Global Commerce

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Deciphering the NAFTA
by Kim Green, International Trade Specialist, Tennessee Export Office

When the full text of the NAFTA agreement was made public in September of 1992, after a seeming eternity of secretive negotiations, the sheer complexity of this behemoth of a treaty led many to wonder if its release had actually shed any light upon its substance. With over 1,000 exceedingly dense pages of text and an additional 2,000 pages of annexes, anyone not well-versed in the nuances of trade would find NAFTA's provisions esoteric and mind-numbingly tedious.

The controversy preceding NAFTA's ratification on January 1, 1994, served to further obscure understanding of the possible ramifications to the U.S. economy and to our neighbors to the north and south. More than three years later, the debate still rages about the impact of the creation of the world's second-largest trading bloc (after the European Union). Supporters cite job growth and expanding exports, and refer to their opponents as "xenophobic." Critics contend that NAFTA will facilitate the exploitation of workers from the Yucatan to the Yukon, as wages fall, and call their opposition "ruthless capitalists." Amid this storm of controversy, how does one figure out what's really going on?

Let's start with the facts: What does the NAFTA agreement actually *say*?

First, the treaty creates a list of objectives for NAFTA:

- the elimination of barriers to trade in goods and services
- the promotion of "conditions of fair competition" within the free trade area
- an increase in investment opportunities within the free trade area
- the effective protection and enforcement of intellectual property rights
- the creation of a framework for further cooperation to enhance the benefits of the agreement

The eighteen chapters which follow outline the specifics of how these objectives are to be achieved.

Chapter 3, entitled "Tariff Elimination and Market Access," discusses the schedule for tariff reduction and the removal of non-tariff barriers on various product categories. In many categories, tariffs were immediately reduced or eliminated (e.g. computers and autos), while tariffs on other product categories will be gradually phased out at intervals of 5, 10, and 15 years. Other barriers, such as import licenses and quotas, were also removed for certain categories.

Chapter 4 deals with NAFTA's convoluted rules of origin, which provide preferential treatment for goods which satisfy its criteria. Complying with the rules of origin formulae is about as simple as understanding the U.S. tax code, and the five-year Certificate of Origin record-keeping requirement can be onerous for smaller companies. Tracing component and production stage costs may be particularly difficult, as small and medium-sized firms normally do not maintain records in such detail. New-to-export businesses need to assess the potential of tariff savings versus the costs of initiating compliance.

The remaining chapters address a number of other issues, including:

Other traditional non-tariff barriers to trade, such as phytosanitary restrictions on agricultural products, arbitrary technical standards on manufacturing products, and "non-scientifically based" environmental restrictions.

Fair competition and antitrust measures for state enterprises, government procurement, and certain formerly government controlled industries, such as telecommunications and energy.

Decreased restrictions on trade in services, investment, and finance.

Policies for emergency safeguards for especially vulnerable industries, treaty dispute settlement procedures, and intellectual property protection and litigation procedures.

Net surfers with time on their hands can peruse the full text of the treaty at a number of sites on the World Wide Web (MIT maintains one at *http://the-tech.mit.edu/Bulletins/nafta.html*). Others might prefer to check out one of the many detailed summaries prepared by experts (Trade Point U.S.A. has a NAFTA analysis at *http://www.i-trade.com/dir05/book/*).

However, understanding the actual document provides few clues about NAFTA's long-term effects on individual businesses and on the U.S. and Mexican economies as a whole. Without question, the treaty will make U.S. goods more competitive in the traditionally protectionist Mexican market, especially in industries with historically high tariffs, such as agriculture. But how this will translate to U.S. economic growth remains unclear.

The mistake that both NAFTA critics and supporters tend to make is to expect immediate results. Gradual changes in our trade balance with Mexico, a relatively small economy, could scarcely affect the overall number of jobs and/or the standard of living in the U.S. Promises of immediate job creation were most likely used to sell short-sighted politicians on a long-term approach to economic growth.

The peso crisis of 1994 impeded former President Salinas' attempts at economic and political reform which had begun to open Mexico to U.S. exports. Mexico's current pace of recovery from this crisis mirrors the more realistic reform efforts of many of the Eastern European nations. Economic reform is generally a slow and painful process, especially when former industry protections and subsidies are suddenly removed.

Thus a more realistic way to view NAFTA is as a farsighted foreign policy initiative, a buttress for continuing Mexican economic and political reform, that can only stand to benefit all of North America in the long run. As evidence of U.S. and Canadian confidence in the Mexican economy, NAFTA serves as an investment in Mexico's future, and therefore, the future of the U.S. Because even a struggling nation in the throes of tortuous reform makes a much better neighbor than a population of the angry, the marginalized, and the impoverished, the likely result of any U.S. isolationist backlash.

For more information:

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Paul Krugman, "How is NAFTA Doing?" The New Democrat, May/June 1996.

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NAFTA and Tennessee

by Steven Livingston

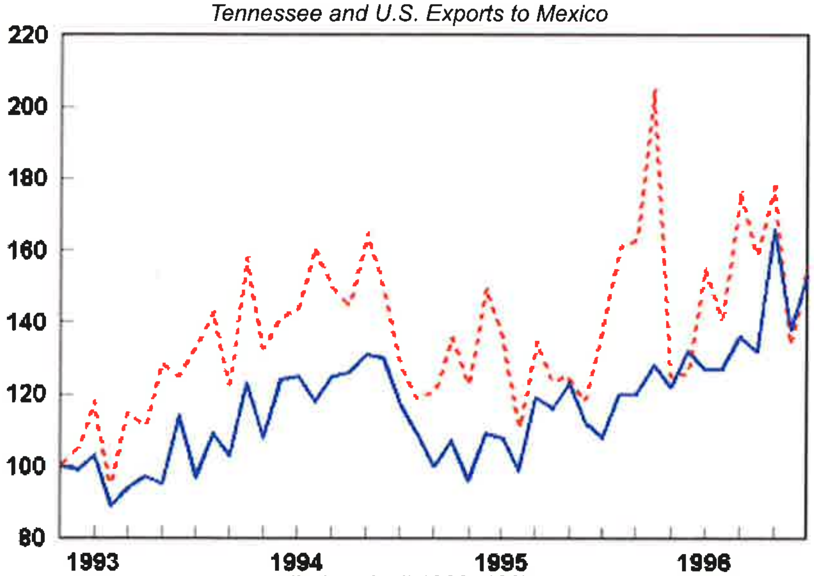
On July 11, President Clinton, reporting to Congress, concluded that NAFTA has had a "modest positive effect" on the U.S. economy. Can the same be said for Tennessee? Let's find out. A full evaluation of NAFTA, of course, should include trade with both Mexico and Canada. But since the last issue of *Global Commerce* featured an analysis of Tennessee-Canada trade, here we will focus on Mexico. And most of the controversy over NAFTA involves Mexican trade (to Americans that is, Canadians complain about the US!), so this seems especially warranted.

The North American Free Trade Agreement, which came into force on January 1, 1994, is an extension to Mexico of the earlier U.S.-Canadian free trade agreement. Assessing its impact is no easy task. First, NAFTA will not fully be implemented for another decade, so judging it now may be premature. Three years is a pretty short time in which to see a policy's impact. More importantly, the Mexican economic meltdown of late 1994, an event virtually all experts see as unrelated to NAFTA, makes it difficult to isolate the effects of NAFTA from those of the terrible economic depression which has hit Mexico. On top of all of this, NAFTA really only continues a removal of trade barriers which began much earlier; the formal agreement is more the symbol of an ongoing development than a change in direction. Nevertheless, let's see what we can discover about Tennessee's trade with Mexico in the wake of the NAFTA.

Surveying Tennessee's Trade with Mexico

Mexico has long been an important trade partner for Tennessee. It vies with Japan as the state's second largest market (behind Canada). In 1996 Tennessee exported just under $660 million of products to Mexico, roughly 7.3% of all of the state's foreign sales, and about 1.5% of all U.S. exports to its southern neighbor. It's a surging market: Tennessee's Mexican sales have grown more than $360 million since 1991, a 124% increase. Like Canada, it is a varied market.

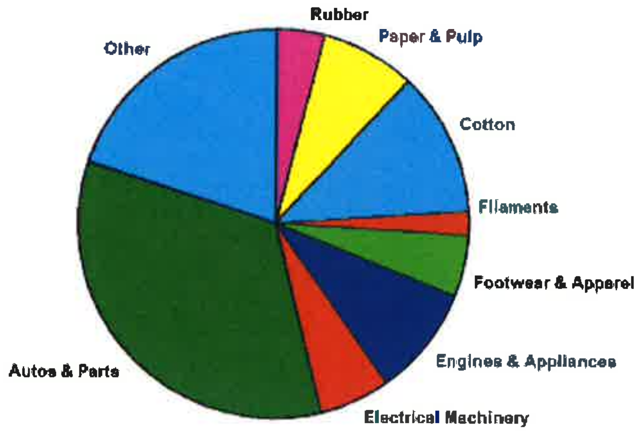
Tennessee and U.S. Exports to Mexico



(Index, April 1993=100)
Red=Tennessee, Blue=United States

Some fifteen different Tennessee commodities sell more than $1 million a month to Mexico. Also like Canada, the automotive industry is the single biggest state exporter. The pie chart of 1996 exports by commodity groups shows the commanding position of autos and automobile parts in Tennessee's trade, and we should remember that most of the rubber, engine, and electrical machinery sales are also auto related. Where Mexico differs from Canada is in being a more

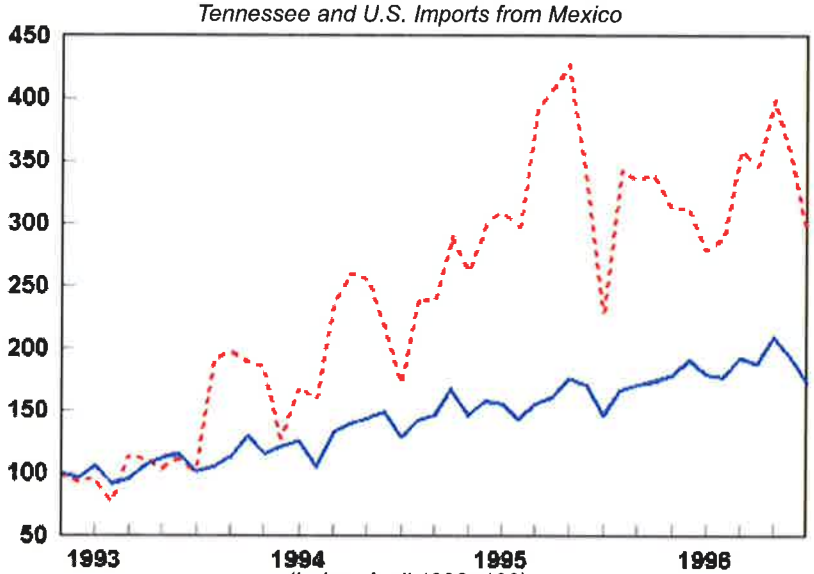
1996 Tennessee Exports to Mexico



significant market for the state's nonmanufacturing industries. Cotton, especially, is a large export.

Tennessee is every bit as important a market for Mexico. 1996 Mexican sales to Tennessee were $2.283 billion, 3.7% of all that country's exports to the U.S. To put this in perspective, Mexican exports to the Volunteer state actually approach those of Canada ($2.608 billion). Here growth has been even more phenomenal. Imports from Mexico have increased by one billion

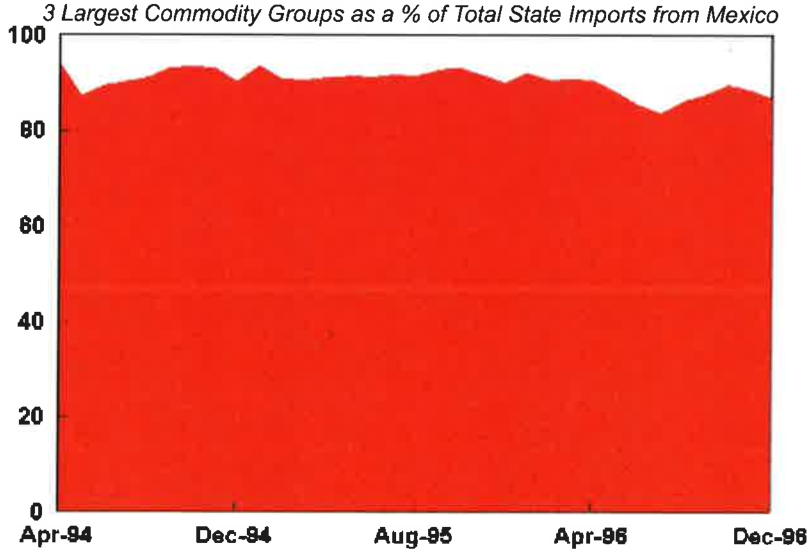
Tennessee and U.S. Imports from Mexico



(Index, April 1993=100)
Red=Tennessee, Blue=United States

dollars just since 1994. On the other hand, the range of these imports is very concentrated; the overwhelming majority are associated with the auto industry. Auto related goods account for four-fifths of all of Tennessee's imports from Mexico. This industry concentration distinguishes the pattern of the state's

3 Largest Commodity Groups as a % of Total State Imports from Mexico

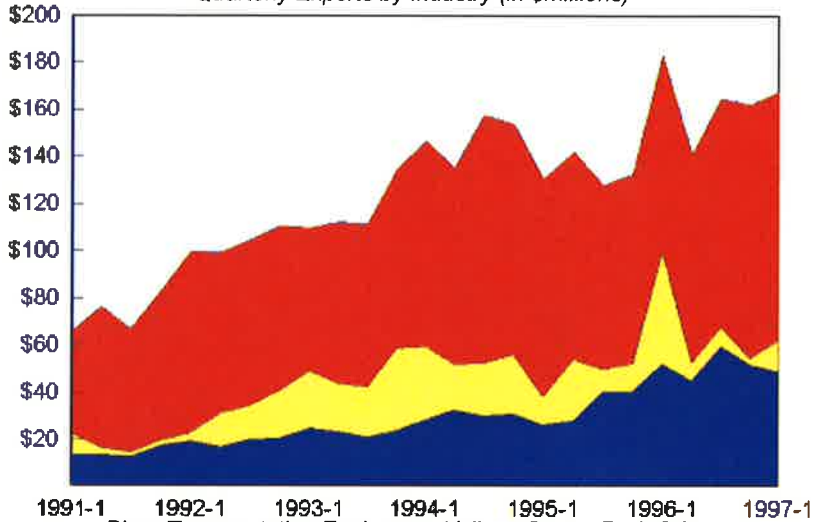


imports from its exports, or, for that matter, from the pattern of the state's trade with Canada.

NAFTA and the Trend of the 90s

So how has this picture changed since NAFTA? Tennessee's post-NAFTA export growth to Mexico has generally matched that of the rest of the U.S., and the composition of those exports has not been changing that much. This export growth has remained strong, even in the face of Mexico's grave difficulties; preserving this market for the U.S. over this very rough stretch may indeed be NAFTA's biggest success. As noted above, state exports to Mexico are quite diverse. While many export commodities have been doing very well in the post-NAFTA environment, only the state's apparel, machinery, and vehicle (and parts) industries have appreciably increased their share of state exports over the past several years. This

Quarterly Exports by Industry (in $millions)

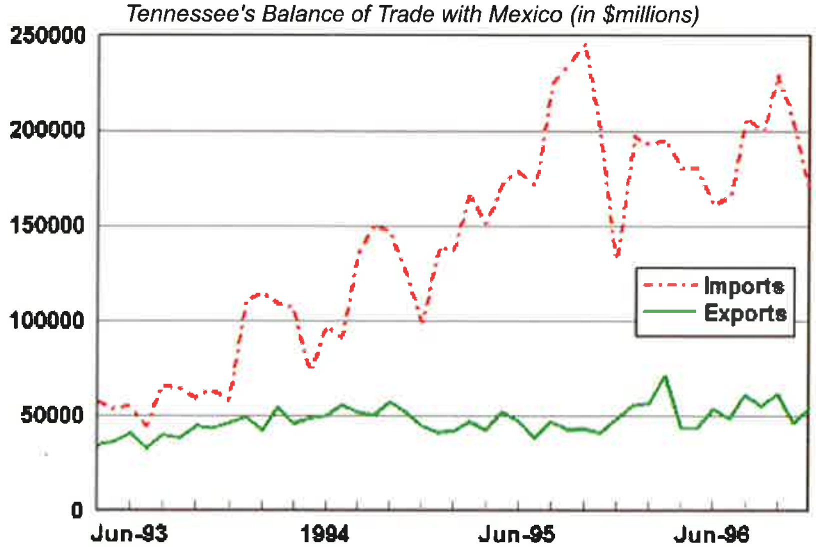


Blue=Transportation Equipment, Yellow=Crops, Red=Other

has mostly been at the expense of aluminum and cotton exports so we can see a slow shift to manufactured exports. In the long-run it is the transportation sector which seems destined to dominate: in 1992 it accounted for about a fifth of the state's exports, in 1994 it composed a little under a fourth of the state's exports, and today it has risen to just under one-third.

Imports are another story. Tennessee's imports from Mexico have grown at a much faster rate than imports from Mexico into the rest of the U.S., producing a very large state trade deficit with Mexico. We can explain why with that same word:

Tennessee's Balance of Trade with Mexico (in $millions)



automobiles, in fact, if the automotive related sectors aresubtracted from both the state's exports and imports, the state actually runs a small surplus. Last year, the state imported almost $600 million in car and truck engines and air conditioning equipment, over a billion dollars of electrical machinery (largely for trucks and cars, though this commodity group includes televisions and parts, which are a sizable import into Tennessee), and over $400 million worth of trucks, cars and auto parts. And this does not count automotive glass and other such miscellaneous items. More than eighty-five percent of all imports were in one of these three commodity groups. Within this "big three," imports have been shifting from the electrical components group to the vehicles group.

Though Tennessee imports are overwhelmingly auto related, this hardly means the state is not purchasing other Mexican products. For although these other imports are much smaller in amount, they are growing at an even faster clip. From 1995 to 1996 imports

Exports in Transition: Commodities Undergoing Large Changes in Mexican Sales

Booming	*Struggling*
Tannins, Dyes, and Pigments	Cooking Oils and Fats
Sugar Confectionary	Soaps, Washes, and Lubricators
Plastics	Wood and Wood Articles
Man-made Staple Filaments	Pulp and Paper Scrap
Glass and Glassware	Industrial and Laminated Textiles
Articles of Base Metals	Aluminum

from outside the three big sectors grew about 48%, and are now closing in on $300 million per year. Among these smaller commodities, the apparel sector stands out. It now ranks as the largest non-automotive sector, and is growing rapidly.

Is Tennessee Heading South?

Nearly balanced in the early 1990s, Tennessee now has a huge trade gap with Mexico. Imports have soared, and are close to four times the amounts the state is exporting. Superficially, then, NAFTA does not look like it was a good deal for the state. But such a conclusion overlooks two salient facts: a significant portion of Tennessee's trade deficit is due to the peso crisis, and, even more importantly, that deficit is simply the flip side of the vigorous expansion of Tennessee's auto industry, the source of much of the strong state growth of the 1990s. A look at the time chart of Tennessee exports shows the dramatic effects of the Mexican economic crisis on state exports. The crisis has cost Tennessee around 30% of its potential exports over the last three years, an amount equal to $275 million dollars in 1996. The Mexican economy is recovering, and with it state exports, but it will be a number of years before they return to the growth path of 1994. We can infer that imports were also boosted by the extraordinarily cheap peso, though a lack of data does not allow us to project by how much. The end of the steepest rise in import growth by late 1995 seems to confirm the importance of currency rates in the overall trade picture. As much as a third of the increase in the state's Mexican trade deficit is probably due to the 1994 peso crisis.

But of much greater importance in understanding Tennessee's trade relationship with Mexico is the globalization of the automotive industry, in which this state is a key participant. Note that automotive *exports* to Mexico have also posted considerable gains since 1994. Note also (see the last chart of the *Tennessee International Trade Report*) that the rise in Mexican imports occurred exactly as Tennessee's global exports exploded in 1994-95, and the driving force, so to speak, of *that* explosion was the same transportation sector. The surge of Mexican imports into Tennessee is thus but one element of the increasing global integration of the world auto industry, it is part of a larger pattern: Tennessee, for example, buys large amounts of automotive related goods in Mexico and then sells large amounts of automotive products in Canada. This explains why Tennessee runs a large deficit with Mexico at the same time as it has a surplus with Canada. This also shows why looking at Mexico-Tennessee trade in isolation can be a little misleading.

Blaming NAFTA because of a big increase in state imports is thus too easy; the growth in Mexican imports, rather than being a simple "giant sucking sound," is actually a sign of the size and strength of the Tennessee automotive sector. It is today an internationally integrated business, both importer and exporter. Outside of that sector, as we have seen, state trade remains relatively balanced, with both exports and imports growing robustly. By the same token neither should we credit NAFTA for most of this growth. Though our chart does show a rapid gain in exports just following its implementation, the trend towards greater trade and closer economic integration with Mexico predates the agreement by half a decade. Trade with Mexico has developed its own head of steam, with or without NAFTA. As a document, the effects of NAFTA are probably, to date, slight. But as a symbol, NAFTA alerts us to the unalterable fact that Tennessee's economic vitality is tied not just to the U.S. but increasingly to the other economies of North America and the world. Here, perhaps, is its "modest, positive effect."

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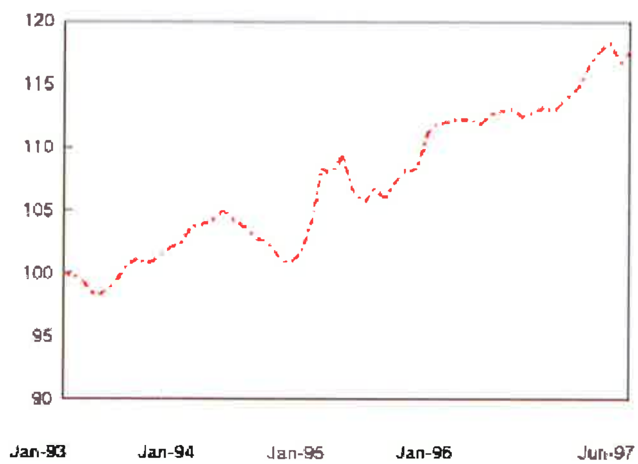
Tennessee Trade-Weighted Dollar Index

The dollar's relentless rise over the first part of 1997 has at least briefly abated. The June Tennessee trade-weighted dollar index stood at 117.76, virtually unchanged from the spring. The index peaked in April, breaking the 118 mark for the first time. While European currencies (except for the British pound) continued to fall against the dollar, albeit at a slower rate, Asian currencies began to strengthen. In fact the largest change among the currencies composing the index was the rise of the Yen, which gained nearly seven percent against the dollar during this last quarter. Perhaps surprisingly, Hong Kong remained stable, posting a very slight increase against the dollar. Whether this Asian trend will continue in the wake of the recent crash of Thailand's Baht remains to be seen. Both Canadian and Mexican currencies weakened over this past quarter, though neither decline was very significant. Though the dollar has stopped its rise, at least momentarily, Tennessee exporters continue to face their toughest currency environment in years. Past experience tells us the strong dollar is undoubtedly cutting into the state's exports. How long this environment will last seems to be anyone's guess experts expect a continued strengthening dollar at least over the short term.



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Tennessee International Trade Report
1st Quarter 1997

With Tennessee's foreign sales at $2.374 billion, 1997 opened with both good news and bad news. The state's manufacturers provided the good news. First quarter exports of manufactured goods grew better than ten percent the strongest performance in several quarters. The bad news came from Tennessee farmers. Agricultural crop exports collapsed. Crop sales were off nearly two-thirds from a year ago, a loss of $149 million. The crash in crop exports was dramatic enough to hold overall export growth to a rather modest 3.1 percent for the quarter, well under the U.S. average. This is still an improvement, however, from 1996, when first quarter exports grew less than 1 percent.

The sharp drop in crop sales was the most dramatic change in any of the state's export sectors. But most sectors posted healthy gains for the quarter. The other major exception was the primary metals industry, which continued its recent poor performance with another ten percent decline in exports. The chemicals industry was perhaps the state's star sector. After a slow 1996, chemical (and allied product) exports increased by almost $90 million (24.5 percent). With foreign sales over $453 million, it nearly regained its old position as the state's leading export sector. However the apparel industry can also make a strong a claim to preeminence. Its 32.1 percent growth rate was the highest of any of the state's large export sectors, as it continued to defy predictions it would be hurt by NAFTA. The paper, furniture, and fabricated metal industries were also big gainers. The poor performance of agricultural crops did not extend to livestock sales, incidentally, which posted a gain of 89 percent, one of its best quarters ever.

Geographically, the story was also one of good news, bad news. After a mediocre 1996, state sales to Europe rose some $66 million. Sales to Canada were also strong, increasing $77 million (10.5 percent) from the first quarter of 1996. But China, once again, was another story. There exports fell by almost two-thirds. The resulting $65 million in lost exports virtually wiped out all of the gains made in Europe. Tennessee's second and third largest markets, Mexico and Japan, were also soft, though nothing like China: each dropped about 10 percent. South America continued its schizophrenic ways overall exports were flat, but the region included some of Tennessee's best performing markets (Brazil, Chile) and some of its worst (Venezuela). Outside of East Asia, the toughest region was Africa. Each of the three biggest African markets, Egypt, Nigeria, and South Africa, contracted more than $3 million from 1996.

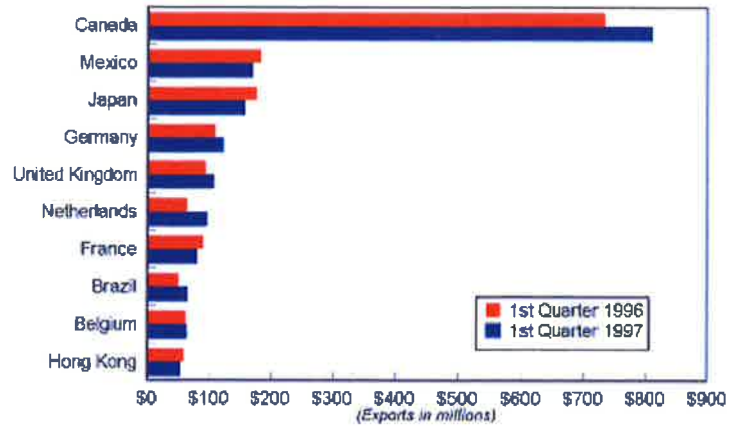
The most remarkable performance of the quarter, though, was to be found in Central America. Not only were two of the state's five fastest growing export markets in Central America, total exports to the region grew over $20 million: a combined growth rate of 80 percent. Together these countries imported $45 million of goods from Tennessee. If considered as a country, Central America would rank as the twelfth largest Tennessee export market, ahead of Australia, China, or Italy, among others.

The second quarter looks off to a very good start. April 1997 exports were up 10.9 percent, the best monthly performance since June 1995. The woes of crop exporters, however, seem to be continuing.

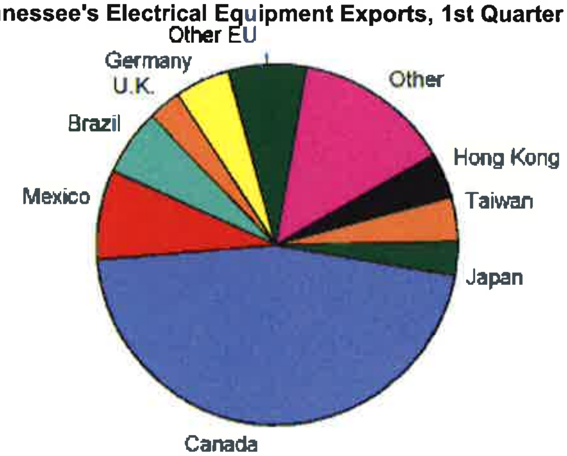
Tennessee's Largest Export Sectors, 1st Quarter 1997

	Exports	Change from Last Year
Transportation Equipment	$465,356,861	8.5%
Chemicals	$453,833,550	24.5%
Industrial Machinery	$356,348,554	8.9%
Electronics & Electrical Equip	$175,866,221	8.1%
Instruments & Related Products	$122,126,895	5.3%
Paper and Paper Products	$112,949,564	18.6%

Tennessee's Leading Trade Partners



Tennessee's Electrical Equipment Exports, 1st Quarter 1997



Tennessee's Exports to Brazil, 1st Quarter 1997

Largest Growth and Decline in Exports by Industry, 1st Quarter 1997

	Value of Exports	Growth%	Decline%
SECTORS WITH THE GREATEST GROWTH			
Metal Mining	$1,463,854	599.7%	
Petroleum & Coal Products	$2,294,904	165.4%	
Livestock	$389,066	89.3%	
Tobacco Manufactures	$139,904	68.4%	
Apparel	$50,249,437	32.1%	
SECTORS WITH THE GREATEST DECLINE			
Scrap & Waste	$4,348,933		-73.8%
Agricultural Crops	$77,443,729		-65.8%
Coal Mining	$635,472		-47.4%
Used Merchandise	$757,518		-30.1%
Fishing, Hunting, & Trapping	$1,308,649		-26.4%

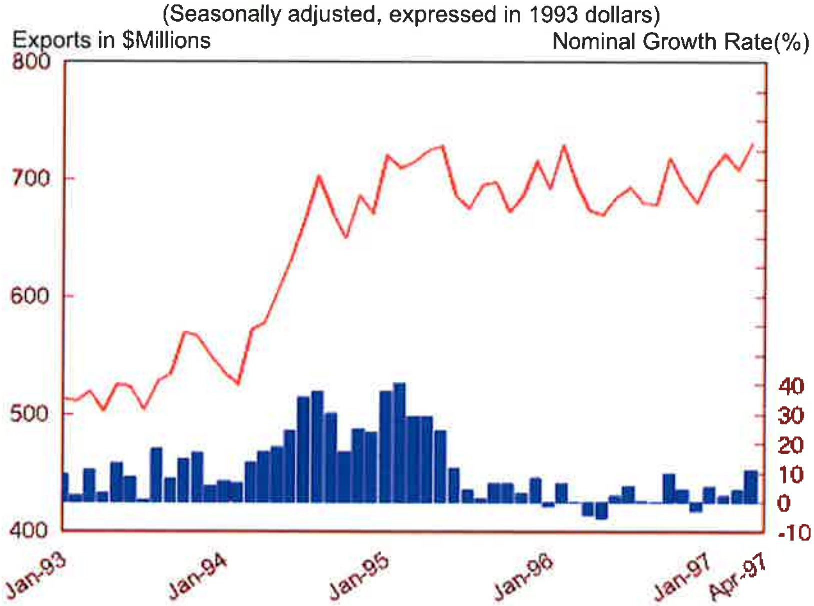
Fast Changing Export Destinations, 1st Quarter 1997

Among countries averaging more than $2 million in sales per quarter.

	Value of Exports	Gain %	Decline %
COUNTRIES WITH THE GREATEST GROWTH			
Ecuador	$5,584,496	170.3%	
El Salvador	$11,986,883	150.4%	
Honduras	$6,586,031	142.4%	
India	$18,514,494	141.6%	
Pakistan	$2,718,571	87.7%	
COUNTRIES WITH THE GREATEST DECLINE			
Nigeria	$378,591		-94.9%
China	$38,105,316		-63.1%
Egypt	$4,383,407		-48.3%
Norway	$3,004,489		-44.2%
South Africa	$7,518,705		-41.9%

Tennessee Monthly Exports

(Seasonally adjusted, expressed in 1993 dollars)



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