
10 Fortress or Free Market? NAFTA and its Implications for the Pacific Rim

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Introduction

When the Canada-US Free Trade Agreement (FTA) was signed in the second half of 1987 and implemented in January 1989, a Canada-US-Mexico free-trade accord was not even considered a remote possibility. The announcement in June 1990 by Mexican President Salinas de Gortari and US President Bush of their intention to begin discussions on a bilateral Mexico-US free-trade agreement forced the Canadian Government to decide whether or not it wanted to participate in a new round of trade talks. With an affirmative Canadian decision accepted by the United States and Mexico, the three countries began discussions in mid-1991 to create a North American Free Trade Agreement (NAFTA).

State initiatives, such as the NAFTA negotiations and bilateral US trade accords with Canada and Mexico, are one critical factor shaping the evolution of an increasingly North American political economy. The other is the changing realities of global investment patterns which have over the last decade seen many multinational enterprises (MNEs) begin to organise production on a continental basis, and a concomitant rise in the levels of direct investment by MNEs in production facilities in Mexico.

These state and market forces are examined in this chapter through an exploration of the rationales behind government moves towards regional trading blocs in general, and the impact these state policies are having on how multinationals organise for production within and between these blocs. We are also interested in the effects that technological change, in particular the shift to 'lean production' techniques, is having on MNE locational patterns in North America. Investment decisions by Asian MNEs, particularly those from Japan, over the last decade have been

responsive to these same state and market forces. Asia-Pacific trade with and investment in North America are of significance to all three parties to NAFTA, and Asian firms consider these North American investments as crucial components of their globalisation strategies. As the three North American political economies negotiate to institutionalise the growing integration among their economies, Pacific Rim traders and investors have reason to be cautious about the impact of a NAFTA on their future trade and investment opportunities.

A North American regional trading bloc

Strong multilateral institutions are in the interest of all countries concerned about the stability of the global economy. For over three decades the General Agreement on Tariffs and Trade (GATT) was successful in promoting tariff reductions, thereby increasing international trade. The very successes of multilateral tariff negotiations generated tensions in an organisation insufficiently equipped to handle expanding global trade and the inevitable national adjustment pressures that resulted. An increase in membership and a more complex agenda now focused primarily on non-tariff issues have brought international trade negotiations to a point of uncertainty. Moreover, the globalisation of production and the growing importance of trade between related companies have reduced the relevance of GATT. The difficulties of launching the Uruguay Round of GATT talks turned out to be but a precursor of the problems that resulted in their failure to conclude any agreements well into 1992.

Frustration with the complexities of attaining agreement among so many members on a wide range of issues has prompted many states to seek alternative ways outside the global trading system to promote their individual and collective economic interests. In addition, the perception that other states are not playing by GATT rules encourages regionalism as a way of increasing leverage against these free riders. Regional, including bilateral trading arrangements are but one of these strategies, and some states are moving to ensure a position for themselves within trading blocs: the United States by negotiating the FTA with Canada, and now NAFTA with Mexico and Canada; the European Community (EC) by intensifying the integration process through the reduction of border controls and the mutual recognition of national legislation; the members of the European Free Trade Association (EFTA) by seeking EC membership; and Japan by establishing subsidiaries in many East Asian countries as well as in the other two blocs.

Regional trading agreements provide many of the advantages of the multilateral trading system. Moreover, they may be easier to negotiate, and may encompass issues that have not been resolved at the global level; for example, the FTA addresses investment and service issues that have not yet been the subject of broader international accords. The difficulties

of the Uruguay Round, particularly when contrasted with the relative success of regional blocs, may simply reinforce the attractiveness of these regional entities.

Jeffrey Schott defines a trading bloc as 'an association of countries that reduces intra-regional barriers to trade in goods (and sometimes services, investment and capital as well)' (Schott 1991, p. 1). Despite significant differences in the level of economic development between Mexico and the other two NAFTA participants, Schott suggests that North America meets the other three criteria he identifies as requisites for a 'successful' trading bloc: geographic proximity; similar or compatible trading regimes; and political commitment to regional organisation (Schott 1991, pp. 2, 7–10). Although large, crossborder income disparities are likely to create difficulties both during and after the NAFTA negotiations because 'producers in the richer countries are inevitably seen as swamping those in the poorer countries' (Schott 1991, p. 2), Mexico's trade regime since 1986 has become quite similar to that of Canada and the United States, thus facilitating regional integration.¹

Intra-North American trade and investment patterns

What exists in North America is a pair of bilateral trading partners characterised by the asymmetric dependence of one party in each dyad on the United States. Elsewhere (Eden & Molot 1991, 1992; Cameron et al. 1992) we have documented the 'hub-and-spoke' nature of the trade and investment linkages among the three North American economies. The pattern of intra-North American trade is shown in Figure 10.1 using 1988 data.

The United States is the hub—the major trading partner—absorbing roughly 70 per cent of merchandise exports from the two 'spokes', Canada and Mexico. The United States in turn, sells about 20 per cent of its exports to Canada and 6 per cent to Mexico. Mexico and Canada trade very little with each other: Canada may rank sixth among Mexico's trade partners but each country's exports account for less than 5 per cent of the other's imports.

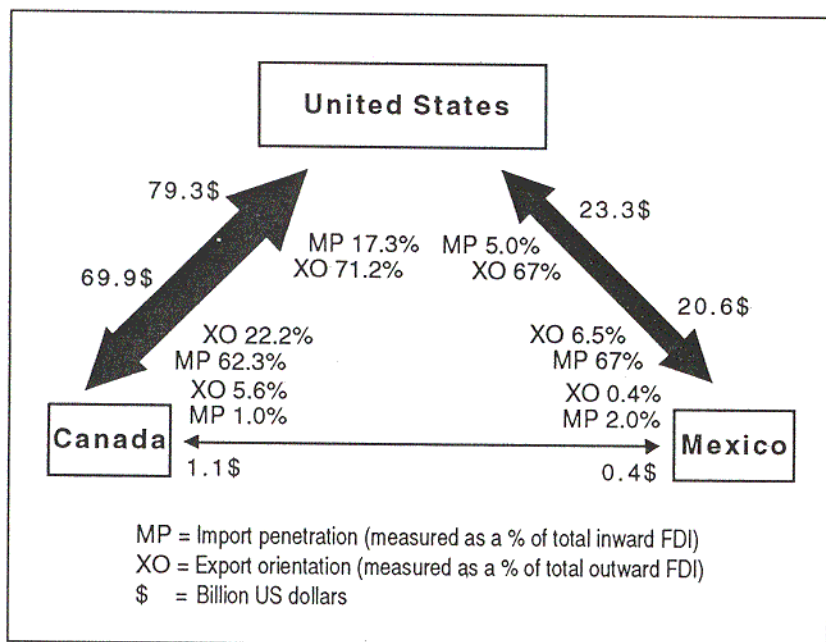
Despite recent efforts to stimulate Mexico–Canada economic linkages, the increase in trade since 1989 has been one way, that is, a rise in Mexican exports to Canada: these increased by 23 per cent in 1989 (External Affairs 1991). In 1990 the trade balance in Mexico's favour grew as Canadian exports to Mexico fell by 4.2 per cent (Fagan 1992, p. A1); Canadian exports to Mexico fell again in 1991.² Moreover, Mexico

¹ See, however, Helleiner (1990) for a less sanguine view.

² The explanation for the decline in Canadian exports to Mexico in 1991 is in part due to a glut in the world sulphur market. Given the concentration of Canadian exports to Mexico in products such as raw materials and agriculture, which are subject to dramatic price fluctuations, the Canadian Government

exports a higher percentage of fully manufactured goods to Canada (69 per cent of exports) than Canada does to Mexico (24 per cent).

Figure 10.1 Intra-North American trade 1988 (\$US billion)



The composition of intra-North American trade in 1987 is shown in Table 10.1 and illustrated in Figure 10.2, using an economic grouping developed by Magun (1991). Canadian exports to Mexico consist primarily of raw materials, agricultural products and machinery and transport equipment (MTE), while Mexican exports are almost entirely in the MTE sector. Canada-US trade is also heavily dominated by this sector, as is US-Mexico trade.

One method for examining intra-North American trade relationships is the index of revealed comparative advantage (RCA) (Vollrath 1985, pp. 12-13). The RCA index measures the relative comparative advantage country *i* has in a particular commodity *h*, compared with countries *j* and *k*. An index over 1 implies country *i* has an RCA in exporting commodity *h*; an index below 1 indicates a comparative disadvantage in exporting the

hopes that Canada's exports to Mexico will move from commodity-based goods to manufacturing (Scotton 1991, p. 6). For an article critical of the composition of Canadian exports to Mexico see Godfrey (1992, p. 9) who entitles his article 'Mexico or Canada: which is developed?'

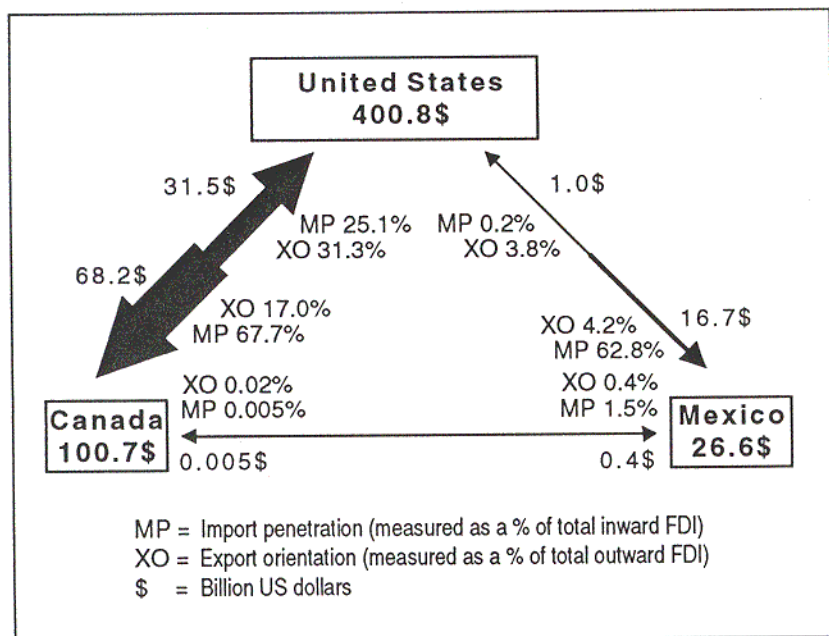
commodity. Indexes over 1 thus indicate areas of trading strength for a country; indexes below 1 areas of weakness. RCA indexes should be treated cautiously, however, since they measure *actual* comparative advantage as distorted by trade and other barriers rather than underlying competitiveness. In addition, they tell us very little about *future* competitiveness. A clearer measure than RCA would perhaps be a measure of current export specialisation.

Table 10.1 The structure of intra-North American trade 1987 (\$US billions and percentage distribution)

Direction of trade Categories	from Canada to Mexico	from Mexico to Canada	from Canada to the US	from the US to Canada	from Mexico to the US	from the US to Mexico
1. Mineral fuels, lubricants and related products	0.001 0.33%	0.108 12.3%	8.614 11.6%	1.448 2.8%	4.056 19.8%	0.698 4.5%
2. Agricultural products	0.203 48.6%	0.087 9.9%	12.696 17.0%	3.902 7.5%	2.393 11.7%	1.609 10.4%
3. Resource-intensive manufactured goods	0.064 15.4%	0.033 3.7%	10.671 14.3%	3.798 7.3%	1.798 8.8%	1.227 7.9%
4. Labour-intensive manufactured products	0.004 1.0%	0.033 3.7%	1.501 2.0%	1.516 2.9%	0.845 4.1%	0.889 5.8%
5. Chemicals and related products	0.007 1.6%	0.011 1.3%	3.209 4.3%	3.246 6.3%	0.416 2.0%	1.425 9.2%
6. Machinery and transport equipment	0.132 31.7%	0.568 64.4%	34.783 46.6%	33.773 65.3%	8.716 42.5%	7.737 50.1%
7. Miscellaneous manufactured equipment	0.006 1.3%	0.042 4.8%	3.096 4.2%	4.041 7.8%	2.294 11.2%	1.855 12.0%
Total Exports	0.417	0.882	74.572	51.726	20.523	15.452

Source: Magun (1991, p. 6).

Figure 10.2 Structure of intra-North American trade 1987



The RCA index is here defined relative to the other two North American trading partners. While normally one would calculate RCAs by summing exports over all countries in the world, due to data constraints we simply sum over the three countries in the North American triad.³ Thus our index of revealed comparative advantage judges the comparative advantage of one of the three countries relative to the other two partners. The formula for the RCA index is:

$$RCA_{i^h} = \frac{X_i^h / [X_i^h + X_j^h + X_k^h]}{X_i / [X_i + X_j + X_k]} \quad (1)$$

where X is the dollar value of exports, i , j and k are countries, and h the commodity. The RCA of country i in commodity h is defined as the ratio of two fractions. The first is country i 's exports of h as a percentage of all countries' exports of h ; the second is country i 's total exports as a percentage of total exports of all countries.

Table 10.2 calculates 1987 indexes of revealed comparative advantage for the three countries in terms of total merchandise exports based on the data in Table 10.1. An index over 100 shows the country has an intra-North American RCA in this category; an index below 100 shows a com-

³ The term 'triad' is used by Ohmae (1985).

parative disadvantage. Canada's RCA lies in the first three categories: fuels, agricultural products and resource-intensive manufactures; Mexico's in labour-intensive manufactures and miscellaneous manufactured goods; while the United States' RCA is highest in the more finished manufactured products, categories 4 through 7. In terms of the MTE sector, the US dominates with an RCA of 117.9, compared to RCAs in the 80s range for Canada and Mexico.

Table 10.2 Indexes of intra-North American revealed comparative advantage 1987

	Canadian revealed comparative advantage	Mexican revealed comparative advantage	US revealed comparative advantage
1. Mineral fuels, lubricants, and related products	125.8	213.3	35.0
2. Agricultural products	134.7	90.7	64.2
3. Resource-intensive manufactured products	133.1	79.5	69.6
4. Labour-intensive manufactured products	68.4	139.8	122.5
5. Chemicals and related products	84.4	39.2	136.8
6. Machinery and transport equipment	88.9	82.8	117.9
7. Miscellaneous manufactured equipment	59.7	157.5	126.6

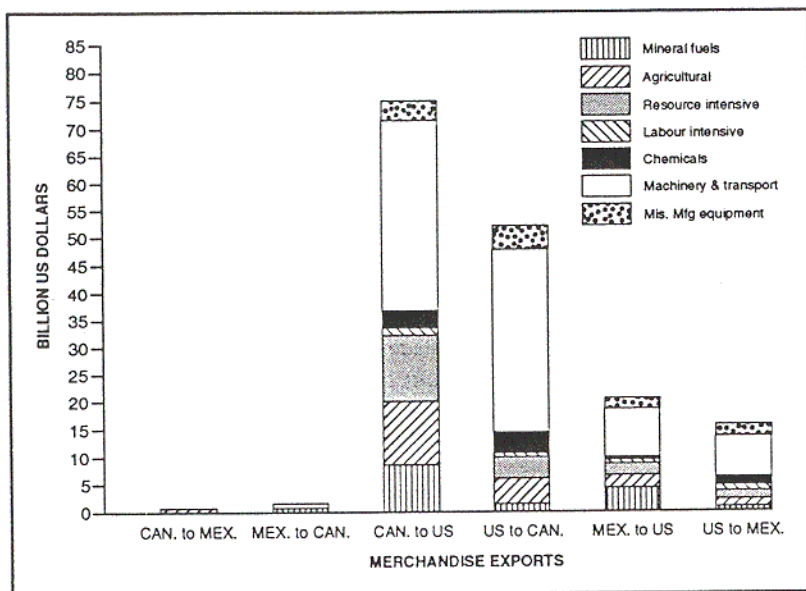
Source: Calculated using data from Table 10.1

Although trade is obviously important in linking the three economies, the above noted statistics illustrate the uneven character of trade concentration. What is equally as important in the building of ties among Canada, the United States and Mexico is investment. Indeed, it is from this investment by multinational corporations that much of the bilateral trade is generated. In the contemporary global economy, trade and investment are complementary and cannot be separated.

The distribution of the stock of intra-North American foreign direct investment (FDI) is smaller but similar in direction to that of trade flows. The pattern of intra-North American FDI is illustrated in Figure 10.3. Approximately two-thirds of FDI in Canada and Mexico is controlled by US multinationals. The majority of the now over 1900 (Gereffi 1991a) maquila firms are owned by US multinational corporations and medium-

sized US companies. At least 57 of the Fortune 500 largest US corporations have maquila plants, including the 'Big 3' US automobile producers and the major players in the consumer electronics industry. General Motors is now the largest employer in Mexico (SCEAIT 1990, p. 32).

Figure 10.3 Intra-North American investment 1989—stock of foreign direct investment (\$US billion)



Canadians control about 25 per cent of FDI in the United States. In contrast is the level of Canadian FDI in Mexico which historically has been limited, and now is about \$US400 million. This comprises 1.5 per cent of total FDI in Mexico, and places Canada seventeenth among countries with investments in Mexico.⁴ In contrast to the huge numbers of US-owned maquila firms stands the less than a dozen such Canadian-owned companies, primarily in the automobile parts industry. There are also approximately 160 Canadian joint ventures in Mexico (Fagan 1990, p. B5).

⁴ Four reasons can be given for the lack of Canadian investment in Mexico: (a) general lack of interest on the part of many Canadian-owned firms in outward FDI, except perhaps in the United States; (b) the lack of an FDI mandate for subsidiaries located in Canada; (c) distance between Canada and Mexico and therefore trans-shipment costs; and (d) the lack of Canadian provisions comparable to US tariff items 806 and 807.

In sum, the dependence of both Canada and Mexico on the US market and on US investment, and the limited nature of the economic ties between them clearly demonstrates both the hub-and-spoke nature of economic linkages with North America and the basis for an emerging trading bloc. In a global economy in which trading blocs are becoming critical, all three countries in North America have an interest in creating a trading unit which will enhance their economic opportunities. NAFTA would be larger in size, population and gross domestic product than the EC of the twelve.⁵ However, unlike the EC, as we have illustrated in Figure 10.1, a North American trade and investment bloc would be dominated by the hegemon at its centre (Wilkinson 1991).

North American trade policies

The two pairs of 'hub-and-spoke' economic linkages analysed in the previous paragraphs have evolved without many formal agreements. Though there was periodic interest on Canada's part in the negotiation of free-trade agreements with the US, the last of which occurred in 1947⁶, for the most part the two countries eschewed formal arrangements and the establishment of bilateral institutions (Molot 1974). Reasonably regular consultations at the official and political levels were for the most part seen as sufficient to maintain the increasingly complex economic relationship. Exceptions to the reluctance to negotiate formal agreements are the Trade Agreements of 1935 and 1937, the Hyde Park Agreement of 1941, the Defense Production Sharing Agreements of 1958–63, and the Auto Pact of 1965. The US–Canada economic relationship has been structured historically by the Canadian tariff (which made it attractive for US manufacturers to invest in Canada to serve the Canadian market), by the interest of US MNEs in Canadian resources, and by US and Canadian participation in the GATT.

Formal US–Mexican agreements are primarily a phenomenon of the 1980s.⁷ Although there was a reciprocal trade agreement signed in 1942, it lapsed in 1950. The United States actively supported Mexican accession to the GATT both in 1979 and in 1986. The two countries signed a trade agreement in 1985 and two additional ones in 1987 and 1989 to promote consultation on and the resolution of trade disputes. Of far greater importance in promoting the development of bilateral US–Mexican economic

⁵ The relevant comparable figures are:

	NAFTA	EC (of twelve)
size	21 m sq k.	2.25 m sq k.
population	355 million	324 million
GDP	\$5 trillion	\$4.15 trillion

Source: World Bank 1989 (cited in Schott 1989b, p. 1).

⁶ Hart (1989) discusses the 1947 Canada–US trade negotiations.

⁷ This paragraph and the one following are based primarily on information contained in Hart (1990, pp. 62–4).

ties have been two US trade policies: the GSP (generalised system of preferences) adopted in 1976, and 1961 changes to US tariff regulations to permit the re-import into the US duty-free of US-made components sent abroad for assembly. Though Mexico is the fourth greatest beneficiary of the US GSP, it uses this system far less than do other states to promote their exports to the United States. It is tariff items 806 and 807 which lured US MNEs to locate in Mexico in the 1970s and 1980s. These tariff preferences form the basis for the close trade and investment ties between the two economies.⁸

Although both the United States and Canada continue to be supporters of the international trading regime, both are now advocates of a North American trading arrangement. The reasons for this US policy orientation lie in frustration with the complexities of multilateral trade negotiations, already noted, and in concerns about the economic and political stability of its southern neighbour (Morici 1991; Weintraub 1990a, 1990b). Worries about the international competitiveness of US firms relative, in particular, to Japanese multinationals have also prompted US policy-makers to pursue a freer investment climate in Mexico. Lastly, NAFTA may be one step in the building of President Bush's plan for an 'Enterprise of the Americas', that is, a broader and deeper economic bloc centred on the United States that includes countries from both North and South America.

NAFTA is seen by the Canadian Government as a way to preserve and enhance the gains won in the FTA (External Affairs 1991). While concerns that NAFTA talks could lead to a reopening of this agreement and to the loss of hard-earned gains in the FTA were deterrents to Canada's participation in the talks, fear of not having a 'seat at the table' was the primary motivation behind its entry. The gains to Canada are expected to be small, and primarily in the form of Canadian exports to an expanding Mexican market (Investment Canada 1990; Eden & Molot 1991, 1992; Cameron et al. 1992; Molot 1991).

NAFTA is seen by the Mexican Government as the avenue to consolidate its economic liberalisation policies through guaranteed access to the United States, its most important export market (Bueno 1988; Weintraub 1990a, 1990b, 1990c). Mexican worries about trade diversion as a result of the first step in institutionalising the North American trading bloc, namely the FTA, was one of the major factors prompting Mexican President Salinas to propose a bilateral Mexico-US trading arrangement. Like Canada, securing and enhancing unrestricted market access to the United States was the major consideration in Mexico's free-trade calculus,

⁸ The US 806 and 807 tariff preferences levy US duties only on the difference between the value of goods imported from developing countries after subtracting US input costs. Thus US multinationals were encouraged to shift sub-assembly functions to maquiladora plants in the Mexican export processing zones.

since Mexico, like Canada, has faced continual and escalating harassment from US firms through countervailing and anti-dumping duty cases (Cameron et al. 1992; Weintraub 1990b). However, unlike Canada, because of its developing country status and deep balance of payments difficulties, Mexico has been particularly anxious to attract inward FDI to trigger its long-promised 'great leap forward' into the status of a middle-income country (Helleiner 1990).

Formal negotiations on NAFTA began in June 1991. Although all three participants anticipated a rapid and successful conclusion to the talks, progress has been slow. There are no real precedents for negotiating a free-trade agreement between developed market economies and one frequently described as a newly industrialising economy (NIE). Domestic US politics, including elections in 1992, and the 1991 recession have dampened expectations that a NAFTA accord can be negotiated quickly⁹; the subjects proving most intractable are agriculture, textiles, energy, automobiles, investment, and a dispute settlement mechanism (*Globe and Mail* 1992, p. B3). A successful conclusion of the Uruguay Round would facilitate completion of the NAFTA talks, since agreements at the multilateral GATT level could be used as a benchmark or floor for negotiations in NAFTA. The difficulties notwithstanding, all three participants remain committed to the establishment of NAFTA.

MNE responses to a North American trading bloc

The impact of regional trading blocs on MNE choices of location is clear. Firms recognise the advantages of proximity to markets, and are aware of the importance of a site within a bloc; many MNEs have moved into Europe in anticipation of 1992, for example. Multinational enterprises in North America resemble their European counterparts, which pressed for the removal of tariff and other barriers in Europe.

There is generally a clear relationship between the degree of firm multinationalisation and its support for freer trade (Milner 1988). Much of the corporate support in both the United States and Canada for first the FTA and now NAFTA comes from firms whose overall operations would be facilitated by the successful negotiation of a regional trading area (Eden & Molot 1991, 1992; Doern & Tomlin 1991). Proximity to markets permits product manufacture for specific tastes as well as innovations in the organisation of production which reduce inventory costs.¹⁰ Another

⁹ See for example a report in the *Financial Post* (Morton 1991, p. 5) which quotes two key members of Congress who are sceptical that a NAFTA pact would either be presented to or passed by Congress in 1992.

¹⁰ The restructuring or reorganisation of production to reduce inventory—known as 'just-in-time' production—has been pioneered by Japanese corporations. In North America its most common expression is in the automobile industry. Other components of this approach to production include zero-defect policies

reason for relocation by some companies in some industries is non-tariff barriers, for example voluntary export restraints (VERs) or other quota arrangements which reduce market access through trade. The location of Japanese automobile producers in the United States can be partly explained by the imposition of VERs in the automobile sector.

The changing nature of technology

The investment activities of large multinational corporations and innovations in the organisation of production generated by technological change are critical components of the global economy. Although the recession has slowed MNE investment activity in the last two years, the late 1980s witnessed a surge of multinational investment as MNEs prepared themselves for the competitive environment of the next decade. According to Sylvia Ostry, 'the value of aggregate OECD investment flows ha[s] more than tripled [since the mid 1980s], vastly outstripping trade growth of less than 5 per cent a year in the same period' (Ostry 1990b, p. 14).

Worldwide sourcing by multinationals

The reasons for the globalisation of production hardly require reiteration here. Suffice it to note that the migration to cheaper labour sites in East Asia and Latin America, which began in the 1960s, continues by MNEs producing consumer goods which were (and remain) labour intensive (Fröbel et al. 1978; Hoffman & Kaplinsky 1988). By 1987, foreign components, frequently from offshore plants, were being used by close to 90 per cent of US manufacturers (Pastor & Castaneda 1989, p. 210).

Many Third World states offer location incentives to multinationals, among them export processing zones (EPZs) into which components can be imported duty-free for purposes of assembly and then export. Mexico's maquiladoras, a form of export processing zone, were established by the Mexican Government in 1966 to encourage diversification of exports away from staple products.¹¹ Mexico, together with some of the East Asian newly industrialising countries (NICs), was on the leading edge of the trend to international sourcing. It is the availability of cheap labour in

and greater worker responsibility. For a discussion of this approach to production as well as its introduction in North America see Hoffman and Kaplinsky (1988, pp. 121–38, 253–65).

¹¹ By the second half of the 1980s the composition of Mexico's exports had changed from a majority based on primary commodities (primarily oil) to a majority comprised of manufactured goods. By 1987, 78 per cent of Mexico's exports of manufactures went to the United States (Schott 1989b, p. 10; Weintraub 1988, pp. 15–16).

the maquila factories that so worries labour unions in the United States and Canada, and is at the root of their opposition to NAFTA.

The internationalisation of production has also altered the basis on which international trade occurs; a growing proportion of trade is no longer arm's length, but is accounted for by the movement of goods among related companies. Trade between affiliated companies, whether intra-firm or other forms of non-arm's length transactions accounts for a significant part of both US-Mexican and US-Canadian trade. Approximately 35 to 40 per cent of Canada-US trade is intra-firm and up to 70 per cent is not at arm's length. While figures for Mexico are difficult to find, a significant percentage of Mexico-US trade is also accounted for by the movement of goods between affiliated companies. According to Weintraub 'because of the extensive trade that takes place between affiliates of the same company in Mexico and the United States, imports and exports have become part of the same process'. This explains why intermediate goods have become so important in Mexico's exports of and overall trade in manufactures: exports of intermediate goods rose from 61 per cent of Mexico's manufactured exports in 1980 to 70 per cent in 1986; imports of intermediate goods were 65 per cent in 1986, up from 57 per cent in 1980 (Weintraub 1988, p. 23). Some Canada-Mexico trade is also in intermediate products, primarily automobile parts, but also some consumer electronics.

The shift to lean production methods

Concomitant with worldwide sourcing, and having the opposite impact on MNE location decisions, is the growing significance of knowledge-based production. There are a number of components to the new production style, among them (i) information technologies such as computer-aided design and manufacture, robotics, telecommunications hardware and software (van Tulder & Junne 1988, p. 8); (ii) just-in-time manufacturing, which comprises demand-driven supply of components, zero-defect quality, and minimisation of downtime (Hoffman & Kaplinsky 1988); and (iii) flexible manufacturing systems which combine the two. Called by some authors 'post-Fordism' or 'systemofacture' (Hoffman & Kaplinsky 1988), and by others 'lean production' (Womack et al. 1990), the new factory is located proximate to its suppliers, accepts only defect-free components, utilises mechanised production technology, can rapidly shift production from one product line to another, and employs a highly skilled and flexible workforce.

As a result of these new techniques, the economics of location are changing. The essence of foreign direct investment by MNEs is foreign production and intra-firm trade. As Eden has argued elsewhere (1991), the location selected for an affiliate depends on the affiliate's role in the 'value chain', the range of activities (such as extraction, processing, sales

and distribution, technology development) performed by the MNE. Affiliates can be classified according to which of three basic motives for foreign direct investment they fulfil: resource-seeking, cost-reducing or market-driven FDI. Each of these three motives reflects one of the underlying primary activities of the multinational: extraction, processing or sales. A resource-seeking affiliate is set up to extract and process raw materials at the upstream end of the value chain; a cost-reducing affiliate to manufacture parts and make sub- and final assemblies; and a market-driven affiliate to sell at the downstream end.

The choice of affiliate location depends on the motive for FDI, the relative attractiveness of various host locations, and the availability/cost of alternative contractual arrangements. Whereas foreign plants in one location (for example, Mexico) may be established in order to access low-cost labour for subassembly, another affiliate may be located in a high-cost location (for example, Canada) to access the local market. The size and value of intra-firm trade and FDI flows are primarily determined by MNE production strategies, but are also constrained by tariff and taxes (Eden 1991).

As long as labour was a significant factor in overall manufacturing costs, MNEs had an incentive to locate in lower-wage countries. With the introduction of the new production processes, the location calculus is different; as a result some MNEs are relocating parts or all of their assembly activities closer to the final demand for the product. In the North American environment the adoption of the new production style may assuage some of the concerns of labour with respect to the loss of manufacturing jobs to lower-wage Mexican factories. More likely, however, because of their location proximate to the US border, Mexican factories are being integrated into just-in-time delivery systems.

In sum, as we move along in the 1990s the way in which multinational corporations are organising for production is becoming more diverse. At the same time as many firms in a variety of industries continue to establish plants at cheaper production sites, others in some of these same industries are relocating in the developed market economies. Indeed, some corporations, for example the Japanese car manufacturers, are adopting both strategies. This discussion of considerations that influence firm location decisions—the economics of location, as well as MNE responses to the growing importance of regional trading blocs—establishes the parameters for our analysis of the implications of NAFTA for the Asia-Pacific.

Implications of NAFTA for the Asia-Pacific

What are the likely implications of the formation of NAFTA for Pacific Rim countries, in particular, the Asian NICs, Japan, Australia and New Zealand? Given the changing dynamics of technology and trade policy, and how these factors are affecting MNE locational decisions in North

America, what are the implications for intra-firm trade and investment patterns with the Pacific Rim? We address five basic issues in this regard: (1) the potential loss by Asian firms of access to the North American market if NAFTA becomes 'Fortress America'; (2) the increased competition Asian MNEs may face with North American firms in global markets; (3) the impact of a larger and deeper NAFTA on MNE location and trade patterns; (4) the potential weakening of the US commitment to multilateralism; and (5) the potential impact on US-Japan relations.

1. The potential loss of market access

The potential loss of access by Asia-Pacific firms to the North American market depends on the degree of trade diversion generated by NAFTA; that is, the extent to which North American consumers and firms switch from buying products made by Asian firms and transplants to buying them from higher priced domestic firms. This will depend primarily on (i) whether Asian products are close substitutes for North American products; (ii) the relative heights of NAFTA member-country tariff and non-tariff barriers against nonmember-country products; and (iii) the volumes of trade with Asian countries. Table 10.3 provides some data on Asia-Pacific trade with North America in 1989, for Australia, New Zealand, Japan and South Korea.

Of the North American economies, these four Asia-Pacific countries trade most heavily with the United States (with shares of exports and imports in the 11 to 33 per cent range), followed by Canada (shares in the 1 to 4 per cent range) and Mexico (under 2 per cent). South Korea and Japan are the two most involved in trade with the United States; both countries sold about 33 per cent of their exports to, and imported about 24 per cent of their imports from, the United States in 1989. Australia and New Zealand rely almost as much on imports from the United States, but are much less export oriented (about 12 per cent compared to 33 per cent). Thus, any changes in North American trade policies should impact more strongly on Japan and South Korea. If NAFTA raises barriers against non-member-country imports, these barriers are likely to reduce Northeast Asian exports to North America more heavily than the Antipodes.

In terms of developing countries in the Asia-Pacific, a recent study by Kim and Weston (1992) looked at the implications of NAFTA for five East Asian less developed countries (LDCs)—China, Indonesia, Malaysia, the Philippines and Thailand, and three East Asian NICs—South Korea, Singapore and Taiwan. Making the assumption that trade diversion was most likely to occur through Mexico as Mexican exports replaced Asian exports, they estimated the amount of lost trade that each Asian country could expect. Using 1986 trade data, they calculated a 'similarity index' for commodities where Mexico faces a 5 per cent or higher US tariff and where Mexican exports currently exceed one million dollars. The highest similarity indices are for Singapore (29.0), followed by Taiwan, Korea and

Table 10.3 Asia-Pacific trade with North America: share of trade with North America, selected countries 1989

	Australia	New Zealand	Japan	South Korea
CANADA				
exports to Canada	\$470.03	\$149.68	\$6 806.93	\$1 882.25
imports from Canada (\$USm)	\$958.50	\$172.61	\$8 335.83	\$1 680.09
Canada export share	1.4%	1.7%	2.5%	3.0%
Canada import share	2.4%	2.0%	4.0%	2.7%
UNITED STATES				
exports to US	\$3 712.62	\$1 166.59	\$93 701.99	\$20 694.32
imports from US (\$USm)	\$9 065.86	\$1 472.97	\$48 457.44	\$15 903.79
US export share	11.2%	13.2%	34.1%	33.2%
US import share	22.7%	16.8%	23.4%	25.9%
MEXICO				
exports to Mexico	\$30.06	\$124.31	\$1 907.68	\$461.83
imports from Mexico (\$USm)	\$75.63	\$20.80	\$1 729.88	\$163.36
Mexico export share	0.1%	1.4%	0.7%	0.7%
Mexico import share	0.2%	0.2%	0.8%	0.3%
WORLD				
exports to World	\$33 204.87	\$8 830.52	\$275 039.71	\$62 283.35
imports from World (\$USm)	\$39 869.09	\$8 756.59	\$207 356.18	\$61 347.46

Note: Country X Export Share is the percentage of total exports from Asia-Pacific country Y that is exported to North American country X; Country X Import Share is the percentage of total imports by Asia-Pacific country Y that is imported from North American country X.

Source: Authors' calculations based on data from the 1989 United Nations International Trade Statistics Yearbook (1991).

Malaysia (all about 20.0), with the remaining indices being lower. Next the authors calculated a 'trade diversion risk index' which measures the share of each country's exports to the United States in these overlapping categories. China, South Korea and Taiwan all have trade diversion risk indices of around 25 per cent. Multiplying these two indices produces an 'impact coverage index' which estimates the portion of each country's

exports to the United States that could be captured by Mexican exporters; this ranges from a low of 0.4 for Indonesia to a high of 5.3 to 5.8 for South Korea¹² and Taiwan. The authors concluded that trade diversion may be larger for the East Asian tigers than for the 'cubs'. It should be noted that using 1986 data may underestimate the trade diversionary effects if Asian export patterns since 1986 have grown more similar to Mexican ones.

However, access to the North American market is not only via exports from the Asia-Pacific, but also through production by Asian transplants in North America. As we have argued above, Asian multinationals have set up plants in all three countries, primarily designed to access the US market. The establishment of Japanese and Korean automotive assembly plants in Canada is the most obvious example of this strategy. Through the FTA, Asian plants in Canada have had substantially tariff-free access to the US market since 1989. In addition, the duty-drawback system in place in Canada allowed automotive transplants to import parts from their Asian parents duty-free. (This latter programme is, however, being phased out under the FTA.) Similarly, through the Mexican maquiladoras programme (which also has a duty-drawback system), and the 806/807 and GSP US tariff laws, Asian transplants in Mexico have had ready access to the US market.

Trade diversion as a result of a NAFTA would depend on the tightness of the domestic content legislation—the rules of origin—and how the Mexican maquiladora duty-drawback programme is treated. Signs suggest that both the US and Canada want to limit the potential for Mexico to be used as a back door for Asian firms to enter their markets; hence, the content rules of a NAFTA are likely to be stringent unless the Asia-Pacific countries are able to lobby successfully to prevent this (*Far Eastern Economic Review* 11 July 1991, pp. 42–6; Kim & Weston 1992, pp. 8–11; *JEI Report* 1991).

2. NAFTA and the Asia-Pacific as competitors

The second issue that arises for the Pacific Rim in connection with NAFTA is the extent to which NAFTA could act as a competitor with the Asia-Pacific in terms of trade and investment flows. It is clear that policy-makers and firms in all three countries do see NAFTA as the way to increase their global competitiveness through reaping the economies of scale from a larger, more integrated market, and from shifting low-skilled labour production to Mexico, thus intensifying the co-production role Mexico plays for multinationals in North America (Weintraub 1990a, 1990b; Morici 1991). All three countries are international debtors and see trade, both internally and externally, as a way to reduce their debt burdens.

¹² For another argument on the trade diversion impact on South Korea of additional free-trade areas involving the United States, see Park and Yoo (1989).

Thus, NAFTA reinforces the existing locational attractions to multinationals of a continental production strategy linking low-cost labour sites in Mexico with the research and development stage in the United States, and final assembly in the United States and Canada. Once again, the automotive industry is the prime example. Investment rationales for NAFTA thus dominate trade motivations for US multinationals. Substantial rationalisation of production on a continental basis, however, raises fears of job losses and runaway plants in the minds of the Canadian and United States publics, fears that politicians in an election year in the United States are apt to exploit.

To the extent that North American MNEs become stronger competitors, this affects Asia-Pacific trade in three ways: first by reducing Asia-Pacific exports to North America; second by increasing the competitiveness of North American exports to the Asia-Pacific; and third in terms of increased North American competition in third-country markets. The competition is not just in terms of trade, however; competition for investment increases because North America, and particularly Mexico, would become a more attractive investment location if the content rules are not too stringent.

3. *Deepening and expanding NAFTA*

The third implication for the Pacific Rim is the potential effects of NAFTA subsequently growing and deepening. It is not clear whether NAFTA will include an accession clause, but already several Latin American countries (for example, Chile) have announced their interest in becoming NAFTA members. The United States has a clear, long-run interest in the extension of a regional trading bloc to Latin America, as a way of fostering its economic and political hegemony in the region.

Accession through additional bilateral agreements with the United States versus joining a trilateral NAFTA pact has differing implications for new members, the US hub, and for nonmembers such as the Asia-Pacific countries (Wonnacott 1990). Whether new members would be able to influence the terms of their entry remains to be seen; although Mexico is clearly redefining and opening the Canada-US free-trade agreement, it is not clear that a fourth country would be allowed this flexibility, unless it negotiated a bilateral treaty with the United States alone. Whether Asia-Pacific countries, in particular Australia and New Zealand, should approach the United States for admission to NAFTA, and whether they would be admitted, are difficult issues. The United States is unlikely to be willing to allow the entry of the Asian NICs to NAFTA, since they are already seen as aggressive users of non-tariff barriers and are being pressured to graduate from the generalised system of tariff preferences the United States offers developing countries.¹³

¹³ Korea and Taiwan, in fact, were graduated from the US GSP in 1988.

The issue of the deepening of NAFTA over time is also of consequence for Pacific Rim countries. Since the agreement will be more than a simple free-trade area that eliminates intra-regional tariff barriers, the question is whether such a pact sets forces in motion that will lead to deeper economic and political cooperation among the three countries, for example, to pressures for a customs union with a common external tariff, improved exchange rate coordination with the Canadian dollar and peso pegged to the US dollar, harmonisation of social policies and environmental standards. If NAFTA deepens, this 'ups the ante' in terms of new members joining later in the game, imposing more stringent terms and more adjustment costs on newer partners.

4. NAFTA and multilateralism

A fourth potential impact of NAFTA concerns the commitment by the three countries to multilateralism. Even if success in the Uruguay Round is deemed to have been achieved (and the signatories are likely to argue that it has), the gains are likely to be small. Does a weak outcome in this GATT round mean that the trend to regional blocs will be strengthened? As John Ruggie (this volume) argues, the 'either/or' view of multilateralism versus regionalism is a false dichotomy; regionalism can complement multilateralism. Some authors fear that the NAFTA pact will be the last nail in the GATT's coffin; others like Ruggie and Weintraub (1990b) see possible ways that regional blocs can complement and reinforce the trend to multilateralism. The rules and the wording embedded in the NAFTA documents, that is, whether they are fully consistent with GATT Article xxiv on preferential trading areas, are crucial determinants of whether regionalism and multilateralism are complementary or competitive policy options.

For Canada and Mexico, however, Helleiner (1990) and Wilkinson (1991) argue that small countries are better off under a multilateral approach because multilateralism offers a way to constrain the behaviour of large, potentially opportunistic players like the United States. In a bilateral or trilateral situation, these authors fear that the United States can exploit, and has already exploited in the FTA negotiations, its bargaining power to extract larger concessions from the smaller players.¹⁴

¹⁴ Helleiner (1990, pp. 15, 17) argues that bilateral bargaining in the FTA did not get Canadian firms protection from US non-tariff measures, nor solve export subsidy issues; the two items most important to Canada. In addition, the United States appears to be interpreting the Canada-US dispute settlement mechanisms very narrowly and opportunistically (witness the recent pork dispute). Overall, he concludes that US concessions have been disappointing. At the same time, he concludes that Canadian concessions, such as more liberalised access for US investors and a services agreement, were required as side payments in order to induce the United States to sign the FTA. Thus, the larger country extracted, on net, higher payments from the smaller country.

There is also a fear that the United States is now less committed to multilateralism. If the Gephardt letter to the US President (Gephardt et al. 1991) is any indication, clearly some members of Congress prefer a 'Fortress North America' approach to unrestricted international trade and investment. Whether the US executive branch can constrain the protectionist thrusts of the Congress in an election year is not clear. Again the content rules built into the NAFTA documents will be crucial components demonstrating the US commitment to multilateralism. Since 28 per cent of NAFTA trade is with Pacific Rim countries, compared to 36 per cent internal NAFTA trade, clearly NAFTA members have an incentive to maintain an open door with their Pacific Rim trading partners (Schott 1991).

5. *NAFTA and US-Japanese relations*

Lastly is the issue of the impact of NAFTA on US-Japan economic and political relations. Japanese firms, particularly automotive and electronics multinationals, have been heavy investors in Mexico in recent years (Szekely (ed.) 1991; Szekely & Wyman 1988). Intense global competition in automobiles and consumer electronics has prompted the location of Japanese plants in Mexico to take advantage of lower labour costs as well as proximity to the United States. Japan now ranks as Mexico's largest trading partner after the US, and fourth as a source of foreign investment.

Japanese FDI in Mexico, in both the maquiladoras and outside them, totalled close to \$1.5 billion in 1989 (Szekely (ed.) 1991, p. 117, Table A-6; Investment Canada 1991, Table 9, p. 37).¹⁵ Thirty-three (of 111) Japanese corporations on the Fortune 500 list have investments in Mexico (Szekely (ed.) 1991, p. vii). Japanese MNEs have located in Mexico to serve what they perceive as the growing Mexican market, but more importantly to use Mexico as an export platform for the United States. Szekely and Wyman argue that 'the United States has replaced the Mexican market as the chief target for Japanese producers expanding their operations in Mexico' (Szekely & Wyman 1988, p. 181). Maquila plants supply components to Japanese industries located in the United States as well as finished goods. Moreover, maquila exports can circumvent US voluntary export restraints on exports from Japan. By 1990 there were more than 70 Japanese maquila firms, up from only eight in 1980 (Szekely (ed.) 1991, p. 121). Many of these Japanese corporations, in the maquiladoras and outside them, began their operations in Mexico during the 1980s, when the Mexican economy was in deep depression. Szekely suggests that Japanese investors found the combination of cheap Mexican labour, an appreciating Japanese yen, and growing US demand 'difficult to ignore' (Szekely (ed.) 1991, p. xi). Although Mexico has thus far pur-

¹⁵ For a detailed analysis of the Japanese manufacturing firms in Mexico see Szekely (ed.) (1991).

chased its capital goods and services from the US, more attractive Japanese capital goods and services might well mean a shift in the orientation of Mexican preferences. Morici argues that Japanese MNEs, with their access to skilled labour, capital and technology, may be in a 'better position to exploit new opportunities in Mexico than US and Canadian MNCs' following the conclusion of a NAFTA (Morici 1991, p. 7).

The maquiladoras and Japanese investments in these in-bond factories are contentious issues in the NAFTA negotiations. Already the FTA is being used against Japanese transplants in Canada. The current dispute over whether Honda Civics are North American or Japanese cars demonstrates the United States' willingness to use tighter definitions of domestic content to enforce greater use of local automotive parts production (*JEI Report* 1991, p. 6). The increased vigilance of the Internal Revenue Service in terms of tax payments by Japanese transplants also shows this, as did the recent trip of George Bush to Japan asking for more sales of US-made cars in Japan. The pressure for tighter domestic content legislation is clearly aimed at 'closing the back door'; that is, at preventing Asian manufacturers, particularly from Japan, from using Mexico as an export base. The 50 per cent Canada-US content rule under the FTA is widely expected to be raised to 60 per cent North American content for NAFTA (*Far Eastern Economic Review* 11 July 1991, pp. 42-6).

To the extent that NAFTA is seen by the Japanese as the creation of a fortress designed to keep out its products, it is possible that Japan will respond by intensifying its own trade and investment co-production linkages with the Asian NICs. Schott notes that since 1985 Japanese trade with East Asia has grown twice as fast as that with North America (Schott 1991, p. 12); Japanese investment in East Asia has also increased considerably in recent years. Morici (1991, p. 96) suggests that Japan already has access to East Asian markets through the distribution networks of Japanese *keiretsu* in a way that US and Canadian MNEs cannot replicate in NAFTA.

In the eyes of some, Japanese trade and investment patterns have led to the creation of a *de facto* East Asian trading bloc (Schott 1991, p. 11). The explicit formation of an Asia-Pacific regional economic bloc led by a Japanese regional hegemon is not now on the cards—nor is it part of the plans for Asia Pacific Economic Cooperation—but perceptions of 'Fortress North America' would clearly encourage such a development. A failure of the Uruguay Round and the subsequent protectionist pressures such a failure would likely unleash would also be factors hastening the development of an Asian trade bloc under Japanese leadership.

In summary, given the changing dynamics of technology and trade policies in North America, we argue there are at least five areas that should be of concern to policy-makers in the Asia-Pacific: access to the North American market; increased competition with North America; broadening and deepening of NAFTA; the impact on multilateralism; and

US-Japan relations. Each of these issues poses political and economic problems and opportunities.

The implications of NAFTA for the Pacific Rim, therefore, depend very much on the ability of the Pacific Rim countries to make their views known during the NAFTA negotiation process. In order to avoid the opportunistic view that 'the party without a seat at the table is always wrong', it is essential that the Asia-Pacific countries lobby against high domestic content legislation, for example, and for continued North American support for multilateralism.

Conclusions

The international production activities of large MNEs are a critical factor explaining the direction and size of trade and investment patterns among the North American economies. Their location of foreign plants, either as horizontal competitors or as vertical complementary factories, is the key to understanding MNE pressures for NAFTA, and the likely responses once NAFTA is introduced.

Given the close connections among affiliates of the same MNE family, it is not surprising that FDI and intra-firm trade flows have been silently integrating the three North American economies. Nor is it surprising that American MNEs are generally in favour of NAFTA since there is a clear relationship between the degree of firm multinationalisation and its support for freer trade. Much of the corporate support in both the United States and Canada for first the FTA and now NAFTA comes from MNEs whose overall operations would be enhanced by the successful negotiation of a regional trading arrangement.

Investment decisions by Asian multinationals have been responsive to these same state and market forces. What we see is that corporations have little location commitment and continuously examine location decisions in terms of competitiveness and market access. It is these factors which have determined and will continue to determine MNE location strategies as the largest firms become increasingly global players.

As Canada, the United States and Mexico negotiate to institutionalise the growing integration among their three economies, Pacific Rim policy-makers and multinationals have reason to be cautious about the impact of a NAFTA on their future trade and investment opportunities.