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# NORTH AMERICAN FREE TRADE

## PROCEEDINGS OF A CONFERENCE

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# Contents


Preface. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . v

About the Presenters. . . . . . . . . . . . . . . . . . . . . . . . . vii

Session One—Evidence from Computable General Equilibrium Models

*Canada's Role in an Integrated North American Economy: Thoughts and Evidence.* . . . . . . . . . . . . . . . . . . . . 3
Steven Globerman, Simon Fraser University and the Fraser Institute

*Proposal for a North American Regional Development Bank and Adjustment Fund.* . . . . . . . . . . . . . . . . . . . . 15
Albert Fishlow, Sherman Robinson, and Raul Hinojosa-Ojeda
Institute for International Studies,
University of California at Berkeley

*A Dynamic Dual Model of the Free Trade Agreement.* . . . . . . . . . . . 25
Leslie Young, University of Texas at Austin
Jose Romero, El Colegio de Mexico A.C.

*Trade Liberalization in a Multinational-Dominated Industry: A Theoretical and Applied General Equilibrium Analysis.* . . . . . . . 39
Linda Hunter, San Diego State University
James R. Markusen, University of Colorado
Thomas F. Rutherford, University of Western Ontario

Session Two—North American Free Trade and the Texas Economy: Overall Effects

*Preliminary Results: The Impact of a Free Trade Agreement with Mexico on Texas* . . . . . . . . . . . . . . . . . . . . . 45
Timothy K. Armstrong, Eva DeLuna-Castro, Matthew C. Witosky,
Professor Sidney Weintraub, and Professor Leigh Boske
Lyndon B. Johnson School of Public Affairs,
University of Texas at Austin

*Texas Under Free Trade: Some Sectoral, Regional, and Modeling Considerations* . . . . . . . . . . . . . . . . . . . 53
Chandler Stolp, Lyndon B. Johnson School of Public Affairs,
University of Texas at Austin
Jon Hockenyos, Texas Perspectives, Inc., Austin, Texas

*Environmental Protection: A New Trade Issue* . . . . . . . . . . . . . 67
Jan Gilbreath Rich, Lyndon B. Johnson School of Public Affairs,
University of Texas at Austin

Session Three—North American Free Trade and the Texas Economy: Border Effects

*Implications of North American Free Trade for Infrastructure and Migration on the Texas-Mexico Border* . . . . . . . . . . . . . .75
Steven L. Cobb and David J. Molina
Center for Inter-American Studies and Research, Department of Economics, University of North Texas

*Implications of a North American Free Trade Agreement for the Border* . . . . . . . . . . . . . . . . . . . . . . . . . . . . . .91
Donald A. Michie, Institute of Manufacturing and Materials Management, University of Texas at El Paso

*The Impact of a North American Free Trade Agreement on the Maquiladora Industry* . . . . . . . . . . . . . . . . . . . . . . 95
Elsie L. Echeverri-Carroll, University of Texas at Austin

Session Four—The Political Economics of a Free Trade Agreement: Politics and Policies

*The Domestic Politics of Mexican Trade Policy* . . . . . . . . . . . . . 103
Sylvia Maxfield, Yale University

*Real Exchange Rates and Investment Booms in Mexico* . . . . . . . . . . .109
Darryl McLeod, Fordham University
John H. Welch, Federal Reserve Bank of Dallas

*Promising Developments in Technology Transfer and Intellectual Property Protection in Mexico* . . . . . . . . . . . . . 123
Edwin F. Einstein
Smith, Barshop, Stoffer and Millsap, Inc.

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# Proposal for a North American Regional Development Bank and Adjustment Fund

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## Motivation

The recent debate on the formation of a North American free trade area (FTA) has concentrated on the FTA's impact on wages, employment, and the environment in the United States. Analysis of these issues indicates that the formation of an FTA, by itself, will have little effect on the U.S. economy.[1] A free trade agreement, by itself, also will not resolve many of the fundamental problems that have impeded Mexican growth and development over the last decade. These problems relate more to factor markets than to commodity markets, involving issues of labor migration, capital movements, and the foreign debt overhang. However, if the creation of an FTA is accompanied by additional policies that enable Mexico to resolve some of these problems and shift to an open development strategy with increased trade, investment, and productivity growth, then analysis indicates that both the United States and Mexico gain significantly.[2] Given the potential benefits to both countries, it is important to expand the discussion of forming an FTA to include consideration of additional policies that are crucial to facilitating Mexico's transition to the new strategy. In particular, we wish to address issues of investment.

Mexico has already taken a number of important steps to open its economy, including actions such as unilaterally lowering tariffs and joining the General Agreement on Tariffs and Trade (GATT). While further multilateral trade liberalization is a necessary part of any successful regional integration, other concomitant policies are also needed. The successful

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[1] Recent studies of the impact of the creation of an FTA include Hinojosa and McCleery (1991), Hinojosa and Robinson (1991), KPMG (1991), Interindustry Economic Research Fund (1990), and USITC (1990). The first three studies are based on multisector computable general equilibrium (CGE) models of U.S.-Mexican trade. Additional U.S.-Mexico trade-focused CGE models are under development at the International Trade Commission and the U.S. Department of Agriculture. Work is also underway to extend an existing model of the U.S.—Canada FTA to include Mexico (Brown and Stern 1989).

[2] Hinojosa and Robinson (1991) and KPMG (1991) analyze such scenarios.

integration of the North American economies poses a number of challenges for Mexico, Canada, and the United States.

- Regional development gaps in North America are much wider than in any other group of countries that have attempted to integrate their economies. Groups such as the European Community (EC) and the European Free Trade Association (EFTA) started with much smaller differences in per capita (and total) gross national product (GNP) among member countries than what exists between Mexico and the United States.
- Because of demographic trends, Mexico's labor supply is growing at about 3 percent a year and will continue to do so for about a decade. This rapid growth will place strains on the labor market, leading to migration pressures both within Mexico (rural to urban) and internationally.
- The large differences in initial income highlight problems of reconciling labor and environmental standards across the region, especially the need for integrated government investment and regulatory policies. Migration is very sensitive to labor market conditions in both the United States and Mexico as well as to differences in incomes between the two countries. Capital flows are potentially sensitive to environmental standards as well as to differences in economic conditions. The costs of achieving integrated labor and environmental standards will be relatively higher for Mexico, the poorest of the three countries, and will require public infrastructure investment to provide an environment conducive to complementary private-sector investment.
- Mexico starts with a debt overhang of around $100 billion, which is the second-highest (after Brazil) among developing countries. No other developing country that has made a successful transition to an open development strategy started with such a large debt burden.[3]
- After a decade of crisis management and policy focus on stabilization, Mexico has neglected its physical and social infrastructure and must

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[3] Turkey, which faced a debt crisis in 1978 and also shifted development strategies, provides an interesting comparator. Mexico's debt overhang, however, is far larger by any measure.

generate renewed investment in social overhead capital. Such social investment is necessary to complement private investment. Both investments are required to generate productivity growth. Achieving rapid productivity growth, in turn, is a crucial element determining the success of the new development strategy.

Taking advantage of the opportunities provided by increased integration in North America requires that the economies be able to reallocate labor and capital within and across sectors. To achieve these reallocations quickly and efficiently, policies are needed to minimize the adjustment costs that necessarily accompany displacement of labor and capital.

Establishing an FTA is a necessary part, but only a part, of the policy package that will enable Mexico to shift its development strategy. If the new strategy is to succeed, Mexico's domestic and foreign capital needs will expand greatly. Mexico will need to mobilize resources for a major investment effort and be able to reenter world capital markets. Unfortunately, the next decade is projected to be characterized by increasing shortages of international capital. The creation of an FTA may well improve confidence for private investors, including Mexicans who have maintained large investments abroad during the past decade. Under existing institutional arrangements, however, and given Mexico's debt overhang, more capital will be needed, especially to finance large-scale social overhead investments.[4]

**A Regional Development Bank and Fund**

We propose the creation of a new institution, a regional North American Development Bank and Adjustment Fund (NADBAF), to facilitate both increased investment in targeted sectors of the Mexican economy and structural adjustment in all three countries. This institution would serve two functions: (1) as a regional investment bank, it would lend funds to finance long-term development projects; and (2) as an adjustment fund, it would provide short- to medium-term assistance to facilitate the reallocation of

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[4] For example, the World Bank recently increased lending to Mexico, exceeding its normal limits on loan exposure to any single country.

resources required to generate productivity increases in the region.

The underlying assumption is that there will be no major shortage of private investment funds but that there is a real need to mobilize resources for long-term investment in social overhead capital. Institutions with functions similar to the proposed NADBAF were established in Europe, as the Common Market expanded to include relatively less-developed countries such as Greece, Spain, and Portugal. Institutions such as the European Regional Development Fund and the European Social Fund have been very successful in facilitating the integration of poorer new members into the European Community. What we are proposing for North America draws on lessons learned from the successful experience of Europe. One major difference with the European experience, however, is that the operation of NADBAF need have no aid component. The sorts of long-term investments that are needed should be socially profitable, and the issue is that the government needs to capture enough of the returns to ensure repayment.

The investment bank would focus on long-term development projects in

- physical infrastructure that would facilitate improved trade, such as roads, bridges, ports, railroads, border facilities, and integrated border development;
- social infrastructure aimed at improving trade performance, such as technical assistance, worker training, collaborative research, educational exchanges, research and development, and support for trade-promoting organizations;
- investment projects aimed at promoting sustainable rural development, given increased trade and the need to manage labor market integration;
- investment projects for environmental improvements, including establishing institutions for monitoring, enforcement, cleanup, and adoption of new technologies;
- institutional development aimed at improving the operation of capital and labor markets to facilitate efficient, equitable, and environmentally sound integration across the three countries.

The development bank would focus on lending based on need and would be

patterned after the European Regional Development Fund, which was established to assist relatively poorer regions in Europe to integrate into the Common Market. Mexico would be the major recipient of such lending in North America, although the NADBAF might also lend for projects in poorer regions in the United States and Canada that would be affected by the establishment of an FTA.

The assistance fund would focus on short- to medium-term financing to help affected communities adjust to changes emanating from the establishment of a North American FTA. The intent is to facilitate speedy adjustment by minimizing the costs associated with shifting labor and capital and ensuring that labor does not bear a disproportionate share of the adjustment costs. The goal would be to help communities adjust for dislocations arising from the establishment of the FTA, including plant closures, labor retraining, and conversion investment.

While the assistance fund would be linked to the investment bank, its disbursements would be handled nationally, with separate national entities administering the fund in each country. The fund would draw on the expertise of the investment bank, particularly in determining the impact of the formation of the FTA on affected industries. Responsibility for setting standards for determining the need for adjustment assistance would thus rest with the investment bank and be insulated from political pressures in the three countries.

The need for adjustment assistance to affected sectors should be seen as transitory. The life of the adjustment fund should be tied to the transition period for establishing the FTA, in any case no longer than 10 years. Once the FTA is fully implemented, the assistance fund should be terminated.

## Institutional Structure

There are a number of possible institutional arrangements for establishing the NADBAF. When functioning as an investment bank, it is very close in function to the World Bank (International Bank for Reconstruction and Development, or IBRD) and the Inter-American Development Bank (IDB). Indeed, it would be possible to organize the NADBAF as a separate institutional entity administered by either the World Bank or the IDB. The World Bank already runs

such specialized institutional entities, including the International Finance Corporation (IFC) and the International Development Association (IDA). However, given that the function of the NADBAF is to facilitate the formation of a North American FTA, it has a regional focus that probably requires a separate administrative entity. The World Bank and even the IDB have broader geographic interests.

The NADBAF would have a research function, with a mandate to report (perhaps annually) on the state of the development of the region and the progress of the FTA. The intent is to build institutional expertise on regional issues, expertise which would also be very useful for private investors in the three countries.

The assistance fund aspect of the NADBAF represents a different function and will require special administrative arrangements. Our proposed design has a number of characteristics that are intended to overcome the political and administrative problems associated with attempts to design adjustment assistance programs.

- Tying the assistance fund to the NADBAF links the assistance to the formation of the FTA. The staff of the NADBAF would be responsible for determining the need for assistance. They will have special expertise in determining investment needs as part of the FTA and will be well-equipped to analyze the impact of the FTA on industries and communities. They will be best equipped to differentiate adjustment problems arising from the FTA from normal ebbs and flows of the three economies.
- The transition period incorporated into an FTA treaty provides a natural time limit for implementing adjustment assistance. The problem of determining how long adjustment assistance is required is thus established at the beginning, with all participants clearly understanding the limits.
- Adjustment assistance is seen as a country-specific problem. The administration of the funds should be organized on a national basis so that approved projects are administered within each country. While the NADBAF will have an important role in determining the needs for adjustment assistance, the funds will be disbursed nationally.

**Financial Structure**

Similar to the World Bank, IDB, and the new Eastern European Bank for Reconstruction and Development, the NADBAF will be capitalized by paid-in shares of its member countries. It will then raise funds for its lending operations by selling bonds, with a conservative gearing ratio.[5] The assistance fund function of the NADBAF would be financed by annual contributions from the member countries.[6] These contributions would be tied to the transition period set in the treaty establishing the FTA. The ratio of disbursements across the three countries should be established as part of the funding legislation.

Given that the NADBAF is being established to facilitate the formation of a North American FTA, the founding stockholders will be the United States, Canada, and Mexico. There is already interest in extending the FTA to include other Latin American countries, and it might be worthwhile to include other countries as stockholders from the beginning. In any case, as the FTA evolves, the NADBAF would also be expanded.[7] At some point, it would probably be sensible to merge the NADBAF with the IDB.

Considering the importance of Mexico's debt overhang, a potentially productive form of capitalizing the NADBAF would be to permit Mexico to finance some fraction of its capital contribution through conversion of existing old long-term Mexican debt held by foreigners into new debt, which would be held by the NADBAF. The procedure would be a variant of the Brady plan and would be designed to further the process the Brady plan started—to retire old Mexican debt. The NADBAF would exchange NADBAF bonds for existing old Mexican debt, largely held by private banks, at a negotiated discount. The exchange would be entirely voluntary on the part of the banks currently holding Mexican debt. The NADBAF would then treat these Mexican obligations (amounting to perhaps about $10 billion) as part (perhaps half) of the Mexican

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[5] The gearing ratio for the World Bank is 1, which would also be reasonable for the NADBAF.

[6] The funding mechanism is similar to that for the IDA, which is administered by the World Bank or the European Regional Development Fund.

[7] At that point, other Organization for Economic Cooperation and Development (OECD) members might also join. The Eastern European Bank for Reconstruction and Development, for example, has 42 member countries.

contribution to the NADBAF, effectively retiring this debt. As under the Brady plan, the private banks gain because they exchange risky Mexican debt for low-risk bonds. Mexico gains because the debt is converted to a capital contribution to the NADBAF and no longer involves debt servicing.

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