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Workers harvest lettuce near Watsonville. If U.S. tariffs are lowered through a free trade agreement, Mexican lettuce and other specialty crops will become more competitive with those of the U.S.

Free trade with Mexico: economic impacts

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Economic models show that the U.S. will benefit economically from a free trade agreement (FTA), but Mexico is likely to benefit more. The creation of an FTA will result in the movement of labor and capital across sectors in both economies. The benefits to Mexico will be augmented if significant economic development occurs as a result of the agreement. The FTA is likely to cause a reduction or change in the mix of California horticultural products directly competitive with Mexico. (See sidebar, p. 7.) Market opportunities are expected to develop for other products.

Discussions concerning a North American Free Trade Agreement pose important choices for Mexico, Canada and the United States on how best to manage their economic relations in an environment of increasing global internationalization and competition. Mexico is poised for a potentially complementary integration with its more developed Northern neighbors. The U.S. administration has decided that a successful Mexico transition that leads to growth and political stability is in the national security interests of the U.S. Mexico's ability to move to a sustained pattern of efficient growth is seen as the best chance for the maintenance of political stability.

If the transition is successful, it is argued, there will also be important economic benefits to the U.S. However, there will also be adjustment costs, and these will have to be addressed politically. U.S. labor unions and affected producer groups fear that they will be forced to absorb dislocation costs without compensation. Unless some form of adjustment assistance is established, opposition of this type can be expected to continue throughout the negotiation process. In addition, there are concerns that a free trade agreement (FTA) will allow U.S. firms to move production to Mexico to take advantage of what are perceived to be more lax labor and environmental standards. In a recent shift of position, the U.S. administration has agreed with Congress on the need to address environmental regulation and labor concerns. This indicates recognition that the constituency which has raised these issues must be included in the negotiation process.

From the Mexican perspective, President Carlos Salinas de Gortari has argued that the central challenge to successful implementation of an FTA is is that of providing economic benefits to Mexican society throughout the period of transition to new growth. There must be sufficient employment and real wage growth so that broad elements of the Mexican nation will support the continued pursuit of the new development strategy. Mexico is still faced with severe development needs which must be addressed to avoid potentially

Editor's note: This article and the accompanying sidebar are drawn from a 1991 study by Hinojosa-Ojeda and Robinson, "Alternative Scenarios of U.S.-Mexico Integration: A Computable General Equilibrium Approach," and from Moulton's analysis of horticultural industries in Mexico and California.

dangerous regional and social polarization, as well as continued environmental degradation, both urban and rural.

In addressing these challenges, Mexico starts with a relatively high level of industrialization and a skilled work force, which can provide the foundation for a dramatic economic transformation. The stated policy of President Salinas, who took office in 1988, is to reverse Mexico's historic inward-looking development strategy and to pursue on outward-oriented strategy, following the lead of successful semi-industrial countries such as South Korea, Taiwan, Turkey, and Spain.

While there are lessons to be drawn from the experience of other semi-industrial countries, especially Spain's entry into the Common Market, there are many unique aspects to Mexico's situation. The success of the new strategy for Mexico in terms of sustainable growth and equitable income distribution will depend on the mix of trade, financial, and labor market policies that accompany a medium-term adjustment in the North American region. Institutionally, the formation of an FTA is a modest step. Managing environmental impacts, employment conditions, and disparities in regional development will require a greater degree of harmonization and institution building than is currently being considered in FTA negotiations.

This article focuses on the potential economic impact of the creation of an FTA on the U.S. and Mexican economies and on their economic relations. In addition to analyzing the impact of removing trade barriers, we also consider changes in migration, capital flow, and productivity that might accompany the creation of an FTA.

Methods

For the empirical analysis, we developed a three-country, seven-sector, trade-focused, computable general equilibrium (CGE) model which includes the U.S., Mexico, and the rest of the world. We use the model as a policy laboratory, doing a variety of experiments under various trade, capital, productivity, and migration scenarios.

A CGE model provides a means to evaluate an economy's operation. It incorporates the profit-maximizing behavior of the principal economic actors, as well as the actions of government agencies that make rules affecting market performance, collect taxes and tariffs, and dispense services. The model imposes market-clearing conditions that establish equilibrium prices for commodities, labor and the other factors included. It simultaneously solves for supplies, demands, prices and incomes.

CGE models are particularly well-suited for studying interdependent economies and trade liberalization. In common with all empirical economic models, however, they must be used with care. The results should not be viewed as "forecasts," but instead to indicate the potential impact of different policy choices and external shocks. Starting with a model that captures the relevant structure and operation of the two economies, the empirical results are nonetheless conditional on a host of assumptions about the external environment and policy choices. This type of model is especially valuable in capturing the important mechanisms through which policy changes affect the two economies in the medium to long run, and in tracing out the empirical importance of links between them. Through a series of "what if" experiments, the model can be used to analyze the sensitivity of each country's economy to changes in policies and in the external environment.

General results

The general conclusions from the empirical experiments with the FTA-CGE model are:

■ The lowering of tariffs and nontariff barriers (NTBs) by itself has a relatively minor impact on the U.S. economy. The impact on the Mexican economy is greater, which is to be expected given the relative size of the two economies.

■ Even under pro-competitive assumptions, including productivity gains from decreasing factor-market distortions, the creation of an FTA has much less effect on the U.S. economy than changes in trade relations currently under discussion in the Uruguay Round of General Agreement on Tariffs and Trade (GATT) negotiations. This result is hardly surprising, given the relatively small size of U.S. trade with Mexico compared to trade with Europe and East Asia.

■ If the creation of an FTA is accompanied by other policies which together succeed in achieving increased Mexican growth, there will be increased trade with the U.S. and net benefits to both economies. The potential gains depend largely on collateral policy changes accompanying the creation of an FTA, such as changes in foreign investment flows and debt relief, which affect Mexican growth. In general, while the gains are proportionately greater for Mexico, they are also significant for the U.S.

■ The creation of an FTA will result in the movement of labor and capital across sectors in both economies. These structural adjustments are proportionately far larger for Mexico than for the U.S. In both countries, however, the size of the adjustments are small relative to the aggregate capital stock and labor force. In the U.S., the required adjustments are a fraction of the factor movements typically observed during the business cycle. In Mexico, they are far smaller than the swings observed in the past decade, as the Mexican

TABLE 1. Estimated changes in U.S. agricultural sector arising from different assumptions about free trade and development

Experiment number	Production	Exports to: Mexico	Exports to: others	Imports from: Mexico	Imports from: others
	% change from base year*				
1	0.0	5.7	0.0	1.8	0.2
2	-0.1	19.0	-0.1	11.0	0.7
3	0.3	26.4	-2.8	12.5	3.9
4a	0.5	39.2	-2.0	16.7	4.2
4b	0.2	39.5	-2.9	17.4	4.1
5a	0.7	61.9	-2.0	1.7	3.4
5b	0.0	63.0	-4.6	3.9	3.0

*Base year is 1988.

TABLE 2. Estimated changes in Mexico's agricultural sector arising from different assumptions about free trade and development

Experiment number	Production	Exports to: U.S.	Exports to: others	Imports from: U.S.	Imports from: others
	% change from base year*				
1	-0.1	1.8	1.9	5.7	0.3
2	0.2	11.0	-2.6	19.0	4.6
3	1.6	12.5	-9.1	26.4	11.9
4a	7.9	16.7	6.1	39.2	23.9
4b	8.5	17.4	9.2	39.5	24.3
5a	4.3	1.7	-41.8	61.9	47.0
5b	6.6	3.9	-34.4	63.0	48.6

*Base year is 1988.