TRADE LIBERALIZATION AND ECONOMIC GROWTH IN MEXICO

Georgina Kessel
Comisión reguladora de energía de México

Let me begin expressing my gratitude to the Seoul National University for their kind invitation to participate in this conference on Trade Liberalization and Economic Growth in Mexico. The theme of the conference, Mexico's international trade and the regional effects of a free trade agreement, is of great importance in our bilateral relations and its timing could not have been a more appropriate one.

As many other latin american countries, and perhaps as a result of our pessimism regarding the behaviour of our terms of trade, Mexico relied on import substitution for more than four decades as a strategy to promote economic development and industrial growth. Trade policy favoured the creation of many medium-sized industries to serve the needs of a small, but growing domestic market. Firms, most of the time, operated with high unit costs and were unable to compete in the world market. Protection granted to the industrial sector expanded those activities which substituted imports at the expense of sectors where the economy had a comparative advantage and therefore with greater potential for the creation of jobs in a labour-abundant country.

The events following the 1982 debt crisis showed that our approach to economic growth through an import-substitution strategy wasn't appropriate anymore. It's success during the sixties and early seventies depended heavily on the availability of foreign financing to sustain the increase in imports that were required to carry out production. In 1982 when external financing was cut, the mexican economy entered in the most severe recession characterized by a declining gross domestic product, inflation rates in the order of 100%, a considerably large public foreign debt, and a private foreign debt of around 20 billion dollars.

The situation of the mexican economy was bleak at the end of 1982, Miguel de La Madrid administration was faced with two basic challenges: macroeconomic stability and structural change. Furthermore, in order to avoid an increase in unemployment more than a million new jobs needed to be created every year to incorporate new incomes into the labour force, this was a result of high population growth rates of appropriately 3.5% observed during the seventies. It was then recognized. That in order to achieve sustained economic growth and high rates, the mexican economy required a new strategy to promote economic development, and allow a more efficient allocation of resources and higher rates of jobs creation.

The economic behaviour of other developing countries that had abandoned import-substitution and were relying on exports-promotion to achieve industrial growth provided some evidence of the strategy change advantages.

At the macroeconomics level, the mexican government committed itself to bring down domestic inflation and reactivate the economy. Policy measures adopted include: drastic reduction in the public sector's deficit that was achieved by increasing prices of other measures adopted include the elimination of official prices which were used quite often as a device for protection, fixed many times above their international levels and then used as a reference to calculate import duties. As a result of the trade liberalization program, Mexico is currently one of the most open economies, according to developing country standards.

The more competitive environment faced by domestic firms provides them with the required incentives to promote higher levels of efficiency in productive processes, increase total factor productivity, introduce new technology and specialize in those sectors where Mexico has a comparative advantage. The increase in the size of potential markets that is favoured by trade liberalization will also allow firms to achieve scale economies which were not possible under import-substitution given the limited size of the domestic market.

Nevertheless, our success in converting Mexico into a full-fledged exports-oriented economy depends not only on international trade policy measures adopted unilaterally, but also on the reduction in trade barriers towards mexican exports in the rest of the world. In this regard, Mexico began negotiations in 1985 to improve the access of its products in world markets both at a multilateral as well as at a bilateral level.

During 1986, Mexico became a member of GATT and was awarded all tariff concessions which were previously negotiated between other members parties. The country also committed itself to a gradual reduction of tariffs and to observe GATT's codes of conduct regarding import licensing, customs valuation, antidumping and countervailing duties, technical standards, and certification. By the end of 1987, Mexico had already surpassed its commitments regarding tariff levels. Most importantly, Mexico's adherence to GATT helped enhance credibility in the trade liberalization process, which was lacking at that time because previous attempts at liberalization were reversed in the past.

At a bilateral level, attempts at improving access to mexican products concluded with a trade and investment framework agreement signed with the Untied States in 1897. This agreement provided both countries with a consultation mechanism to address trade and investment issues. Some of the concrete results observed in the last few years include an increase in the export quota of mexican steel products and improvement in market access for mexican textiles. In return, the United States received several concessions regarding it's exports of beer, wine and liquors, as well as for U.S. textiles and apparel. This agreement represented the first step towards a more comprehensive trade and investment agreement with the Unitied States. Of government goods and services and rationalizing subsidies, a very ambitious program of privatization, reduction in overall government spending and a comprehensive tax perform.

These economic reforms were faced also by the Carlos Salinas administration. With these continuity Mexico achieved healthy macro-economic aggregates. For example, coming from an inflation rate of almost 180% at the beginning of 1988, it was granted by 1993 an inflation rate of 8%, the lowest one in twenty years. In order to achieve this goal, the government implemented a tight monetary policy that was made possible only by the huge fiscal adjustment achieved. In addition, Banco de Mexico, Mexico's central bank, will be autonomous by april of these year: it's major objective will be to maintain the stability of prices. The government will not be able to force it to finance its deficit and therefore assures that the tight monetary policy will be permanent.

In addition, an ambitious program of privatization was implemented. The largest firms in transportation, financial, aviation, telecommunication and tobacco sectors are now controlled and managed by private owners. These firms are now more efficient, and the government no longer finances them: in this way, government resources are invested in more productive projects. Perhaps the most important program was the privatization of the banking system which was nationalized in 1982. furthermore. Mexican government is opening the banking system for international investment. The forecast is that 10 foreign banks will be allowed to open by the end of these year, to finish with a total of 55 banks in the banking system.

The income from privatization and the reduction of government expenses took public finances to a surplus. One important aspect with respect to these funds is that they were chained to the reduction of both internal and external debt, which resulted in further reductions in the government deficit from the savings in the service of its debt, in 1991 the total government expenditures as a percentage of GDP were 26.7%, and the total share of revenues were 26.2%, the mexican tax system is know competitive, this was achieved by reducing the tax rate and in creasing the tax base. Furthermore, the tax revenues have grown rata faster rate than GDP.

In the mid 1980's the mexican government implemented a program to promote structural change. It's basic purpose was to increase efficiency through greater exposure of domestic firms to foreign competition. Trade policy reforms played a crucial role in this effort. In less than five years. The mexican economy moved an extremely restrictive import regime in which almost every item was subject to import permits, to a regime in which quantitative restrictions apply only to a few selective sectors of the economy. By the end of 1985, licenses were eliminated on 96% of import categories and 75% of the value of imports. In 1992 these rates were 98% and 89% respectively. Currently tariff rates range from 0 to 20% according to the degree of processing of the product; the maximum rate applies to consumer goods and the lower rates to capital and intermediate goods. The current average tariff rate is approximately 13%.

The north america free trade agreement (NAFTA) which started in january of this year, brings a more certain scenario for investment and export enterprises. The liberalization program is clear and permanent for each industry.

There are several ways in which firms tend to the more competitive environment provided by trade liberalization. Their success or failure depends in the way they adjust their production process, distribution channels and marketing efforts; and even their product lines to defend their share of the domestic market from import competition and to reach into international markets.

Some of the expected responses include, the expansion of plant and equipment, greater specialization of product lines, new investment to upgrade existing facilities and improve operating efficiency, and enhanced marketing efforts.

Some positive results of the trade liberalization program are already being observed. These have been influenced by other factors such as the reduction in domestic demand which was a result of the fall in the price of oil and the reduction in real wages. Nevertheless, we experienced a reduction in growth rates as a consequence of the macro stabilization program, it is one of the cost's adjustment that we have to bear after the deep structural change that took place. However, the behaviour of some indicators is encouraging, and there are projections for sustained growth for next year.

One of these indicators is the dynamic behaviour of manufactured exports observed since the implementation of the trade liberalization program. This represents a positive sign of the adjustment process that is taking place in domestic industries. The share of non-oil exports in total exports has increased from 22% in 1982 to 66% in 1989, and 82% in 1992. The share of manufactured exports in total exports in 1989 was 55%, and in 1992, it stands at 77%.

Mexico is currently exporting a whole range of manufactured products that goes from textiles, plastics and synthetic rubbers, to steel products, machinery parts, personal computers, and automobiles. Even though this behaviour might have been influenced by macroeconomics performance, exports have grown since the beginning of the 1980's under rather unfavourable conditions. Both, the domestic infrastructure and the regulatory framework in which mexican firms were operating, were built under the import-substitution regime that favoured production to serve the needs of the domestic markets and created strong distortions that interfered with international trade. However, there is a strong movement towards removing these distortions and adapting the mexican infrastructure to the new trade strategy which is favouring exports, in 1988, the mexican authorities implemented an ambitious program of deregulation of internal markets. Its basic objective is to promote a more competitive environment by diminishing artificial entry barriers and discretionary measures; it also seeks to reduce administrative procedures and to create clear and and stable rules to guide economic activity these rules promote free trade and also protect against unfair international trade practice that damage national production. Furthermore, in 1993 congress authorized a federal antitrust law which created a commission to supervise it. The goal of this law was to promote economic efficiency and protect the process of competition and the free entrance to markets.

New rules also apply to allow the participation of private sector in creation of infrastructure. Several projects have been undertaken in the construction of highways and cellular telephone services. Now a private firm can also generate electric power for its own-consumption, sell to the national electric company (CFE), and export or import for its own consumption.

An important reform on the property of land for agricultural use was made in 1992. The main goal of this reform is to make an institutional framework which gives more certainty to land owners promoting investment in this area.

Another factor that points toward sustained growth of exports is the cost reductions experienced by domestic firms as a result of trade liberalization program. These cost reductions were made possible through the availability of imported inputs that created a more competitive environment in the market for intermediate products, reducing prices and increasing quality.

Another step taken to improve competitiveness at industry and firm levels is the increase on investment outlays. A clear indicator of this process is the substantial increase in imports of capital goods that has taken place in the last few years. The annual rate of imports of capital goods, crucial to incorporate new technology into the production process, was 20% in 1989 and

35% in 1992. Imports of capital goods included telecommunications equipment, machinery and equipment for the rubber and textile industries, and computers.

Another sign of the adjustment process is the restructuring of existing product lines and specialization patterns which is an obvious response to the more competitive environment being faced by domestic firms. Although there isn't much evidence in this respect, some industries are experiencing it; this is the case of automobiles manufacturing. Mexico is specializing in the production of economy-size models and importing technology-intensive luxury cars. In other sectors, as the household-appliances industry, production-sharing process have been established. Mexican plant's assemble stoves, refrigerators and washing machines which are sold both in Mexico and the United States.

All of these adjustments are costly, there is no doubt that in the process, we can expect to find winners and losers. Trade liberalization represents a significant structural change in the way the economy has traditionally conducted its foreign trade. The costs of adjustment include, among others, the income and wealth losses sustained by owners of resources, who were initially employed in protected industries, as well as the required learning process in understanding how international markets work nevertheless, the long-run benefits in terms of economic factor productivity, efficient allocation of resources, economies of scale and scope, introduction of new technology, and the availability of goods at lower prices, surpass the short-run costs.

The attempts to extend multilateral discipline to such practices have met strong resistance in developed and developing countries alike. Non-tariff barriers have been raised perhaps to compensate for the sharp reductions in tariff levels achieved during the past seven rounds of multilateral negotiations within GATT, the successful Uruguay Round, and as a result of macroeconomic imbalances affecting major industrialized countries.

Furthermore, the GATT system has not adjusted to the changing pattern of international trade. New rules need to be implemented to regulate the growing international flows in services and to protect intellectual property. The liberalization of the capital markets and technological progress have facilitated trade in banking, insurance, and telecommunications services which are not subject to GATT rules.

In other areas, existing GATT rules need to be subject of revision, for example the application of contingent protection measures and the lack of an effective process of dispute settlement. On the other hand, NAFTA presents a mechanism for the treatment of possible disagreement and discord in the application of the free trade rules. It's important to companies from the three countries to be sure that equity and neutrality will be applied in case of a disagreement.

Concern about the effectiveness of the GATT process to address these issues has led some countries to concentrate their efforts in improving bilateral and regional trade relationships and diminish their participation in multilateral negotiations. This has led to an observed tendency towards the formation of economic blocks which will increase trade flows between its members but could also lead to a reduction in trade flows with the rest of the world. Three big economic areas are foreseen: Europe now extended to The East, Southeast Asia, and North America. This tendency towards the formation of economic blocks provides an opportunity to promote further trade liberalization between its members.

Some of the factors that increase success probability for the free trade agreement, NAFTA, are the following:

First, our long-standing trade relationship raises the probability of increases in net trade volumes and in welfare gains as a result of an agreement that reduces barriers to commercial flows in sectors traditionally protected in both countries. Mexico is the third largest trading partner of the United States. U.S.. exports to Mexico amounted to 41 billion dollars from july 1992 to june 1993 which represents almost 90% of its exports to Japan. For Mexico, 69% of our trade is carried out with the United States. For the same period, mexican exports to the us amounted to 34 billion dollars, and our trade relationship is reinforced, increasing the benefits derived from the agreement and reducing the probability of potential losses because of trade diversion.

Another factor that can work in favour of the increase in net trade volumes is the degree of complementarity in factor endowments which results in important differences in comparative advantage. The United States has comparative advantage in those industries intensive in the use of high technology and capital, and, in the case of Mexico, abundant labour, has the advantage in productive processes which are basically labour intensive.

For the United States, a source of inexpensive labour can support it's international competitiveness in traditional industries in which it is currently endangered because of high labour costs. In return, Mexico requires new technology and know how to upgrade it's production processes.

Our geographical position makes the untied states our natural market. Transportation rates between our countries are lower than those which have to be covered to enter the european or asian markets. Geographical proximity may also raise to complementarities in the structure of our economies, particularly at the border, that increase the potential benefits of larger trade flows.

The creation of a north american free trade area increases the size of the potential market for our products. The combined population of the three countries amounts to 386 million people with an annual income of more than five thousand billion dollars. The size of the north american market is greater than the one of the european community and will certainly allow industries in the three countries to attain economies of scale and scope and reduce production costs in the area, giving domestic firms an opportunity to enhance their international competitiveness.

Some conditions that NAFTA fulfills which will help to achieve maximum economic gains are the following. First, it guarantees a gradual but firm reduction of tariffs in some sectors, giving domestic producers in each country sufficient time to adjust to a more open economic environment. Second, NAFTA guarantees a stable and open access to each country's markets, but requires the elimination of all non-tariff barriers. Third, it establishes a dispute settlement mechanism to avoid unilateral and arbitrary trade actions, these measures reduce the uncertainty faced by firms when they participate in international markets and accelerate their adjustment process to serve the needs of the entire north american market.

Where will the economic benefits of a free trade agreement come from? Further liberalization of markets provides the required incentives to guide production decisions based on the principle of comparative advantage rather than on the basis of artificial trade barriers that shelter firms from foreign competition. Each country will tend to concentrate its production efforts in industries and goods which it can produce more efficiently, leading to greater overall production and lower costs.

Tile reduction in tariff and non-tariff barriers and assured access to a larger potential market for their products give firms an opportunity to spread the total costs of doing business over larger production volumes, thereby reducing average costs and increasing their international competitiveness. In many cases, these benefits can only be achieved if permanent market access is assured through an agreement that eliminates non-tariff barriers.

Declining trade barriers will also tend to promote higher rates of economic and with them higher levels of domestic spending further increasing the volumes of trade. When Mexico grows, us. Exports to our country will grow at a higher rate.

There is no doubt that the achieved trade liberalization that has been taken place within the framework of NAFTA has additional advantages in terms of providing an effective mechanism to overcome trade barriers to our exports. It will undoubtedly promote further adjustment of mexican producers of the types already discussed, but this time not only to face a more competitive environment but rather to take advantage of the increased size of the potential market for our products without the risk of facing restrictions on market access.

The success of NAFTA in promoting a larger flow of goods and services within the area will certainly improve Mexico's economic prospects, contributing to higher standards of living for our population and with them, greater opportunities to import from the rest of the world.

Thank you