GOVERNMENT OF MEXICO RESPONSE TO USDOC AND USTR REQUEST FOR COMMENTS ON SIGNIFICANT TRADE DEFICITS

Kenneth Smith Ramos
Minister, Trade and NAFTA Office
Embassy of Mexico
www.regulations.gov docket number DOC 2017-0003

Pursuant to Federal Register notice 2017-07827, published on April 17, 2017, the Government of Mexico, represented by the Ministry of the Economy's Trade and NAFTA Office in Washington DC, appreciates the opportunity to present the following comments for the Administration Report on Significant Trade Deficits to the International Trade Administration.

This document is divided into 4 sections. Each section addresses matters for which written comments were requested.

Section 1 addresses the nature of the US aggregate trade deficit and of its bilateral trade deficit with Mexico. The US aggregate trade balance is the result of macroeconomic factors and not of trade policies. The US has a moderate trade deficit with Mexico relative to the bilateral trade volume explained by the integration of North American value chains. This integration has enabled the North American industry to increase its productivity and compete in world markets, benefitting workers, consumers and producers across the region.

Section 2 addresses the question of whether trading partners are imposing unequal burdens on, or unfairly discriminating in fact against the United States. Mexico provides US goods and services preferential treatment under NAFTA, in addition to WTO principles of non-discriminatory, national, and most favored treatments, by law and regulation. Mexico is by far the top consumer of US products when adjusting for income.

Section 3 addresses the effect that the US-Mexico trade relationship under NAFTA has had on production capacity in the region. It illustrates how this relationship has been critical to the growth and success of different productive sectors in the US.

Section 4 assesses the effects of the US-Mexico trade relationship under NAFTA on manufacturing employment and wage growth in the US. Manufacturing jobs in the US and Mexico are complements; workers on both sides of the border work together in the production of goods that compete in global markets. The net effect of NAFTA on US manufacturing employment has been positive.

1. Nature of the US trade balance

The aggregate trade deficit in the US is driven mainly by macroeconomic factors, and not by the trade policy of the US or other countries. It is not a good metric to assess the value of our trade relationship. Indeed, the basic National Accounts identity establishes that the aggregate trade deficit of a country is equal to the difference between its national investment and national savings. The US trade deficit has provided flexibility in the intertemporal allocation of resources in the US, increasing overall welfare by enabling producers and households to sustain higher levels of investment and consumption through imports.

The following factors have contributed to the US aggregate trade deficit: i) a low domestic saving rate, and ii) a persistent fiscal deficit in the US. In 2015, the US Gross Savings as a percentage of GDP was 19%, significantly below the average of East Asia & Pacific countries (36%), the European Union (22%), and OECD members (22%).[1] Moreover, the US has been running budget deficits for the past 15 years, with an annual average deficit of 4.2% of GDP.[2]

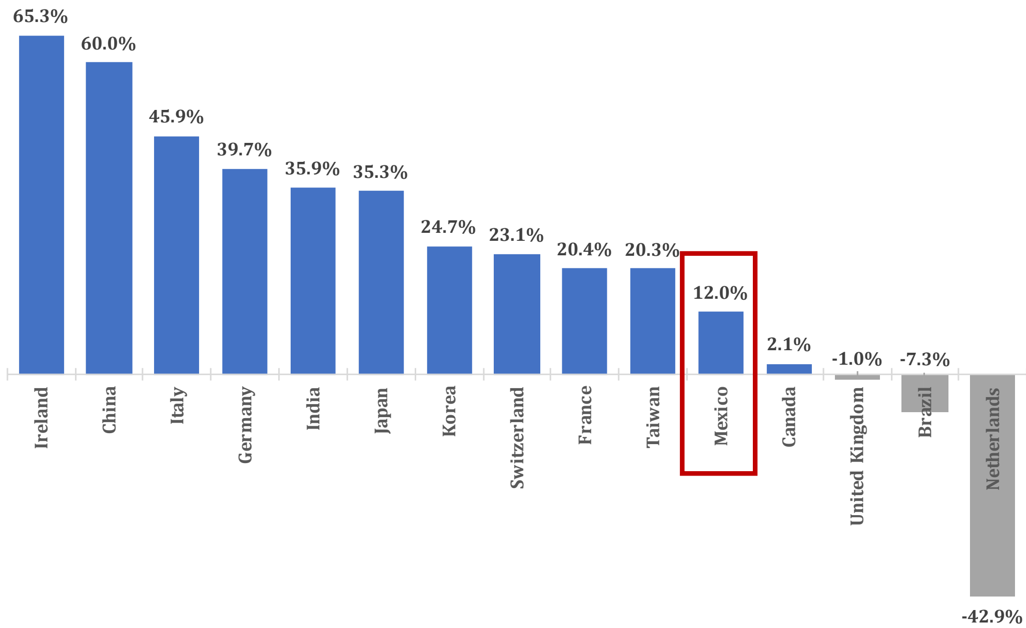
A recent article by the Peterson Institute for International Economics provides additional empirical evidence to support this. It shows that tariffs and trade barriers have little or no correlation with trade deficits, while fiscal deficits and currency manipulation (to depreciate foreign currencies) have a strong and positive correlation with trade deficits.[3]

Trade is not a zero-sum activity. For instance, the trade deficit in one country enables it to finance greater amounts of investment than it would in the absence of trade. Trade also enables North American companies to specialize and increase their productivity, and consumers to have access to a broader set of products at better prices. Therefore, trade openness increases the welfare of all trade partners, independently of the sign of their trade balances. In fact, larger trade deficits in an economy are generally associated with periods of economic expansion (additional household income is partially spent on more imports). Indeed, Chinn (2017) shows that there is a strong positive correlation between quarterly GDP growth and trade deficits as a share of GDP in the US for the period 1975-2007.[4]

The US has a moderate trade deficit with Mexico. It represents only 12% of the total bilateral trade volume between the US and Mexico (Figure 1). Moreover, the US exhibits a trade surplus of $8 billion in services, a growing driving force of the North American economy in the 21st century.[5]

[1] Source: World Bank national accounts data, and OECD National Accounts data files.
[2] Sources: US Office of Management and Budget (OMB), St. Louis Fed.
[3] Joseph E. Gagnon, *We Know What Causes Trade Deficits*, Peterson Institute for International Economics, https://piie.com/blogs/trade-investment-policy-watch/we-know-what-causes-trade-deficits.
[4] Menzie D. Chinn, http://econbrowser.com/archives/2017/01/more-on-the-trade-deficit-and-economic-growth, Econbrowser.
[5] Source: Bureau of Economic Analysis.

Fig 1. US trade deficit with top 15 partners as a percentage of total trade volume
(2016)



Source: US Census Bureau.

The US trade deficit with Mexico is explained mainly by the way North American value chains are integrated. Mexico is the main supplier for many US industries, and this supplier relationship naturally creates trade deficits. Imports from Mexico enable US manufacturers to remain competitive in global markets, enhancing their ability to export to other countries and to provide American consumers with high quality goods at more competitive prices. The Mexican-US partnership strengthens both countries' position in global markets and enhances our regional competitiveness to the benefit of workers, consumers and producers on both sides of the border.

Intra-firm trade between the US and Mexico provides evidence in this respect. The US Census Bureau reports that in 2014 US imports and exports from/to Mexico between related parties totaled $197 billion and $78 billion, respectively.[6] That is, the US trade deficit with Mexico from these intra-firm transactions was $119 billion, whereas the US-Mexico trade between un-related parties exhibited a surplus of $64 billion. Combined, these figures resulted in a US trade deficit with Mexico of $55 billion in 2014.

[6] U.S. Census Bureau News: *U.S. Goods Trade: Imports & Exports by Related-Parties 2014*, May 2015, available at https://www.census.gov/foreign-trade/Press-Release/2014pr/aip/related_party/rp14.pdf.
Related-party trade includes trade by U.S. companies with their subsidiaries abroad, as well as trade by U.S. subsidiaries of foreign companies with their parent companies.

This intra-firm trade benefits US workers, to the extent that these firms are taking advantage of the comparative advantages of each country to increase their competitiveness, while generating jobs in their US headquarter plants. It also benefits US consumers by reducing the prices of the goods that they consume.

The recent increase in the US trade deficit with Mexico from $54.6 billion in 2013 to $63.2 billion in 2016 can be largely explained by the recovery of the manufacturing sector in the US, which has led to higher imports of intermediate goods from Mexico, and partly by the depreciation of the Mexican Peso against the USD (the MXN/USD exchange rate went from an average of 12.8 pesos per USD in 2013 to an average of 18.7 pesos per USD in 2016, a 46.4% increase).[7] This depreciation can be attributed first to the worldwide decrease in oil prices, and more recently to the uncertainty surrounding the US trade policy.

2. Mexico-US trade under NAFTA

By law, regulation, and practices, Mexico provides US goods and services preferential treatment under NAFTA, in addition to WTO principles of non-discriminatory, national treatment, and most favored nation treatment. In fact, Mexico works with the US in nearly every industry to promote joint production and greater commerce. Tariff reductions, regulatory improvements and trade facilitation have increased the competitiveness of both the Mexican and the US economies.

Mexico does not promote overcapacity in goods, and the Mexican government does not subsidize industries to gain a trade advantage.

Under NAFTA, US exporters have gained significant tariff preferences. Indeed, without NAFTA, the average tariff on Mexican exports to the United States under the Most Favored Nation (MFN) treatment would be 3.5%, whereas the average tariff on US exports to Mexico would be 7.1%. Moreover, Mexico's bound rates under the WTO average 36.2%, well above its applied MFN tariffs; while US bound rates average 3.5%, virtually the same as its applied MFN tariffs.[8] Therefore, NAFTA not only provides certainty to US exporters regarding applied tariffs, it also protects them from much larger potential tariff increases in Mexico.

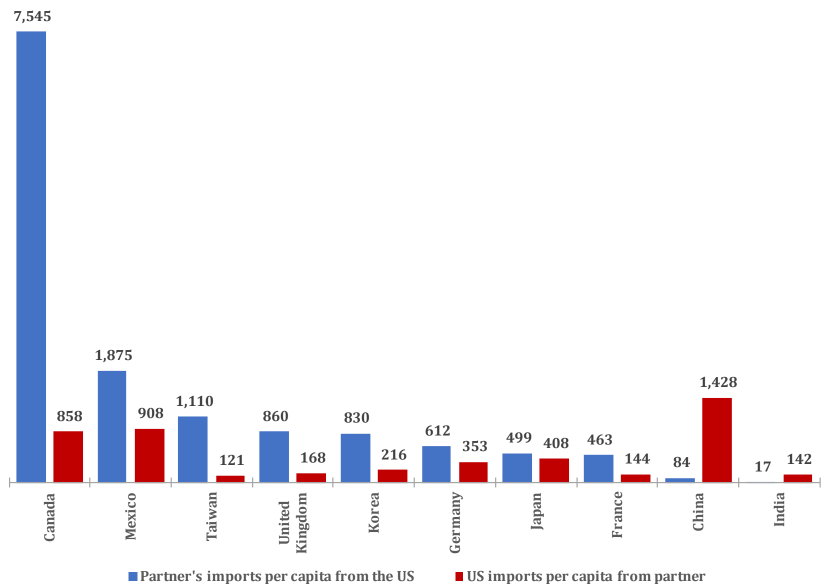
In addition, NAFTA's strict rules of origin favor deeper North American integration. For example, the automotive sector's rule of origin requires a 62.5% regional content, nearly two times higher than the regional content required for the same product in recent US free trade agreements.

As a result, Mexico is the 2nd largest importer per capita from the US amongst the US top 10 trading partners. On average, Mexicans buy from the US twice the amount that Americans buy from Mexico (Figure 2).

[7] Source: US Census Bureau and Banco de México.
[8] Source: WTO, World Tariff Profiles 2016.

Fig 2. Imports from the US per capita and US imports per capita from partner in top 10 US trade partners

(2016; US dollars)

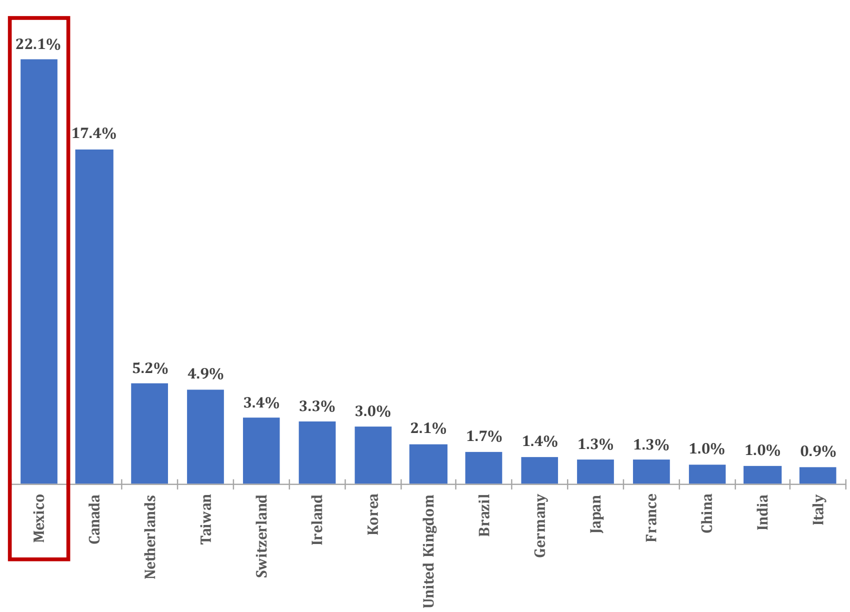


Source: IMF and US Census Bureau.

When controlling for income, Mexico becomes the main customer of US goods, as it spends 22.1% of its GDP on imports from the US (Figure 3). In contrast, the US spends merely 1.6% of its GDP on Mexican imports.

Fig 3. Percentage of GDP spent on imports from the US for US top 15 trade partners

(2016)



Source: IMF and US Census Bureau.

3. NAFTA and the Integration of North American Value Chains

More than two decades of strong trade and economic ties between the United States and Mexico under NAFTA have built effective and efficient regional supply chains that produce goods that are traded in world markets. NAFTA has enhanced regional competitiveness, increasing the regional value-added of goods produced in North America. In fact, US value-added accounts for 40% of Mexico´s exports of final goods to the US.[9] This means that a large portion of US spending on Mexican goods ultimately benefits US companies and workers. The increasing integration of our economies makes Mexico critically important to the US economy, not only as an export market, but also as a partner in production.

NAFTA's tariff elimination and clear rules have significantly intensified regional intra-industry trade, effectively tripling the trilateral trade, which reached $1 trillion[10] in 2016. Over half of North America's total exports are sold within the region, one of the highest levels of intra-regional trade in the world.

Most of the products traded between our countries are inputs, components and parts used along a regional output chain to produce finished goods that are either consumed domestically or exported to global markets. 80% of Mexico's trade volume with the US is in intermediate (56%) and capital goods (24%). In particular, a high percentage of Mexico's exports (75%) are inputs to the US production process. In 2016 Mexico exported to the US around $303 billion, out of which almost $95 billion (31%) were capital goods and almost $131 billion (43%) were intermediate goods. Similarly, a high percentage of imports from the US are inputs to Mexico's manufacturing production. Therefore, the free flow of goods between both countries has a positive effect on the competitiveness of the region.[11]

The automotive, electronics, agriculture and energy industries, as discussed below, are good examples of how supply chains across North America successfully increase the competitiveness of the region in global markets and contribute to manufacturing output and employment in both countries.

The North American Auto Industry

In 2016, the three North American partners produced together 18.2 million vehicles, competing closely with the EU production of 18.8 million vehicles, and narrowing the gap with the 28.1 million vehicles produced by China.[12]

This is clearly the result of the high degree of integration of the North American auto industry. With over $124 billion in cars and auto parts[13] traded annually. Mexico is the US's largest

---

[9] National Bureau of Economic Research. Global Value database in Koopman, Powers, Wang, Wei (September 2010, revised March 2011).

[10] Source: Statistics Canada, Banxico, and USDOC, using import data.

[11] Source: Mexican custom records. The sorting of imports and exports into capital, intermediate, and consumption goods follows the UN classification of goods by Broad Economic Categories.

[12] Source: Organisation Internationale des Constructeurs d´Automobiles (OICA).

[13] Source: US Census Bureau, using 3361, 3362 and 3363 NAICS Codes.

international customer for auto parts, accounting for 36% of its total exports of auto parts. Likewise, Mexico is the top auto parts supplier to the US auto industry, accounting for nearly 40% of its total imports in this sector.

The automotive sector in the US has been one of the main contributors to the economic recovery since the 2008 Financial Crisis. Since June 2009, employment in the automotive industry in the US has added over 300,000 jobs to surpass 930,000 in December 2016.[14] In that same period, US imports of motor vehicles and auto parts from Mexico almost tripled (+183%), and US exports to Mexico in that category more than doubled (+117%). This has been one of the fastest growing export markets amongst the US main global markets during this period.[15]

The North American Electronics Industry

The computer and electronic industry is the US's largest export industry. In 2016, the US's exports of electronic devices and components worldwide exceeded $202 billion[16]. World leading high-tech manufacturers located in the US exported to world markets over $54 billion in semiconductors and other electronic components.

Many of those companies have an important business presence in Mexico, supplying electronic components for further processing or final assembly in both Mexico and the US. Last year, the US exported nearly $43 billion in electronic products to Mexico, including one out of every five semiconductors exported by the US globally, for a total value of $12 billion; its largest export market. Likewise, Mexico exported $58.5 billion in electronic equipment and components to the US, strengthening the competitiveness of its computer and electronic industries.

The North American Agricultural Industry

During the course of NAFTA's implementation, the agricultural sectors of the US and Mexico have become far more integrated, as is evidenced by increased trade in a wider range of agricultural products, substantial levels of cross-border investment, and important changes in consumption and production.

Under NAFTA the US and Mexico liberalized trade in all agricultural products. Tariffs and quantitative restrictions were fully phased out on January 1st, 2008, including for sensitive products like corn, dry edible beans, and nonfat dry milk.

As a result, over the past 23 years, US agricultural trade with Mexico has multiplied by six, surpassing $42 billion in 2016.[17] Mexico is the 3rd destination for US agricultural products and its 2nd largest source of imports.

Trade liberalization has also promoted a specialization of the type of agricultural products traded between Mexico and the US, taking advantage of the complementarity of the regional climate and geography. US exports are concentrated in grains, meat, and oilseeds, accounting for over

---

[14] Source: Bureau of Labor Statistics, using data from Current Employment Statistics survey for motor vehicle and motor vehicle parts industry.

[15] Source: US Census Bureau, using motor vehicles and auto parts NAICS codes 3361, 3362, and 3363.

[16] Source: US Census Bureau, using 334 NAICS Code.

[17] Source: US Census Bureau, using Harmonized System Code, Chapters 1-24.

50% of agricultural exports to Mexico. In comparison, nearly 50% of Mexico's agricultural exports to the US are fruits and vegetables.

The growth of trade in agricultural goods has also strengthened regional production chains. Among the most relevant examples are grain-meat, sugar-confectionary, malt-beer, millet-brooms, lemon-pectin, fresh produce-canned food, and cotton-textile and apparel. Because of NAFTA, the North American market has flourished for US ranchers and farmers, spurring benefits across the United States and Mexico.

The North American Energy Industry

A major component of our shared manufacturing sectors is our energy trade. The energy markets of Mexico, Canada, and the United States are becoming increasingly interdependent as infrastructure continues to be built across North America. Geographic proximity has also led to market integration in North America. It creates incentives to trade energy commodities like natural gas and electricity within the region, while other commodities such as oil and oil products travel more freely overseas.

As a result, Mexico, Canada, and the United States can be considered a single increasingly integrated regional energy market with internal commodity flows and external links to the rest of the world. For example, most of the oil exported from Mexico and Canada finds its way into US refineries, and much of the US demand for oil imports is satisfied by its neighbors. The United States also exports a large amount of oil products to Canada and Mexico. The US Energy Department recently stated that "US crude oil exported to Mexico is one of the more lucrative commodities for North American trade." As with many other sectors, the US has a trade surplus with Mexico in energy ($11.5 billion in 2016).[18]

The US-Mexico energy trade is multifaceted and is a critical component of North American security. Mexico accounted for 9% of US crude oil imports in 2015, 4th behind Canada, Saudi Arabia, and Venezuela. Mexico is the largest export market for U.S. refined oil products and U.S. natural gas. In fact, in 2016 Mexico received 60% of all US natural gas exports, and that value is growing rapidly. North American energy trade is a major component to the US industry's success, and contributes greatly to continental security.

4. The Effect of NAFTA on US Manufacturing Jobs and Output

The integration of the North American value chains through NAFTA has made the US and Mexico's manufacturing sectors complements, not substitutes. American manufacturing jobs depend on Mexican manufacturing jobs and vice-versa, since workers on both sides of the border work together in the production of goods to successfully compete in global markets.

Manufacturing employment in the US grew during the first years of NAFTA, from 16.8 million employees in December 1993 to 17.1 million in December 2000.[19] It was not until after China's

[18] Source: US Energy Information Administration.
[19] Source: Bureau of Labor Statistics, using data from Current Employment Statistics survey for manufacturing.

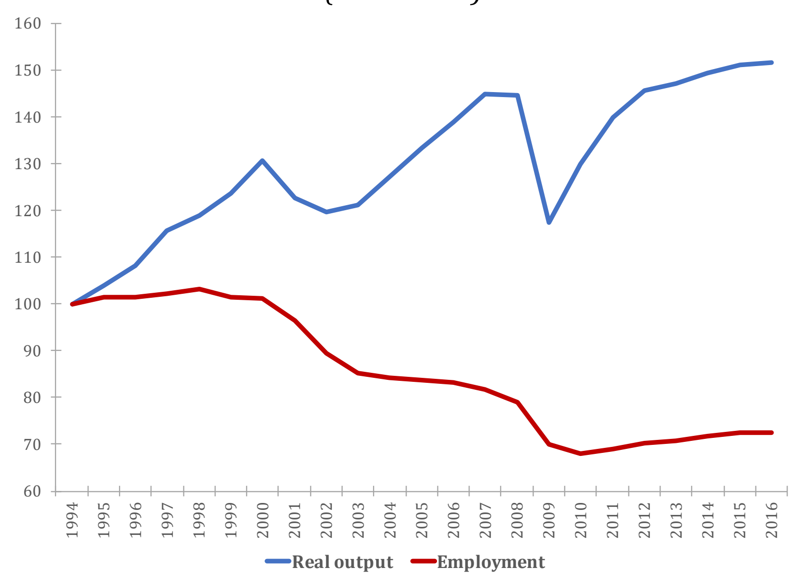
entry into the WTO in 2001 that manufacturing employment in the US began its decline. This observation is consistent with the findings in Autor et al. (2013), who argue that the growth of US imports from China led to a significant decline in manufacturing employment in some regions of the US, but find no evidence of similar effects generated by NAFTA.[20]

In addition, a recent study attributes most of manufacturing job losses in the US between 2005 and 2015 to enhanced productivity derived from automation and technological innovation.[21]

It is important to note that despite job losses since 1993, real output in US manufacturing has increased by 60% (figure 4), and manufacturing remains the largest sector of the US economy by a substantial margin, with a gross output of $5.8 trillion in 2016.[22] In that same period, real manufacturing output per hour worked more than doubled.[23]

Fig 4. Real output and employment in the US manufacturing sector

(1994 = 100)



Source: U.S. Bureau of Labor Statistics (retrieved from FRED, Federal Reserve Bank of St. Louis).

Undoubtedly NAFTA, automation and technological innovation have had an impact on the employment landscape in the US and Mexico; both have contributed to job displacement and reallocation across sectors. For example, growth in the US automotive manufacturing base has shifted from the Midwest to the South; motor vehicle manufacturing jobs in Kentucky have doubled since 1993, while auto parts manufacturing jobs in Alabama have more than doubled since 2000.[24]

---

[20] Autor, David, David Dorn, and Gordon Hanson, The China Syndrome: Local Labor Market Effects of Import Competition in the United States, American Economic Review 2013, 103(6): 2121–2168.

[21] Michael Hicks, Srikant Devaraj, The Myth and the Reality of Manufacturing in America, Ball State University, 2016.

[22] Source: U.S. Bureau of Labor Statistics (retrieved from FRED, Federal Reserve Bank of St. Louis) and Bureau of Economic Analysis.

[23] Source: U.S. Bureau of Labor Statistics (retrieved from FRED, Federal Reserve Bank of St. Louis).

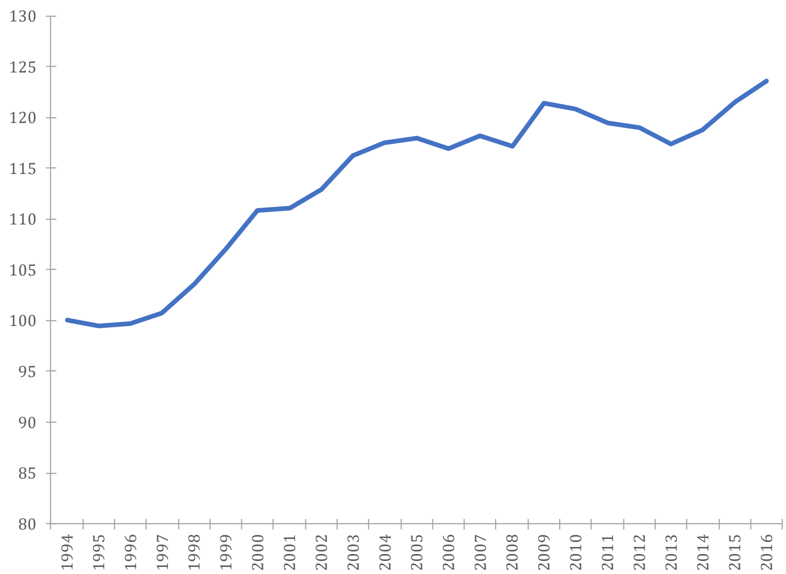
[24] Source: Bureau of Labor Statistics.

NAFTA's overall impact on US employment has been positive. According to a recent study by the US Chamber of Commerce, trade with Canada and Mexico supports nearly 14 million US jobs.[25] Similarly, the Woodrow Wilson Center's Mexico Institute estimated in 2016 that trade with Mexico supports nearly 5 million jobs in the United States. That is, one in every twenty-four US jobs depends on US-Mexico trade.[26] In addition, Mexican companies have invested over $52 billion[27] in the US, supporting more than 120,000 jobs.[28]

In addition, wages in the US Manufacturing sector have increased since NAFTA came into force, especially before China's entry into the WTO (Figure 5). Real compensation per hour in the US manufacturing sector grew at an average yearly rate of 1.2% between 1993 and 2001, and at an average rate of 0.65% per year from then on.

Fig 5. Real compensation per hour in the US manufacturing sector

(1994 = 100)



Source: U.S. Bureau of Labor Statistics (retrieved from FRED, Federal Reserve Bank of St. Louis).

Mexico is committed to guaranteeing that the benefits of free trade reach the labor force on both sides of the border. To this end, President Peña Nieto introduced, and Congress and the majority of Mexican states approved, a constitutional reform to improve the Mexican labor justice system. The reform, which entered into force in February 2017, facilitates the resolution of labor conflicts through specialized independent courts, strengthens workers' rights to engage in labor unions and collective bargaining agreements, as well as to elect their leaders through personal, free and secret votes.

[25] Source: US Chamber of Commerce, NAFTA Triumphant, Assessing Two Decades of Gains in Trade, Growth, and Jobs, 2015.

[26] Source: Christopher Wilson, Growing Together: Economic Ties between the United States and Mexico, Wilson Center, 2016.

[27] Source: IMF Coordinated Direct Investment Survey (CDIS), using outward position (stock) data 2015.

[28] Source: iMapData.

5. Conclusions

The US-Mexico bilateral trade relationship is rich, complex and has been very positive for both countries and their citizens. Our trade relationship has created greater economic growth, a stronger manufacturing industry than would otherwise exist, and which has enabled the US to increase its exports not only to Mexico, but to other countries as well, through the synergies created by the North American value chain. It has also boosted the service sector and provided consumers in North America access to a larger set of high-quality products at better prices.