MEXICAN TRADE POLICY
IN THE 21ST CENTURY
Mexican trade policy in the 21st century

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Abstract
The change of course in US trade policy since 2017 has sent shockwaves through the global economy, nowhere more so than in Mexico. US neo-protectionism poses a threat to the progress achieved throughout North America during the last 25 years. This protectionist onslaught is not confined to Mexico: the United States has withdrawn from the Trans-Pacific Partnership (TPP) and has threatened to pull out of the free trade agreement with South Korea. Moreover, the North American Free Trade Agreement (NAFTA) is currently being renegotiated, and the US has imposed trade restrictions on China, Canada, Mexico and the European Union. A large country like the United States is able to replace foreign trade with domestic trade, although protectionism will still damage its economy. But a small economy like Mexico is not in a position to replace foreign trade with domestic trade. Accordingly, the best trade strategy for Mexico in the 21st century is to strengthen the liberalisation of trade that began when Mexico joined the General Agreement on Tariffs and Trade (GATT) in the mid-1980s and culminated with NAFTA.

1. The importance of NAFTA
NAFTA’s 20th anniversary prompted numerous studies analysing what it has meant for Mexico. One of the best at “separating fact from fiction”, in its own words, was a paper by Hufbauer, Cimino and Moran (2014) of the Peterson Institute for International Economics (PIIE).

1 I would like to thank Roberto Newell, Javier Mancera and Luis de la Calle for their comments on the early drafts of this article. Any remaining errors are the author’s responsibility. Please send your comments to: manuel.molano@imco.org.mx. The opinions expressed here are those of the author and do not necessarily represent the institutional position of the Instituto Mexicano para la Competitividad.

2 This article was made possible thanks to the generous support of the Friedrich Naumann Foundation for Freedom. The author would like to thank Birgit Lamm and Fernando Valdés for their support, enthusiasm and comments.
NAFTA was extremely controversial in the United States, since it was the first trade accord with a poor country. It was unfairly blamed for the 1994-95 balance of payments crisis and the emergence of the armed group known as the Zapatista Army of National Liberation in the Mexican state of Chiapas. The two decades since the agreement was signed have seen growing inequality in the United States, with free trade agreements and automation being widely held responsible for job losses. In actual fact, nothing could be further from the truth: 2.6 million jobs depend on Canada and 1.9 million on Mexico. Furthermore, the net number of jobs gained or lost in the US economy due to free trade agreements is statistically insignificant (Hufbauer, Cimino and Moran, 2014).

Figure 1. Employment, population and GDP growth in the United States, 1957-87 and 1988-2018

The growth rate of the US economy has declined by a third over the past 30 years compared to the previous 30-year period. However, this is perfectly normal for a mature economy with relatively high levels of income and wealth. While the employment growth rate fell by almost 50%, it nevertheless remains higher on average than the population growth rate. The fact that employment growth was much higher than population growth between 1957 and 1987 was in all probability responsible for the rise in labour costs in the US economy. During the subsequent 30-year period, this forced American companies to establish operations and do business in countries like Mexico and China, where labour costs were lower.
In Mexico, there was a dramatic improvement in living standards after NAFTA came into being, even if the growth rate was seen as disappointing both at home and abroad. The change in the availability of food commodities in Mexico after the agreement was signed provides one measure of this improvement. From 1980 to 1994, Mexico produced an average of 9.24 kilos of poultry meat and 13.4 kilos of egg per capita, whereas between 1995 and 2016 the equivalent figures were 32.5 kilos of poultry meat and 29.4 kilos of egg. This combined increase in domestic production and imports means that the vast majority of Mexicans now have access to unprecedented quantities of protein. Moreover, despite the relatively low productivity of maize and other grain farming in Mexico, maize productivity has still doubled since the establishment of NAFTA. Markets that, prior to trade liberalisation, were characterised by limited competition, restricted consumer choice and expensive, poor-quality products, have now been transformed, providing far more families and individuals with access to world-class goods and services.

Figure 2. Poultry meat production in Mexico (kg/per capita)

Source: author’s own calculations, based on data from SIAP (gob.mx)

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3 Authors own calculations, based on data from the Agrifood and Fishery Information Service of the Mexican Ministry of Agriculture, Livestock, Rural Development, Fisheries and Food (SAGARPA-SIAP), available at gob.mx
Even after NAFTA was signed, the energy sector remained in the hands of the State monopolies Pemex and CFE, and was not opened up to international trade. This accounts for the sector’s underdevelopment, poor quality, high prices, low reserves and other problems. The 2012 energy reform marked the first step towards addressing these issues.

It has also proven difficult to increase the productivity of services due to their non-tradable nature (i.e. the fact that they cannot be sold in a physical package). Many services are local monopolies and therefore generate economic rents. As a result, many workers have taken refuge in the service sector, which goes some way towards explaining the low growth rate of the economy as a whole. The recent telecoms market and competition policy reforms have helped to improve productivity in the service sector. These second-generation reforms would never have taken place if they had not been preceded by NAFTA.

Contrary to the claims of many observers, Hufbauer, Cimino and Moran (2014) found that NAFTA did not damage the US economy. They conclude that the only valid criticism of the treaty is that it failed to drive the kind of growth rates for the Mexican economy that had initially been expected. Moreover, the economy did actually grow significantly in those parts of Mexico that were able to take advantage of the opportunities offered by NAFTA, primarily those regions that have sufficiently good logistics and energy and telecommunications infrastructure, and where the rule of law protects investment and ensures that contracts are respected (IMCO, 2016). Perhaps the greatest benefit to the US economy has been the reduction in the number of Mexican immigrants due to the economic development that has
occurred in many parts of Mexico. According to the Pew Research Center, the number of illegal Mexican immigrants has declined by 1 million since 2007, and more non-Mexicans than Mexicans were apprehended at US borders in 2016. Just under 193,000 Mexicans were apprehended in 2016, a sharp drop from the peak of 1.6 million in 2000 (Gonzalez-Barrera and Krogstad, 2017).

“For decades after World War II, Mexico pursued many of the same disastrous economic policies as other developing countries. It maintained high protectionist barriers for manufactured goods, and relied heavily on commodity exports, particularly oil. As a result, it experienced recurrent stop-go cycles, whereby accelerating inflation and ballooning balance-of-payment deficits would force a round of austerity, only for the process to repeat itself after increases in commodity prices, but at a slower rate of growth each time. Not surprisingly, the growth rate during these years waxed and waned dramatically, and by the start of 1989, Mexico’s per capita income was around $2,393 – about 11% that of the US.” (Krueger, 2018).

There is no denying NAFTA’s importance as a public policy instrument for modernising Mexico. The economist Luis de la Calle neatly sums up its impact: “Without NAFTA, there would have been no progress in the APEC negotiations, the web of trade agreements among Latin America’s countries and between Latin America and the United States would never have come into being, and the Uruguay Round that led to the establishment of the World Trade Organization (WTO) would have failed. Mexico would not have negotiated trade agreements with other Latin American countries, the European Union (EU) or Japan.” Furthermore, NAFTA provided a framework that offered some stability for doing business, the protection of private property, respect for investors and the resolution of disputes, areas in which Mexico’s legal framework still continues to suffer from serious shortcomings today, just as it did in 1994.

What will happen in Mexico if the United States withdraws from NAFTA? This has been a recurring question among academics and the media ever since the trade policy pendulum swung back towards protectionism in the US. Although a US withdrawal from NAFTA could significantly change Mexico’s relationship with its northern neighbour, it shouldn’t change much as far as Mexico’s relations with the rest of the world are concerned. The stability that NAFTA brought to Mexico is also provided by its other trade agreements with the rest of the world. Indeed, Latin America’s Pacific Alliance agreement even provides for economic freedoms that go beyond free trade, for example the free movement of people.
Nevertheless, a US withdrawal from NAFTA could still be very damaging to the Mexican economy. The gradual depreciation of the peso against the dollar since anti-NAFTA rhetoric resurfaced in US policy is a good indicator of the harm caused to Mexico by American protectionism. There are of course many other factors that can influence the Mexican currency’s exchange rate, for instance the health of the public finances and US monetary policy. However, there is no denying that the political climate towards NAFTA has at least caused a lot of volatility in the peso’s value against the dollar.

The erratic and unpredictable nature of the US administration means that by the time this paper is published, the possibility of the United States withdrawing from NAFTA may have already become reality. The aim of this paper is to show that if the US does leave NAFTA, there will still be plenty of trading options open to Mexico. To take advantage of these opportunities, Mexico must conclude further multilateral trade agreements with those countries with which it does not currently have free trade agreements.

The possibility of the US withdrawing from NAFTA should not be downplayed, since it would change both the composition of exportable goods and services in many sectors of the Mexican economy and the relative prices of the products and raw materials that form the bulk of Mexico’s trade with its northern neighbours. Nonetheless, it is our contention that there are still plenty of reasons for optimism if this scenario comes to pass. Indeed, it is Mexico’s response to US protectionism that will play a far greater role in determining the damage suffered by the Mexican economy. If Mexico hits back with protectionist measures of its own, this could spell serious trouble for its economy. On the other hand, if it continues to liberalise its trade relations with the rest of the world, including the United States, then it will be able to maintain many of its comparative advantages when it comes to supplying the US market. Now is not the time to change the course of the Mexican economy and make it less open. According to Luis de la Calle (2017), “Some analysts have argued that we need a plan B for the economy. [...] There are those in Mexico who are already starting to call for a less open economy, with less competition and less macroeconomic discipline. If Washington keeps promoting economic populism, it will not be easy to stand up for more globalisation, faster and deeper technological change, more efficient markets and healthy public finances. [...] Now more than ever, we need to reaffirm our commitment to plan A, to a Mexican economy that is modern, stable and open. And more than that, we need to go still further and extend the opportunities to our country’s less privileged industries and regions, invest resolutely in the establishment of the rule of law, put an end to the widespread extortion in our economy and reduce and root out the corruption that so severely restricts our ability to grow. In other words, we need to strengthen the model established by NAFTA and extend it to the rest of the economy and the country.”
What really ought to concern Mexico (and the rest of the world) is the prospect of the United States leaving the World Trade Organization. As long as the US opens the door for China to trade under the rules of the multilateral system, the rest of the world will be able to trade with the United States. Mexico must use its leadership in the global arena, joining with other countries that have suffered at the hands of current US policy in a concerted effort to preserve the WTO. In the interests of protecting the WTO rules, Mexican diplomacy should even seek to enlist the support of China, a nation that is normally one of our chief competitors. The situation was eloquently explained in a recent article by Roberto Newell (2018): “If the WTO goes, the main losers will be small economies like Mexico. If there is no WTO, disputes will once more be resolved bilaterally, as they were before it came into being. This would be detrimental to the interests of the smallest and most vulnerable economies.”

Why is it so hard to sell the notion of free trade?

There is one simple reason for the emergence of the new wave of protectionism in various parts of the globe: it is an idea that pays political dividends, despite the overwhelming evidence that free trade promotes development.

According to the economist and Princeton professor Alan Blinder, the reason that the general public does not share economists’ views about the benefits of free trade is that economists have failed to sell the theory of comparative advantage to the public. Developed by David Ricardo just over 200 years ago, this theory is one of the cornerstones of economics and at the heart of why trade is beneficial to nations. However, it is a notion that is neither obvious nor intuitive. Isaac Newton did a much better job of explaining gravity than economists have done of explaining comparative advantage during the past 200 years (Blinder, 2017). Part of the problem is that the potential benefits of trade have been sold in terms of the jobs that it can create. But the real benefit of trade is not that it creates more jobs. The benefit of trade is the savings it generates for consumers and the fact that it realigns economic activity towards those sectors where there is a comparative advantage. Selling trade on the basis that more exports mean more jobs has allowed opponents of international trade to claim that more imports mean fewer jobs, and has led to the belief that trade deficits are harmful to a country’s economy.

Ever since the day when Donald Trump was sworn in as the 45th president of the United States on 20 January 2017, the US Federal Government has been fixated with the nation’s trade deficit. President Trump sees the deficit as if it were a loss on an income statement and regards a trade surplus as equivalent to a profit – in Trump’s mind, interpreting trade figures is no
different to reading a company’s financial statements (Katz, 2018). The Trump administration believes that a protectionist trade policy can help to reduce the United States’ trade deficit. However, there is a widespread consensus among economists that the trade deficit is actually due to the fact that domestic savings are insufficient to finance investment (see e.g. Freund, 2017, or Krugman, 2018). Using trade barriers to reduce the deficit with one group of countries will only increase the deficit with other trading partners.

But none of this seems to matter to Trump, who insists that free trade with the United States has benefited every country in the world except his own. The recent protectionist measures imposed on aluminium and steel imports from Mexico, Canada and the EU, allegedly for reasons of national security, show how Trump will resort to all kinds of legal arguments to justify a brand of nationalism that has not been witnessed in our northern neighbour since the beginning of the 20th century (Newell, 2018). The steel and aluminium tariffs make even less sense in Mexico’s case, since the US actually has a trade surplus of $4.875 billion with Mexico in aluminium and steel (United States Census Bureau, 2018). Unsurprisingly, Mexico has retaliated by imposing tariffs on US imports, with the net effect that the United States has ended up damaging its own steel exports to Mexico.

The world is at a crossroads. If politicians around the globe follow Trump’s lead and increasingly close off their economies, then we will be headed for a situation closely resembling 1930, when the US passed the Smoot-Hawley Act to try and stimulate its economy and bring it out of the Great Depression. Smoot-Hawley introduced extremely high tariff rates, prompting the rest of the world to take retaliatory trade measures against the United States. It began as a mechanism for helping farmers, but once that goal had been achieved, vested interests in industry lobbied for several other sectors to be included too. Global trade declined from $5.3 billion to $1.8 billion between 1929 and 1933 (The Economist, 2008). The tariff on goods such as sugar rose from 2.20 to 2.50 cents a pound, while the tariff on goods such as milk went up from 2.50 to 6.50 cents a pound. Manufactured goods such as shoes, which had not been subject to any tariffs under the previous Tariff Act of 1922, were then hit with a tariff of 20% (Berglund, 1930).

One key difference compared to 1930 is that the US economy is not currently in recession. The astonishing thing about the new trade war being waged by the US in 2018 is that America’s economy is in the middle of one of the strongest booms in its history. In 1930, Herbert Hoover was faced with an economic crisis on an unprecedented scale, which goes some way towards explaining his actions, even if it doesn’t justify them. At the time, 1,028 US economists signed a petition calling on President Hoover not to sign the Smoot-Hawley Bill. While there is no evidence to suggest that the Act was responsible for the depression – its causes where most
likely monetary in nature –, it did “add poison to the emptying well of trade” (The Economist, 2008). To use the same analogy, Trump’s protectionism could add poison to a well that is already full to overflowing, potentially causing much more damage. What the United States actually needs in its current situation is a more open economy in order to promote a more competitive relative price vector, coupled with immigration to address its severe labour shortage and technological change to improve its competitiveness. The Trump administration is opposed to all three of these actions.

Although the economic and business press has been proclaiming the return of protectionism for at least a decade, the WITS\textsuperscript{4} (World Bank, 2018) database actually shows that tariffs have been reduced almost everywhere during the last 20 years. However, the effective tariff rate imposed by Mexico on the United States has increased on average since 2010.

\textsuperscript{4} World Integrated Trade Solution. World Bank (2018)
Figure 4. Tariffs imposed by the US on the rest of the world and vice versa (effective rate, weighted average)

Source: author’s own calculations based on data from WITS.

Figure 5. Tariffs imposed by the US on Mexico and vice versa (effective rate, weighted average)

Source: author’s own calculations based on data from WITS.
According to the WITS database, Mexico has on average imposed higher effective tariff rates on the United States than vice versa. What are the reasons for this phenomenon? First of all, there was a long period during which the agricultural sector in Mexico was subject to a period of gradual reduction of tariffs which came to an end in 2008 and was designed to help farmers adjust to free trade and prevent an exodus of Mexicans to the United States. The tax relief on agricultural produce goes a long way towards explaining the high average tariff rate during the initial period after NAFTA came into force.

Following a dispute that lasted almost a decade (2008-2016), Mexico imposed compensatory tariffs on tuna imports from the United States. This action was taken under WTO rules, in response to the US placing an embargo on Mexican tuna on the grounds that the fishing methods used were harmful to dolphins.

The cross-border trucking dispute between the two nations is another long-running protectionist saga. Between 1995 and 2001, Mexican haulage firms were denied almost all access to the United States. In 2001, the NAFTA dispute settlement panel found in favour of Mexico, ruling that, in accordance with Chapter 20, the United States was violating the NAFTA treaty by denying access to Mexican trucks (SICE-OAS, 2018). Following this ruling, the US Congress introduced a series of regulatory obstacles designed to delay the United States’ compliance with its obligations. These measures were supported by various environmental, consumer and trade union organisations. In 2007, President Bush announced a “Demonstration Program”, but this was subsequently suspended by President Obama in 2009. Following the suspension of this pilot programme, Mexico imposed US$2.4 billion in import duties ranging from 10% to 45% on 90 products from the United States (Alexander and Soukup, 2010).

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5 The consultations began on 24 October 2008 and authorisation to retaliate was granted on 22 May 2017. WTO (2018b).
6 In February 2001, the dispute settlement panel ruled that the United States had failed to comply with its obligations under Articles 1202 and 1203 in Annex I of the NAFTA treaty, and that the shortcomings of Mexico’s regulatory system for trucks did not constitute sufficient legal grounds for the United States to maintain the moratorium on Mexican trucks entering the US (Alexander and Soukup, 2010).
Even so, as Figure 6 shows, in most of the years since the establishment of NAFTA the average tariff rate imposed by Mexico on the United States and Canada was lower than the tariffs that it imposed on countries with which it does not have a free trade agreement. A comparison of the effective tariff rate imposed by Mexico on the United States and the Most Favoured Nation (MFN) tariff rate imposed by Mexico on countries with which it has no agreements reveals that while Mexico has opened up its economy to its NAFTA partners, it has not done so to the same extent with the rest of the world. However, within this overall liberalisation of Mexican trade policy towards the US there have nonetheless been a number of spikes in the average effective tariff rate that correspond to retaliatory measures in response to various protectionist non-tariff barriers introduced by the United States.

The number of trade disputes brought against the United States at the WTO by its NAFTA trading partners is far greater than the number that the US has brought against Mexico and Canada. This is in line with US behaviour in other parts of the global trade arena: the United States has had more trade disputes brought against it (144) than any other country in the world.
Figure 7. Number of trade disputes at the WTO, June 2018

Source: author’s own calculations based on WTO data (WTO, 2018a)

A famous Alan Greenspan quote\(^7\) sums up the dangers of protectionism: “Protectionism will do little to create jobs, and if foreigners retaliate, we will surely lose jobs” (Crutsinger, 2004). If the world becomes infected with the protectionism that is currently in vogue then, as we will see below, the consequences for the global economy could be extremely serious.

\(^7\) Alan Greenspan probably repeated this phrase on more than one occasion. Crutsinger (2004) reported it from a speech at the Omaha Chamber of Commerce in Nebraska.
Optimal tariff theory

According to R.F. Kahn (1947), “It can be demonstrated that the introduction of a system of import duties will always improve the position of the country imposing it, provided that the rate of duty is below a certain critical level, and provided also that the tariff does not lead to retaliation, in the form of the imposition of higher duties, by other countries. It can also be shown that there is a particular rate of duty which makes the net advantage accruing from the tariff a maximum.” Kahn calculated that the optimal tariff is determined by the elasticity of domestic import supply and the elasticity of foreign export demand. It follows that the optimal rate has been attained if a small increase in the tariff rate neither reduces nor increases the value for domestic supply – and this rate will not necessarily be zero.

Various authors have shown the calculation used by Kahn (1947) to be incorrect, and it can be demonstrated that the optimal tariff rate for a small country is in fact zero. Nevertheless, there is still an abundance of economic literature on the subject of optimal tariffs. Young (1991), for example, states that “a country with monopoly power in trade should exploit this power by imposing tariffs. (...) Optimal tariffs are positive on average if the foreign offer surface is concave down or the foreign country practices free trade and has a strictly convex production technology and a representative consumer with strictly convex preferences. (...) If all goods are normal for the representative foreign consumer and the foreign country imposes a fixed tariff, then optimal tariffs are nonnegative on average”.

One of the key elements underpinning Kahn (1947) is the original theory of protectionism, according to which the imposition of tariffs will remain an optimal strategy as long as foreign countries do not retaliate with tariffs of their own. A trade war occurs when there are tit-for-tat retaliations, and the global economy ends up with a much higher level of tariffs than before. When a country imposes tariffs on exports, the optimal short-term strategy is to respond with counter-tariffs. However, this tit-for-tat exchange has to stop at some point before the tariffs become prohibitive and start inhibiting global trade, as happened in 1930.

The existence of tariffs and the fact that it is so hard to achieve free global trade are partly due to the big differences in the size of different countries’ economies. According to Kennan and Riezman (1988), “It is well known that large countries can manipulate the terms of trade to their advantage by using tariffs. It is widely believed, however, that this invites retaliation, and that the post-retaliation equilibrium leaves all countries worse off than they would be at free
trade. In [our] model, we find that if one country is substantially bigger it can expect to gain from a tariff war, despite retaliation”.

One further problem with strategic tariffs that make use of some form of monopoly power is that the optimal trade policy is always long-term, never short-term. But since the elasticity of supply and demand is much higher over the long term, the optimal tariff will always be lower. Moreover, this is the case even without accounting for technological change. Rather than the efficiency gains from specialisation postulated by Ricardo⁹, the principal source of growth associated with economic liberalisation occurs when the boundaries of what is possible are pushed back thanks to the technological change generated by free trade.

**General equilibrium: trade liberalisation scenarios for Mexico**

During the first half of 2018, IMCO carried out a series of analyses using the GTAP8inGAMS general equilibrium model (Badri, Aguiar and McDougall, 2012, and Lanz and Rutherford 2016), describing what would happen to Mexico’s GDP and relative prices for a range of increases in US tariffs and for a range of different Mexican responses to US protectionist measures.

Before going any further, it is important to make certain points about the design of the general equilibrium model employed. Firstly, it is a static (instantaneous adjustment) model, meaning that there is no endogeneity in the tariff rates that are used and no illustration of the dynamics of retaliation. Secondly, the model assumes that future economic sectors will be the same as those that exist today. In other words, the model tells us little about the long-term economic effects of the innovation induced by changes in relative prices.

It is also important to mention that we were unable to find a solution for the model for very high and uniform tariff rates (e.g. 100%). It is hard to say exactly what is going on here, but one possibility is that when tariffs are at such a high level, the global economy plunges into a deep recession as a result of the lack of trade between nations.

We examined several average tariff rate scenarios that were eventually narrowed down to just five. Our aim is to illustrate the impacts of the different average tariff rates, based on a uniform rate for the 57 aggregated sectors of the economies in question. However, the model could

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⁹ David Ricardo defined efficiency as each country specialising solely in the production of those items for which it has a comparative advantage.
also be used to model the impacts for each sector, and it is perfectly possible that this could significantly alter the results.

Figure 8. Average tariffs

<table>
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<th>United States</th>
<th>European Union</th>
<th>Rest of the world</th>
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<td>0%</td>
<td>0%</td>
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<td>2</td>
<td>0%</td>
<td>35%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>3</td>
<td>35% on US, 0% on rest of world</td>
<td>35%</td>
<td>35% on US, 0% on rest of world</td>
<td>35% on US, 0% on rest of world</td>
</tr>
<tr>
<td>4</td>
<td>5%</td>
<td>5% on rest of world, 35% on EU</td>
<td>5% on rest of world, 35% on US</td>
<td>5%</td>
</tr>
<tr>
<td>5</td>
<td>35%</td>
<td>20%</td>
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For each of these scenarios, we recorded the changes in consumer welfare and Gross Domestic Product in each country. In this paper, we discuss the results for the change in GDP compared to the free global trade scenario. In all the scenarios, the change in consumption of the representative agent is very similar to the change in GDP, and is therefore not discussed here.

The first scenario (free trade, with a tariff rate of zero for the whole of the global economy) is self-explanatory. In the second scenario, the United States raises the tariff rate imposed on the rest of the world to (an arbitrary level of) 35%, but the rest of the world avoids getting sucked into a trade war and the average tariff rate of the rest of the world stays at zero. In the third scenario, the United States imposes a 35% tariff rate on the rest of the world and the countries in the rest of the world retaliate by imposing a 35% tariff rate on the United States, but keep the 0% tariff rate among themselves. In the fourth scenario, a trade war breaks out between the United States and the European Union, both of which impose a 35% tariff rate on each other. However, the rest of the world (including Mexico) only imposes an average general tariff rate of 5% on everyone. In the fifth scenario, Mexico adopts a more protectionist policy than the rest of the world. The United States and the rest of the world all impose the same tariff rate of 20% on everyone, but Mexico imposes a higher tariff rate than everyone else (35%).
The second scenario shows what would happen if Mexico and the rest of the world were to maintain completely free trade despite US protectionism. The Mexican economy would lose around 1% of its GDP as a result of the protectionist measures taken by the United States. However, if the United States imposed an average tariff rate of 35%, the US economy would stand to lose 5.7% of its GDP. Trump’s avowal that he will refuse to trade with countries that have an unfair policy towards the United States will come at a very high price for both the US itself and the other members of its trading bloc.

The third scenario models global retaliation against the United States, but free trade among all the other countries. In this scenario, Mexico’s GDP shrinks by 0.7%, whereas the United States’ GDP grows by 2.9%. The European Union and the rest of the world experience 1.6% and 1.3% GDP growth respectively.

In the fourth scenario, there is a trade war between the United States and the European Union, but the rest of the world avoids getting completely sucked in. Mexico and the rest of the world impose tariff rates of just 5% on everyone else, while the United States and the European Union impose a tariff rate of 35% on each other. Mexico’s GDP increases by 0.4%, the EU’s GDP shrinks by 0.1% and the United States’ GDP falls by 3.1%. The GDP of the rest of the world remains more or less unchanged.

In the fifth and final scenario, all countries impose a tariff rate of 20% on each other, except for Mexico, which imposes a 35% tariff rate on all other countries. In this instance, Mexico’s GDP rises by a modest 0.5%, whereas GDP grows by 6.8% in the United States, 3.4% in the EU and 4.2% in the rest of the world. This is the perfect scenario imagined by RF Kahn (1947), in which the United States takes advantage of its market power in the global trade arena to achieve higher growth than the rest of the world through the imposition of tariffs. However, it is important to note that this growth is unsustainable in the medium term, because the tariff policy will ultimately stifle technological progress in the global economy.
Mexico is not among the winners in any of the trade war scenarios — its GDP either declines or experiences very low growth. The impact on GDP in the last two scenarios (4 and 5) is not quite as bad. However, scenario 4 (a trade war solely between the US and the EU) is unlikely — if the United States decides to engage in a trade war with highly developed countries, then it will in all probability do the same with medium-income countries like Mexico. In the final scenario where Mexico over-retaliates, the rest of the world grows but Mexico doesn’t.

The reasons for Mexico’s imposition of tariffs in retaliation for the US tariffs on steel and aluminium are more political than economic. Their aim is to persuade influential lobbies within the Republican Party and President Trump’s inner circle to change their trade policy. It makes sense to impose these tariffs as long as the rates remain relatively low. However, Mexico could lose out badly in a scenario where it adopts a more protectionist policy (measured in terms of tariff rates) than the rest of the world.

The least harmful scenario for Mexico is scenario 2, where the rest of the world maintains free trade despite US protectionism. The global markets open up even to the United States, and they do so asymmetrically. This is due to the simple reason that the global economy is highly dependent on the US. In Mexico’s case, this dependence is heightened by its geographical proximity and close trading links.

The United States is an example of a country with monopoly power in global trade that can manipulate the terms of trade as described by Kahn (1947). However, it cannot always do so to its own advantage. In fact, there are at least two scenarios where the reduction in economic activity induced by a flawed trade policy has catastrophic results for the US.
It should be pointed out that uniform tariff rates as used in this model underestimate the change in relative prices between tradables and non-tradables. Similarly, since this is a static model that does not consider the impacts of technological change, its results underestimate the extent to which technological change is affected by closed economies.
IMCO recommendations

The Instituto Mexicano para la Competitividad (IMCO) has formulated the following recommendations:

1. **Use Mexico’s soft power to stop protectionism from spreading across the rest of the globe.** One of the least harmful scenarios is where the global economy does not go down the same path as the economy of the United States (scenario 2). In this scenario, the decline in Mexico’s GDP is due to the decline in the United States’ GDP. Mexico is bound to be affected if its main trading partner pursues an irresponsible trade policy. Mexican diplomacy has a track record of achieving global consensuses around good causes such as climate change. As such, it could make a concerted effort to maintain free trade in the rest of the world, even if the US closes off its economy. We must take this opportunity to position Mexico as a pro-trade nation, not just because we can, but because it will enhance Mexico’s image on the global stage, showing it to be a country that believes in competitiveness, believes in itself and, for once, is in the right.

2. **Don’t over-retaliate against the United States or close off Mexico’s economy to other countries.** Mexico cannot afford to be more protectionist than the rest of the world. The worst-case scenario for the Mexican economy is if Mexico pursues an overly protectionist policy and its average tariff rates end up higher than those of the US (scenario 5). In the future, the following points should be taken into account before retaliatory trade measures are taken:

   - Tariffs should only be imposed on products for which there is a clear alternative supply.
   - Never impose tariffs to protect a domestic industry.
   - Tariffs should only be imposed in response to protectionist measures taken by others, and only with the aim of bringing an end to these protectionist measures.
   - Retaliatory trade measures should only ever be temporary.

3. **Strengthen Mexico’s bilateral and multilateral strategy while maintaining its regional strategy.** Barfield, De la Calle, Destler and Vargo (2003) cite De la Calle’s explanation of the relationship between the three trade agreement levels (bilateral, regional and multilateral). De la Calle argued that the three trade agreement levels are interrelated. Together with the European Union, Mexico has the largest network of free trade agreements, and these translate...
into a large number of stable trading relationships. This network allows Mexico to be a significant player in various forums – the WTO, APEC and the FTAA – because it has less to lose than other nations with less stable relationships. Bilateral agreements can have a significant short-term impact on regional and multilateral negotiations, since they can change the incentives. Barfield, De la Calle, Destler and Vargo (2003) also describe how “Barfield argued that the bilateral framework is the least desirable arrangement from the U.S. perspective. He made three points: (1) multilateral agreements should remain the priority of the U.S. Trade Representative (USTR); (2) it is important in regional agreements to prevent parties from excluding whole sectors from the agreement; and (3) all nations should commit to keeping free trade agreements (FTAs) open for other countries to join”.

Historically, Mexico’s trade strategy has concentrated mainly on regional agreements like NAFTA and bilateral agreements such as the Free Trade Agreement between Mexico and the European Union (FTA EU-MX) and the agreement with Japan. However, there has been very little in the way of a multilateral strategy. While it will be important for Mexico to pursue new bilateral agreements (e.g. a potential agreement with the United Kingdom), it also needs to strengthen its multilateral strategy. Although the WTO is far from perfect, it is important to uphold its rules, since otherwise the asymmetry between countries in bilateral agreements will have a detrimental impact on the smaller, poorer countries like Mexico (Newell, 2018). In view of the above, Mexico’s permanent representative to the WTO will be one of the most important appointments in the 2018-2024 administration.

Ultimately, the only genuinely effective trade liberalisation strategy is unilateral liberalisation that does not demand concessions from other countries. The other strategies (especially bilateral and regional trade agreements) are simply a means of gradually moving towards a more open economy where the factors of production focus on the activities where they have a comparative advantage.
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