA, TTIP, the EU-Mexico Free Trade Agreement, and EU-Canada Comprehensive Economic and Trade Agreement (CETA).

Finally, at the international level, in order to support the multilateral trading system through the World Trade Organization (WTO), flexible accession clauses in TPP and TTIP and the guarantee that those agreements are not discriminatory to third countries should be strongly promoted.

NAFTA Membership: Mexico's Necessary Step for International and Domestic Credibility

The positive effects of NAFTA on Mexico's economic development cannot be denied: since its inception, half of its 32 states have registered healthy average annual growth rates, it has become the world's second-largest exporter to the United States, and a strong and competitive industrial base has flourished. Today, Mexico no longer competes for foreign direct investment based on its cheap labor. Rather, it competes based on qualified labor focused on high value-added products, a low risk profile, high return on investment, and a market fully integrated into North American valued-added chains.

Figure 1 – Market Shares of U.S. Imports (as a percentage of the total imported value)



Data for 2016 includes January - May only.
Source: U.S. Economic Census Bureau

Yet, those quantitative effects are merely the measureable part, largely resulting from deeper structural changes brought about by NAFTA: the move from an economy based on patronage to one based on competition in most, but not yet all, Mexican sectors. For decades, the mindset prevailing in the country's business environment was characterized by unspoken agreements between the government and various stakeholders: the government would grant monopolistic advantages in exchange for acquiescence or silence on both politics and policy issues. With closed borders and government concessions, economic agents had little incentive for investment, innovation, or competition.

NAFTA was a real turning point. In Mexico, its fundamental features of permanency and irreversibility were able to set the tone for a new trade policy centered on principles, no longer on interests. Moreover, NAFTA envisioned that a developing economy characterized by various economic complications and high inequality — as was Mexico's case — had to be bound by the same rules and standards of two developed economies. The treaty was a key step toward the rule of law, as it granted economic agents rights, not privileges, in a country little used to respecting the former but with a strong tradition of relying on the latter. As a consequence, clear rules and reduced arbitrariness have become some of Mexico's most relevant strategic strengths in the sectors affected by NAFTA.

NAFTA has allowed Mexico to increase its market share of U.S. imports from around 6 percent before 1994 to 13.8 percent in 2016, second only to China's 19.9 percent and bypassing Canada as the second-biggest source of imports to the United States.

> The key agenda for North American leaders today should be how to position North America within the rest of the world.

This represents an impressive achievement, which allows Mexico to envision growing faster than its main market. Exporting to the United States is a key component for Mexico's GDP growth, so a growing market share is crucial to attaining higher rates of growth. Expanding market share means Mexican exports to the United States need to increase faster than those of the other competitors: China, Canada, Germany, and Japan. Beyond successful market share growth in the United States, it is critical for Mexico to increase its value-added per unit of export and also to become North America's export platform to the world. To achieve this, a goal of additional national content per export unit is crucial for both firms and government.

The rationale for more national content is powerful, especially as it triggers stronger economic development for the country. The successful implementation of Mexico's energy reform will contribute to incorporating more domestic value added. Enacted in December 2013, the reform allows the Mexican state to sign contracts with private national and international companies for exploration, extraction, production, and refining activities of oil and natural gas. The reform's main objectives are to increase efficiency in production, thereby reducing costs for end-users; to guarantee transparency and accountability for Pemex (the state-owned oil company); and to boost natural gas use and penetration in the west and southeast of Mexico. Consequently, the availability of abundant cheap natural gas will allow for more Mexican steel, synthetic fibers, glass and its derivatives, resins, and plastics to be incorporated in final exports.

While NAFTA was originally conceived to increase trade and investment flows between the three countries, the key agenda for North American leaders today should be how to position North America within the rest of the world and how to transform Mexico as the region's export platform. This last objective cannot be reached without the successful implementation of structural reforms, an aggressive commercial program, and high levels of investment in infrastructure and human capital, as well as a web of trade agreements around the world. A competitive energy sector, resulting from the shale gas revolution in the United States and the energy reforms in Mexico, and a more competitive logistics sector integrating the different systems of North America, are both essential to drive Mexico to be the export platform of North America.

Mexico's Location and Web of Trade Agreements as a Comparative Advantage

After implementing the structural changes under NAFTA, Mexico is now well-equipped to have more leverage on the international scene when it comes to negotiating trade agreements. The country now benefits from a strong geopolitical advantage compared with other emerging countries (China, India, Brazil, South Africa, Indonesia, Turkey, etc.) as it is the only player that can participate in transatlantic, transpacific, and Western Hemisphere integration projects. Mexico is now part of 12 free trade agreements with 46 countries, including Japan and most countries in the Americas and Europe. In some cases, overlaps of regional free trade agreements with pre-existing bilateral ones exist, as in the cases of Colombia, Chile, and Peru, which are part of the Pacific Alliance, and the last two are also in the process of ratifying the Trans-Pacific Partnership (TPP).

Furthermore, Mexico is located in what is probably the world's most competitive region today, with clear comparative advantages such as a young population and a high level of innovation. To make the best of this comparative advantage, Mexico needs to concentrate efforts and investment in transport and infrastructure, especially vis-à-vis the United States.

> Mexico needs to concentrate efforts and investment in transport and infrastructure.

Bilateral Agenda with the United States

At the bilateral level, there should be three priorities on the agenda for U.S.-Mexico trade relations: increase border-crossing efficiency, promote education exchanges, and deepen services opportunities in areas such as transport and medical tourism.

In the aftermath of the September 11, 2001, terrorist attacks, higher levels of security at the Mexico-U.S. border have paradoxically resulted in higher levels of criminality. Ease of crossing diminishes the rents derived from illegally crossing the border, rendering crime less economically attractive. Thus, security measures that diminish obstacles to the free movement of goods, people, and services could help reduce criminality in the border regions and should be pursued. To reach such an objective, not only is strong political will from both parties necessary but also significant investments in infrastructure to support transportation, logistics, and trade.

While international student exchange programs have significantly increased in recent years, there is greater potential that could be realized. An increase in scholarships would allow students and academics from both countries to take advantage of a foreign experience and to import the knowledge learned abroad. In September 2013, U.S. President Barack Obama launched the program "100,000 Strong in the Americas,"[1] joining the efforts of the U.S. government and private sector to increase the number of exchange students from Latin America to the United States to 100,000, and the same number in the other direction. Since the implementation of the project, the number of Mexican students studying in the United States increased from 14,779 in the 2013-14 academic year to 17,052 in the 2014-15 academic year, a 15.4 percent increase.[2] Such exchanges generate positive knowledge spillovers in the academic environment and also in the industrial sector. Mexican universities and research centers have considerably improved their potential and created clusters in different places throughout the country that can provide U.S. students with attractive learning opportunities.

On the transportation and logistics side, progress is also being made. Recently, Mexico and the United States signed an open skies agreement that gives full fifth freedom[3] for cargo and opens all destinations for

1 "100,000 Strong in the Americas," U.S. Department of State Fact Sheet, September 13, 2013, http://www.state.gov/p/wha/rls/fs/2013/214201.htm.

2 Opendoors, 2015 "Fast Facts," http://www.iie.org/~/media/Files/Corporate/Open-Doors/Fast-Facts/Fast-Facts-2015.pdf?la=en.

3 As described by Luis de la Calle, fifth freedom is: "the right to fly between two foreign countries during flights while the flight originates or ends in one's own country." For example, "a Mexican company flies from Cancún to Toronto, picks up passengers there, then continues to Chicago or Paris." As stated in: de la Calle Pardo, L. (2012). "NAFTA: Looking Forward." In A. Bugailiskis, & A. Rozental, *Canada Among Nations 2011-2012: Canada and Mexico's Unfinished Agenda* (pp. 111-123). Montréal: McGill-Queen's University Press.

international passenger transportation for all international airports in the two countries. Moreover, three custom preclearance sites have opened in Laredo, Texas; San Jerónimo, Chihuahua; and Mesa de Otay, Baja California. Finally, the new border crossing facilities have transformed the Tijuana airport into a binational one that will also serve southern California.

Due to the aging population and the rise of non-communicable diseases, the health sector already represents more than 17 percent of the U.S. economy. So far, Mexico has not taken advantage of this situation to become a main provider of highly skilled medical staff to the United States. Doing so would imply a significant investment in nursing and medical schools, access to NAFTA visas for professionals, and recognition of degrees. Alternatively, due to the advantageous climatic conditions of many Mexican cities, the affordability of medical treatment, and its proximity to the United States, Mexico could market itself as the key destination for medical tourism.

The expansion of services integration between the United States and Mexico is a key element for future growth and competitiveness. A more integrated transportation and logistics system makes regional manufacturing and the integration of value-added chains more competitive, whereas more educational exchanges serve as a means to tap into one of North America's advantages, its relative youth. Moreover, an expansion of bilateral healthcare services shows great promise since this is the fastest-growing sector in the United States and one of the most dynamic in Mexico.

Consistency of Multilevel Trade Negotiations

As illustrated in Figure 2, Mexico enjoys an extensive network of bilateral and regional trade agreements. While this network brings myriad opportunities to import and export across the world, Mexico should not lose sight of the importance to negotiate outstanding issues and opportunities in its multidimensional international trade agenda. Maintaining consistency and harmonizing disciplines are important for Mexico and the global trading system.

Transpacific and Transatlantic Negotiations

Participating in the TPP negotiations was crucially important for Mexico and Canada. First of all, a stable economic environment and expressed willingness to embrace change are much more important than preferential access to new markets. Mexico's participation in TPP illustrates its commitment to open markets and to respect the rule of law, along with its confidence and assurance that it can compete at the international level.

Figure 2 – Mexico's Trade Agreement Countries, Including TPP

Secondly, it is strategically important to be part of negotiations involving a country's main trading partner. If TPP had been successful without Mexico and Canada's participation, they would have had no other option than to request entering ex-post to ensure NAFTA's continued international relevance.

Moreover, their participation in TPP is a powerful signal of an ambitious commercial policy toward Asia sent to domestic and foreign investors. For Mexico, this is a significant evolution from a long-standing protectionist policy vis-à-vis Asian countries. Such a signal is a stepping stone for the strategy of presenting Mexico as the exporting platform of North America.

The cost of negotiating TPP for Mexico is not significant. Indeed, the marginal effort in lowering average duties is minimal in light of low most-favored nation (MFN) duties, while the newly obtained disciplines in TPP — if the agreement enters into force — will likely be long-lasting and therefore could become the future framework of transpacific trade, including with China and South Korea.

On the Atlantic side, Mexico is in the process of updating its free trade agreement with the European Union, which entered into force in 2000. Updating this agreement is crucial to deepening the scope of the original agricultural negotiations and to widening the coverage of services in telecommunications, transport, education, research and development, and other sectors. The renewed agreement will also be very important to prepare Mexico for a changed landscape if and when TTIP is successfully concluded.

Although it is theoretically possible that Canada and Mexico might join the TTIP negotiations, this prospect is highly unlikely. Nonetheless, it is natural that Canada and Mexico insist in participating as their preferred option since both countries have agreements with the United States and the European Union. If full participation is not possible, the second-best option would be to push for the implementation of the cumulation of origin between NAFTA, TTIP, and the Mexico-EU and Canada-EU free trade agreements. The concept of *cumulation of origin* widens the definition of "originated goods" and therefore increases the possibility of a good to meet the criteria of the origin rule. In other words, as Mexico is part of a free trade area with the United States, while the latter is also part of a free trade area with the European Union, Mexico would be able to incorporate regional inputs of NAFTA countries to export to the European Union. Such a precedent exists in the European Economic Community legislation: on October 11, 2005, a decision of the Council of Ministers allowed the creation of a Pan-Euro-Mediterranean zone of cumulation of origin, when countries signed free trade agreements between each other.[4]

> Canada and Mexico can convince the United States that the disciplines it negotiates with the EU... should also be negotiated to update NAFTA.

But more can be done. Canada and Mexico can convince the United States that the disciplines it negotiates with the EU on regulatory, standards, services, procurement, investment, and other issues should also be negotiated to update NAFTA. In this way, Canada, Mexico, the United States, and the EU would have a common set of rules for international trade and investment that could set the agenda for future trade negotiations worldwide.

The Pacific Alliance

Aside from TPP, the Pacific Alliance is a key priority for Mexico. The key to understanding the two efforts is

4 "Customs: Council Approves New European-Mediterranean Cumulation of Origin Zone," European Commission Press Release IP/05/1256, October 12, 2005, http://europa.eu/rapid/press-release_IP-05-1256_en.htm?locale=EN.

that they represent a shift for Mexico from a defensive to an offensive trade policy vis-à-vis Asia. There is, of course, a question mark as to the political prospects of TPP, particularly in the United States. Mexico, Chile, and Peru should push for Colombia to join TPP if and when it enters into force.

If TPP approvals were to fail, the Pacific Alliance (Chile, Colombia, Mexico, and Peru) is a relevant alternative. Formed in 2011, the Pacific Alliance is a regional integration initiative between these four countries, with Costa Rica and Panama as candidates for membership. It is not impossible to imagine Canada, Australia, New Zealand, and perhaps others also considering joining if TPP fails. The Alliance embraces both a commercial agenda to further reduce trade barriers, and a regional integration agenda with projects including joint embassies in various countries, a common stock exchange, and visa-free travel. At the end of June 2016, Mexican President Enrique Peña Nieto participated in the 11th meeting of the Pacific Alliance in Chile, where he affirmed that Mexico is fully committed to implementing a platform of integration based on economic openness along with the other member states. He added that the group has created a venture capital fund with support from the Inter-American Development Bank, as well as business support networks, for the training and counseling of small and medium enterprises (SMEs) in the four countries.

Consistency with the WTO

TPP is the most important trade initiative of the last 20 years. Since the promise of the Doha Round of negotiations at the WTO has not come to fruition and has been somewhat sidelined, TTIP would represent an ambitious negotiation between the two most important and influential members of the WTO. TPP and TTIP are, in part, a reaction to the lack of progress in the Doha Round. It is very important that if TPP and TTIP become a reality, they contribute to the multilateral trading system rather than posing a risk to it. Consistency with the WTO is crucial to make sure that countries not included in either TPP or TTIP are not left behind. This is particularly important for South Atlantic countries in both Africa and South America. These ambitious regional agreements can be understood in the context of competitive liberalization as an alternative to progress multilaterally.

Rounds at the WTO have become increasingly more difficult to conclude successfully for two reasons: 1) marginal benefits for large member countries are now relatively small compared to previous rounds so that whole sectors do not become involved in the negotiations and approval processes; and 2) negotiations now deal with politically sensitive sectors such as agriculture, services, intellectual property, and regulatory powers. This lack of progress leads countries to rely on regional negotiations as a substitute (TPP and TTIP are prime examples). The problem with alternative negotiations is that they tend to exclude southern countries, particularly from the South Atlantic. This "exclusion" and the lack of progress at WTO imply two costs for non-participating countries: on the one hand, their offensive issues in the Doha Round are relegated (such as agriculture), while, on the other, they do not participate in the shaping and incorporation of new trade disciplines, thus raising the cost of accepting them in the future.

It is very important that if TPP and TTIP become a reality, they contribute to the multilateral trading system rather than posing a risk to it.

This is why making ambitious regional agreements not only consistent but also promoters of the multilateral trading system is so important. To the extent they further the WTO, South Atlantic economies would not be completely left out. Thus, in the context of the TPP and TTIP negotiations, the WTO must effectively safeguard that the newly signed treaties by its members are in line with Article 24 of the General Agreement on Tariffs and Trade (GATT).

The WTO should carefully incorporate such large-scale undertakings within the multilateral framework. In particular, the WTO can encourage TPP and TTIP members to guarantee full compliance with Article 24 by adopting the following two disciplines as part of the final version of TPP and TTIP:

- A flexible accession clause so that any member of the WTO willing to comply with the disciplines implied by any treaty should be able to apply for membership; and
- To guarantee the newly signed treaties are not discriminatory to third countries, TPP and TTIP members would commit to consolidate as bound rates in the WTO the applied duties used as starting points for tariff elimination in TPP and TTIP.

Including these disciplines would be unprecedented. However, TPP and TTIP are also unprecedented agreements and it is crucially important that their impact on the WTO is carefully evaluated. The recent "Brexit" vote for the United Kingdom to leave the EU should serve as a wakeup call for the need to defend globalization. A strong WTO is the best way to ensure trade opening will continue to contribute to growth and poverty alleviation all over the world.

Conclusion

If today NAFTA no longer grants Mexico preferential rates significantly lower than the average applied import duties in the United States, the agreement has had significant positive outcomes for Mexico. In a few years, the country built a solid industrial base that resulted in the proliferation of trade flows and high growth rates in its export-oriented states. NAFTA shifted Mexico's business mindset and legal framework, making it increasingly accepting of competition and rule of law. Mexico became a credible business partner, enjoying an extensive network of bilateral and regional trade agreements with different regions of the world.

To move forward, Mexico needs to use its network of free trade agreements as leverage and conduct negotiations at the bilateral, trilateral, regional, and even multilateral level with international organizations. Aside from the important structural changes and its newly acquired credibility on the international stage, the country's geostrategic location is a key comparative advantage to help Mexico achieve the three priorities discussed here.

> A strong WTO is the best way to ensure trade opening will continue to contribute to growth and poverty alleviation all over the world.

Mexico should push to be included in the TTIP negotiations. This will most likely not be possible, but Mexico should insist on a second-best option: negotiating an upgrade of NAFTA with the United States to include the same disciplines as TTIP and the possibility to apply the cumulation of origin between NAFTA, TTIP, and the Mexico-EU and Canada-EU free trade agreements.

At the NAFTA level, Mexico needs to convince its partners that the main challenge is reaffirming the region's importance in the international context and driving Mexico to become their export platform to the world.

Finally, Mexico should take a leadership role at the international level to advocate for the implementation of flexible accession clauses in TPP and TTIP and the guarantee that those agreements are not discriminatory to third countries.

Importantly, the talks conducted outside its frontiers should not divert Mexico from the necessity of further implementing a culture of rule of law, legal certainty, and inclusive growth. Indeed, it is crucial that the positive effects of trade openness equally benefit the different states of the country, and it will not be so unless these factors are improved in all of Mexico.

About the Author

Luis de la Calle is managing director of De la Calle, Madrazo, Mancera, S. C. (CMM). He served as deputy trade minister for Mexico and as trade representative at the Mexican Embassy in Washington.

About GMF

The German Marshall Fund of the United States (GMF) strengthens transatlantic cooperation on regional, national, and global challenges and opportunities in the spirit of the Marshall Plan. GMF does this by supporting individuals and institutions working in the transatlantic sphere, by convening leaders and members of the policy and business communities, by contributing research and analysis on transatlantic topics, and by providing exchange opportunities to foster renewed commitment to the transatlantic relationship. In addition, GMF supports a number of initiatives to strengthen democracies. Founded in 1972 as a non-partisan, nonprofit organization through a gift from Germany as a permanent memorial to Marshall Plan assistance, GMF maintains a strong presence on both sides of the Atlantic. In addition to its headquarters in Washington, DC, GMF has offices in Berlin, Paris, Brussels, Belgrade, Ankara, Bucharest, and Warsaw. GMF also has smaller representations in Bratislava, Turin, and Stockholm.

About OCP Policy Center

OCP Policy Center is a Moroccan think tank whose mission is to contribute to knowledge-sharing and analysis of key economic and international relations issues essential to the development of Morocco and Africa, through independent research as well as a network of partners and leading scholars. It also strives to make a meaningful contribution in the areas of agriculture, environment, and food security; economic and social development; commodity economics; and geopolitics and international relations. OCP Policy Center aims to bring a "southern perspective" from an African middle-income country to the agenda of major global debates, explaining the challenges that emerging countries face. The Policy Center also emphasizes developing a network of young leaders.