THE NORTH AMERICAN FREE TRADE AGREEMENT: IT'S IMPACT ON CALIFORNIA

Norris C. Clement and James Gerber*

ABSTRACT

In the first half of the paper, the NAFTA Is viewed as the solution offered by policy makers to the problems of falling Import substitution Industrialization, the oil-debt crisis, and Increasing International competitlon. Within each country, however, there are concerns about Job loss. environmental degradation, human rights violations, and the loss of cultural Identity. The second half of the paper puts the NAFTA In the context of Its likely Impact on the state of California. Mexico and Canada are shown to be the state's second and third most important trading partners but an enormous asymmetry exists between California-Canada trade and California-Mexico trade. This asymmetry is examined and winners and losers In California are projected.

RESUMEN

La primera mitad de este articulo discute el ALC (Acuerdo de Libre Comercio) corno lo han presentado los formuladores de política, quienes lo proponen como solución a los problemas que han fomentado el fracaso del modelo de una Industrialización basada en la sustitución de productos Importados, la crisis del petróleo y de la deuda externa y el aumento en competitividad internacional. Sin embargo, dentro de cada país hay preocupaciones sobre una posible reducción en empleos, un deterioro en el medio ambiente, violaciones de derechos humanos y pérdida de identidad cultural. La segunda mitad del artículo examina el ALC en términos de sus Impactos en el estado de California. México y Canadá ocupan el segundo y tercer lugares en importancia en cuanto al comercio de California, pero hay una asimetría Importante entre el comercio California-Cañada y el comercio California-México. Los autores examinan esta asimetría y sugieren quienes serán los ganadores y quienes los perdedores en California una vez que el ALC sea concretado.

* **Norris C. Clement and James Gerber.** The authors are Professor and Assistant Professor of Economics. Department of Economics. San Diego State University.

Introduction

IN June 1991 the governments of the three nations of North America began negotiating a free trade agreement that, if implemented, would over time reduce or eliminate barriers to trade and Investment flows. Such an agreement would pave the way for increased economic integration, which according to orthodox economic theory, would Increase specialization and competition within the free trade area, improving economic efficiency while providing lower prices and higher real incomes to consumers.[1] In the specific case of North America, where a relatively high degree of integration already exists between the U.S. and Canada and the U.S. and Mexico (see Table I),[2] a free trade agreement, it is argued, would eliminate many remaining barriers thereby making each country better off by raising economic growth rates and increasing the region's ability to compete in global markets.[3]

This paper addresses three main questions. First, what are the historic and economic conditions behind the attempt to form a North American Free Trade Agreement (NAFTA) at this time in history? Second, what are the main issues now being debated in the three countries vis-a-vis the NAFTA? And, finally, how might the NAFTA impact California's economy? In the final section of this paper we offer some of our own suggestions as to how California businesses and government might respond to the opportunities and challenges that further North American integration presents to the state.

1 A free-trade area Is but one form of economic Integration that can occur between two or more (member) countries. The lowest level Is the "preferential trading arrangement," providing for the lowering of trade barriers to members while the next higher step Is the "free trade area." Here, trade barriers are eliminated between member countries on a specified group of goods (or all goods) with each country determining Its own level of external tariffs against non-members. Next, a "customs union" provides for free trade and a common external tariff. Finally, a "common market" adds free movement of labor and capital.

2 Intra-regional North American Trade (exports), as a percentage of total exports, was 43.2% ln 1987 as compared to 58.6% for the 12 country European Economic Community and 17.8 % for Japan and the Asian NICs (Brunelle and Deblock, 1991).

3 Most analyses of the economic effects of the proposed NAFTA have yielded quite similar conclusions: economic growth would be Increased In all countries, but Mexico's growth rate would Increase the most. The study most referred to In the United States was carried out by the United States International Trade Commission (USITC, 1991). For a nontechnical discussion of the strengths and weaknesses of these models see Kresi (1991).

Limitations of space prevent an exhaustive coverage of the issues and the vast outpouring of literature produced in recent years by what one author refers to, only partly in jest, as one of the most dramatically expanding Industries in North America, the "Free Trade Debate Industry" (Kresi, 1991).

Historical Background

The obvious question, from an orthodox economic perspective, is why, in view of the potential gains from Increased trade, has it taken these three contiguous countries so long to begin negotiating a free trade agreement?

On one level this question is answered rather simply and directly. Viewed from the perspective of both Canada and Mexico, the history of North America has been marked by United States territorial expansion in the 18th and 19th centuries economic protectionism in the late 19th and early 20th centuries and political-economic hegemony in the 20th. Furthermore, the economies of both Mexico and Canada, until recently, were based mainly on the production and exportation of natural resources and required considerable government stimulation and trade protection in order to promote industrialization and autonomous economic growth. Finally, both countries' economies are relatively small.

TABLE 1
NORTH AMERICAN GDP AND TRADE FLOWS

A. GDP AND POPULATION

	1989 GDP (billions)	POPULATION (millions)	GDP/POP.
Canada	550.2	26	21 163
United States	5 233.0	249	21 016
Mexico	198.9	85	2 340

B. INTRA-REGIONAL TRADE, 1990
(Billions Of 1990 Us Dollars)
(Percent Of Total Exports In Parentheses)

		IMPORTS		
		Canada	United States	Mexico
EXPORTS	Canada	-----	93.8 (72.0)	0.5 (0.4)
	United Sates	83.0 (21.0)	-----	28.4 (7.2)
	Mexico	0.7 (2.4)	30.8 (73.1)	-----

Source *:External Affairs and International Trade* Canada. n.d.; IMF. 1991.

Productivity levels generally lower in comparison with the U.S. so that trade protection and foreign investment regulations were viewed as one way to protect the domestic Industrialization process from the larger, more efficient U.S. multinational corporations (MNCs).[4]

In summary then, historically both Canadians and Mexicans have opted for protectionism out of a strong desire to independently forge their own economic destinies and to protect themselves from their larger and aggressively expansionistic neighbor.[5]

However, the question of why North American integration didn't happen earlier gets much more complicated as one looks at it in the international context. Today's global economic system has its roots in the institutions created during the 1940s, with the ending of World War II. At that time the U.S. was the dominant economic (and military) power, having emerged from WWII with its factories, homes and offices intact as former enemies and allies began the enormous task of rebuilding. The U.S. and its main allies (including Canada) meanwhile set to the task of building a new economic order which came to be based on three important multilateral institutions: the International Monetary Fund (IMF); the General Agreement on Tariffs and Trade (GATT); and the International Bank for Reconstruction and Development (today called the World Bank) .[6] The main objective of these institutions — to provide for the expansion of international trade in a climate of financial stability — has not markedly changed and, arguably (see Blake and Walters, 1987 for a good presentation

4 Although It Is difficult to find sources providing balanced assessments of the United States In the formation of Mexican and Canadian history, culture and economy, Interested United States readers are referred to the books by Riding (1984) and Thompson (1991) for a basic Introduction.

5 It is Interesting to note In this context that Mexico's main population centers are located far from the border with the United States and that the large northern desert long has been regarded as a welcome barrier to United States expansionism. In contrast, 90 % of Canada's population Uves within 200 miles of the United States border, mainly because that region has the most hospitable climate and geography. It was partially because of this that in 1846 the colonies of British North America signed a Reciprocity Treaty with the United States that provided for free trade of manufactured goods. This treaty, however, was unllaterally abrogated In 1866 and subsequently divided Canadians on the Issue of free trade with the United States.

6 Together these Institutions provide a multilateral approach and "rules of the game" for trade (GATT), international financial arrangements (IMF) and for financing development projects (World Bank). While Canada and the United States were founding members of all three Institutions, Mexico did not Join GATT until 1986.

on the debates here), it can be said that they have been quite successful in attaining their objectives: between 1950 and 1990 exports expanded ninefold while world output increased fivefold.

The major point here is that until the 1960s the global economic order established after WWII functioned quite well while simultaneously serving U.S. economic interests. Thereafter, however, increased competition from Japan and the Newty Industrializing Countries (NICs) of Asia, which based their development strategies on the outward-oriented, export promotion model, significantly challenged the advanced industrial countries of North America and Europe. The U.S. responded by trying to open up new markets, pushing for the expansion of GATT negotiations from traditional areas (i.e., mainly manufactured goods where the U.S. competitive advantage was disappearing) into new areas (i.e., agricultural products, intellectual property, services, and investment, where the U.S. advantage was strongest). Europe, however, responded by accelerating the integration process toward the now famous European Economic Community, a common market arrangement allegedly designed to minimize the intrusion of Asian and U.S. MNCs.

Meanwhile, most Latin American NICs, including Mexico, based their development strategies mainly on the inward-oriented, Import Substitution Industrialization (ISI) model which requiring high protection and an active governmental role. Canada's economic model was decidedly outward-oriented with respect to trade tempered by certain limitations on foreign investment. Both Mexico and Canada always have been aware of their extreme dependency on the U.S. as a trade partner — more than two thirds of their trade is with the U.S. —and as the main source of foreign investment.

During the 1970s the dramatic oil price increases brought a new phenomenon to all market economies, "stagflation" (i.e., low or negative economic growth accompanied by high inflation). The old "Keynesian" macroeconomic policies that had guided policy makers in the U.S. for several decades just didn't work any more. It was during this period that "supply-side economics" emerged and provided the basis for the "Reaganomics" of the 1980s that eventually brought: the deepest recession since the 1930s (1981-82), the biggest military buildup since the 1940s, the longest peacetime expansion in the 20th Century, and the largest federal budget and international trade deficits ever, which in turn brought the U.S. to record levels of private and public debt (Pool & Stamos, 1987).

Mexico in the 1970s was already heavily in debt, but with the discoveries of vast oil and gas reserves in 1976 and the subsequent oil "boom" of 1977-82, Mexico too went more deeply into debt in order to develop both the oil industry itself and further its industrialization process. In fact, it was Mexico's inability to service its debt in 1982 that marked the generalized Third World debt crisis and pushed Mexico into austerity and recession. The resulting "crisis" of high inflation, reduced economic output, and falling living standards is now frequently referred to as the "lost decade" in Mexico and most other debtor countries of Latin America. The crisis, however, stimulated the dramatic market-oriented economic restructuring during the late 1980s which included: Mexico's finally joining the GATT (in 1986); decreasing the government's economic role; privatizing many key government owned firms; reducing tariffs and non-tariff barriers to international trade. This process culminated in the request for negotiations for afree trade agreement with the U.S. in August, 1990.

Mexico's President Salinas has argued many times that an FTA is important to his restructuring program by providing guaranteed access to the U.S. economy at a time when the U.S. Congress is becoming increasingly protectionist. An FTA would stimulate foreign investment, a return of domestic flight capital to Mexico and provide increased competition to Mexico-based MNCs and domestic firms, hold down inflation and increase international competitiveness.

Canada too has experienced dramatic changes in recent decades. In the early 1970s, trying to avoid the two extremes of self-reliance and excessive dependence on the U.S., the government attempted to expand trade with Europe and Asia. This so-called "third option", however, was only mildly successful as was the creation of a Foreign Investment Review Agency (FIRA) in 1974 which established certain performance criteria for foreign investors, and the New Economic Policy (NEP) of 1980 which again reduced foreign investment in the energy sector. But a decrease of foreign investment and the 1981 -82 recession seem to have convinced voters that a more open economy led by a conservative party would be in their economic self interest (Thompson, 1991).

The election of the Progressive Conservative Party, led by Brian Mulroney, in 1984 resulted in dismantling of the FIRA and NEP programs and to some privatization of state-owned industry. Arguing that Canada owes its high standard of living to global trade and that an agreement with the U.S. would improve its competitive position with respect to the Japan and Asian NICs Mulroney began negotiations in March, 1985 and signed a Free Trade Agreement (FTA) with the U.S. in January, 1988. The debate over parliamentary approval was very strong, but in December of that year the pact was approved and went into effect in January, 1989.[7] Since that time Canada, like the U.S., has plunged into a deep recession with unemployment rates over 10%. Many Canadians associate the implementation of the FTA with the recession. This, together with the present constitutional crisis over the Quebec question, has led to a dramatic decline of Mulroney's popularity and election victories by the opposition, the New Democratic Party, which is strongly against the FTA. Nevertheless, when Mexico asked to begin negotiations with the U.S. on a bilateral FTA, the Canadian government decided — despite its weak economic ties with Mexico — that in order to protect its interests in the North American economy it would join the negotiations in a trilateral relationship.

The NAFTA Debate

On May 5, 1991 the heads of state of the three countries issued a joint statement providing for "...trilateral negotiations aimed at a comprehensive North American free trade agreement. The goal would be to progressively eliminate obstacles to the flow of goods and services and to investment, provide for the protection of intellectual property rights, and establish a fair and expeditious dispute settlement mechanism" (U.S. Department of State, 1991). Additionally, it is generally assumed that the U.S. -Canada FTA would provide the point of departure for a trilateral agreement and therefore would provide for a phase-in period of 10 years.

As can be seen from Table 1, the wide differences in terms of size, per capita incomes, stages of development and trade flows make such an agreement difficult. However, proponents of the agreement argue that it is precisely those differences that make the economies complementary, and that integration will force a geographical redistribution of investment within the three countries that will permit better realization of potential economies of scale and more efficient allocation of resources.

NAFTA proponents, mainly the governments and the business sectors of the three countries, readily admit that there are many difficult issues that must be resolved with a trilateral agreement, some of which are still

7 It should be mentioned here that the United States has long had sectoral free trade agreements with Canada beginning In 1959 with the Defense Production Sharing Arrangements permitting free trade In military goods and the Automotive Trade Agreement In 1965.

being worked out in the U.S.-Canada FTA.[8] They also acknowledge that there will be some "winners" (i .e., consumers, workers and firms in competitive sectors, and certain geographical regions in all three countries) and some "losers" (i.e., workers and firms in non-competitive sectors and certain geographical regions). But, they argue, the 10 year phase-in period for reducing trade barriers together with "snap back" provisions (i.e., temporary imposition of higher tariffs on sectors especially hard hit) will give sufficient time to adjust.[9]

Nevertheless, the debates in all three countries have revealed many criticisms of such an agreement,[10] which in general terms can be classified as follows.

1. Labor and community groups in (mainly) Canada and the U.S. strongly stress the potential decline of the manufacturing sector, loss of jobs, and deterioration of living standards that could result from freer trade and from MNCs moving to lower cost locations, and the resulting disruptions to communities that would follow. In this view the NAFTA is frequently likened to a gigantic *maquiladora* program like the one that now exists in Mexico. Most labor groups in Mexico, long loyal to the official government party, see job and perhaps wage gains resulting from the NAFTA and therefore have, for the most part, sided with the government's pro-NAFTA position.

2. Environmentalists in all countries, viewing the poor environmental enforcement record in Mexico, foresee a significant exodus of Canadian and U.S. firms to escape the stricter enforcement in their countries, aggravating both regional and global pollution as well as the displacements noted in I above. Additionally there is an growing group of environmental economists who oppose expanding intema-

8 These Include: subsidies; rules of origin; non-tariff barriers; dispute mechanisms; standards; certification; and Investment practices. Those Issues that pertain directly to California's economy will be discussed below.

9 For a good summary of many of the concerns of the United States Congress see the letter by Senator Bentsen (1991) and the rather lengthy response from Presldent Bush(1991).

10 For a variety of views from all three countries see the *Columbia Journal of* World Business, summer, 1991, and the American Review of Canadian Studies, fall, 1991. For a more detailed view of the critiques of the NAFTA from the three countries see NACLA's Report on the Americas, May 1991. The papers by the AFL-CIO (1990) and the Canadian Labour Congress (undated) provide a comprehensive view of organized labor In the United States and Canada respectively, while the Mobilization on Development, Trade, Labor and the Environment (MODTLE) undated, provides an alternative view for North American development, apparently prepared by a group of left-oriented activists In all three countries.

tional trade on the grounds that increasing “global interdependence” is likely to have negative effects on both the environment (e.g., through oil spills) and “institutions of community” within national borders; their general objective is to increase self-reliance and social control of economic institutions at the regional/national level (Daly and Cobb, 1989 and Elkins, 1986).

3. Human rights groups in the three countries point to human rights violations and the absence of truly democratic processes and human rights violations in Mexico and advise that increasing trade links would implicitly condone such behavior.

4. In both Mexico and Canada NAFTA opponents are concerned with the potential loss of cultural identity, sovereignty and political autonomy that could result from a closer, more open relationship with their much larger and more powerful trading partner.

In response, NAFTA proponents argue that while there will be a reallocation of jobs geographically and sectorally due to shifting investment patterns, the reallocation will occur anyway given the current globalization of trade and investment. Additionally, they argue that with lower trade barriers U.S. and Canadian exports to Mexico will rise — as they already have since trade liberalization occurred in the late 1980s. With respect to the environmental objections, they point to the recent environmental reforms carried out in Mexico and assert that the NAFTA will actually aid environmental protection by stimulating economic growth and thereby providing Mexico with the increased resources to fund environmental programs. Finally, they point out that democratic and human rights reforms must wait until the economic reforms have been fully carried out, in order to provide the economic support necessary to political stability during such a period of transition.

Nevertheless, at the time of writing it appears that while negotiations on the NAFTA will continue, presenting an actual agreement to the legislative bodies of the three countries will not occur in early 1992, as originally planned, for two reasons. First, the negotiations have proved somewhat more difficult than anticipated, and second because the anemic recovery from the recessions in Canada and the U.S. makes passage of such a controversial agreement unlikely so close to elections.

With or without the NAFTA, however, economic integration has been given a big “shot in the arm” and the Mexican economy currently is growing much faster than its North American trading partners and is receiving record levels of both direct and indirect investment to fuel its recovery from the tragic “lost decade”.

The Pattern of California's Export Trade

The future pattern of California's trade and investment in an Integrated North American economy will likely develop from current strengths and weaknesses. Therefore, the opportunities and challenges to California from the NAFTA are best understood by examining the present pattern of production and trade.

The growth of world trade in the last decade has had a significant impact on California's production and employment. While there has been substantial real growth in the state's manufacturing output (27.3 percent, 1977-87), the real growth of exports and export related employment has been much higher (98.7 and 74.4 percent, respectively, 1977-87).[11] Table 2 Illustrates the magnitude of the relationship between manufacturing and export growth.

TABLE 2
GROWTH IN CALIFORNIA MANUFACTURING AND MANUFACTURED EXPORTS

	1977	1987	PCT. CHANGE
A. VALUES (Millions of 1987 dollars)			
1. Total manufacturing*	198 463	252 729	27.3
2. Direct exports	14 964	22 996	53.7
3. Indirect exports	6 901	20 454	196.4
4. Total (2 + 3)	21 865	43 450	98.7
5. Exports/Shipments	11.0	17.2	
B. EMPLOYMENT (Thousands of persons)			
1. Total manufacturing	1 752	2 101	19.9
2. Direct export related	134	166	23.1
3. Supporting	71	192	173.3
4. Total (2 + 3)	205	358	74.4

*Value of manufacturer's shipments. Sources: *U.S. Bureau of the Census* (1981 and 1991).

The composition of California's manufactured exports (Table 3) shows that, not surprisingly, California's most dynamic exports

11 In contrast, the real growth In total world trade, 1977-87, was 35.1% (IMF, 1990).

depend on either: (1) a skilled work force in high value added industries coupled with industrial concentration in particular regions (e.g., Silicon Valley for computers, office equipment, semiconductors, etc., and Los Angeles for instrumentation, aircraft, and electrical equipment and supplies); or (2) a unique niche in a particular national and world market in fashion and Interior design (i.e., apparel, furniture, and fixtures). These factors represent the strengths of the current state economy and, despite rumors of a mass exodus of California's manufacturing firms, we believe that these factors will provide the basis for future growth as well. Growth In the remaining industries and in agriculture will either depend on: (1) growth in the local market (e.g., paper, chemical, primary and fabricated metal products) and/or (2) face serious challenges from the NAFTA (e.g., some sectors of agriculture and food processing).

Interpretation: While manufacturing grew by 27.3 percent in value terms, and by 19.9 percent in employment, exports rose more than 3.6 times as fast in value and 3.2 times faster in employment. The much more rapid increase in supporting exports and employment implies that the export sector has become more integrated into the California economy.

TABLE 3
CALIFORNIA'S MANUFACTURED EXPORTS, BY MAJOR INDUSTRY
(Millions of 1987 dollars)

INDUSTRY	VALUE	RANK	GROWTH (1977-87)
1. Food and kindred	1 885.1	6	20.8%
2. Apparel	238.1	16	110.9
3. Lumber/wood products	535.8	13	20.4
4. Furniture	139.3	17	144.8
5. Paper	1 040.1	11	99.3
6. Printing/publishing	621.6	12	396.9
7. Chemicals	1 524.3	8	32.2
8. Petroleum/related products	2 149.2	5	42.4
9. Rubber/plastic products	1 061.8	10	157.2
10. Stone/clay/glass/concrete	349.4	15	54.7
11. Primary metal	1 429.6	9	53.0
12. Fabricated metal, exc. machinery	1 871.6	7	88.8

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13. Machinery, exc. electrical	10 593.0	2	174.6
14. Electrical/electronic mach.	11 630.1	1	239.9
15. Transportation equipment	4 516.2	3	-13.5
16. Instruments	3 356.3	4	211.9
17. Misc.	359.8	14	13.3

Source: U.S. Bureau of the Census, 1981 and 1991.

Interpretation: Industrial machinery (including computers and peripherals) and electrical machinery and equipment (including circuit boards and semiconductors) dwarf the other categories of manufactured exports. They were also among the fastest growing. Note that these items do not depend on a resource base but rather stem from the economics of agglomeration and a skilled work force. Transportation exports shrank (although sub-categories such as aircraft and satellites did well), reflecting the national trend.

In comparison with other U.S. states, California ranked number one in volume of manufactured exports and export related employment (U.S. Bureau of the Census, 1991). But this is not the only source of export revenues. The state is also the number one exporter of agricultural products ($4.24 billion in 1990, mostly fruits, vegetables, nuts, and cotton) and a major exporter of services (ITA, 1991;
California State World Trade Commission, 1991b). State export revenues from entertainment, construction, travel and tourism, aviation, and maritime activities were each over a billion dollars in 1984 (International Technology Management, 1987).

Service exports are difficult to measure and there are no recent reliable estimates or interstate comparisons. Undoubtedly, some service exports are included in the estimates of indirect exports in Table 2 since they tend to be intimately related to manufactured and agricultural exports. A 1987 study by the California World Trade Commission (International Technology Management, 1987) estimates 1984 service exports to have been between 12 and 15 billion dollars, approximately three-fourths the value of manufactured direct exports, and implies a 1987 value of $17.2 billion (.75 times $23.0 billion). More recent estimates are problematic, given the incomparability of the 1987 data with data for 1990. Still, it is clear that service sector exports are important to the economy and that, along with agriculture, they are likely to be affected by the proposed NAFTA.

Interpretation: Although a substantial amount of California's exports are sent to Europe, our location and diversified economy give us an advantage in trade with the Pacific Rim. Canada and Mexico, both Pacific Rim countries, are our number two and three export markets and, taken together, are equivalent to Japan.

Table 4 shows total 1990 California exports broken down according to our trade partners. Canada and Mexico are our second and third most important export markets, respectively. Consequently, California already has a large number of linkages to both countries.

These linkages may prove to be important in two ways. First, they could provide the channels for expanding California and U.S. trade

TABLE 4
1990 CALIFORNIA EXPORTS: TOTAL, AND BY COUNTRY
(Billions of 1990 dollars)

	DOLLARS	PERCENT
1. Total Exports	58.4	100.0
2. Japan	10.3	17.6
3. Canada	5.8	9.9
4. Mexico	4.7	8.0
5. South Korea	3.8	6.5
6. Germany	3.7	6.3
7. United Kingdom	3.4	5.8
8. Taiwan	3.2	5.5
9. Singapore	2.6	4.5
10. France	2.2	3.8
11. European Community	14.9	25.5

Source: California State World Trade Commission, 199 Ib.

further. Market Information, distribution networks, and business contacts are, to a significant degree, in place. Second, given the lack of strong linkages between Canada and Mexico, there is some potential for California to act as a base from which Canadian manufacturers can embark on maquila type production inside Mexico. California's border area is an attractive location for Canadian plants and managers who tend to be unfamiliar with Mexico but wish to avail themselves of lower Mexican wages. This opportunity for the state to attract business has, so far at least, been overlooked.[12]

12 Another opportunity exists In the flight of capital from Hong Kong In anticipation of the Chinese takeoverin 1997. We see no reason that California In general, and San Diego In particular, could not present Itself as an attractive location for firms

Tables 5 and 6 list the top ten categories of exports to Mexico and

TABLE 5
LEADING CALIFORNIA EXPORTS TO CANADA, BY MAJOR INDUSTRY, 1990
(Millions of 1990 dollars)

MAJOR INDUSTRY	EXPORTS	LEADING INDUSTRY GROUPS
1. Machinery, except electrical	1 528.4	1-Computers 2-Engines/Turbines
2. Electrical equip. and supplies	980.3	1-Semiconductors 2-Elect. apparatus
3. Agric. products-crops	669.0	1-Fruits and nuts 2-Vegetables
4. Transportation equipment	506.6	1-Aircraft/Parts 2-Space vehicles/Parts
5. Food and kindred products	471.4	1-Preserved fruits 2-Sugar/Confectionary
6. Instruments and related products	392.0	1-Measure/Control 2-Search/Navigation
7. Fabricated metal products	242.9	1-Struct. metal prod. 2-Screw machine prod.
8. Chemicals and allied products	159.4	1-Drugs 2-Industrial chemicals
9. Primary metal industries	110.9	1-Nonferrous rolling 2-Blast furn/steel
10. Rubber and misc. plastic product	104.7	1-Misc. plastic prod.
Total	5 165.5	
Percent of total exports to Canada	89	

Source: MISER, 1991.

Canada.[13] These goods reflect very closely the state World Trade Commission's 1989 assessment of the state's overall top export

looking to combine low wage manufacturing in Mexico with the high Income market of the United States and Canada.

13 State level export data must be used with caution. The two existing data sources use different methodologies to derive results that are Incomparable. There are numer-

TABLE 6

LEADING CALIFORNIA EXPORTS TO MEXICO, BY MAJOR INDUSTRY, 1990

(Millions of 1990 dollars)

MAJOR INDUSTRY	EXPORTS	LEADING INDUSTRY GROUPS
1. Electrical equip. and supplies	1 015.3	1-Semiconductors; 2-Elect. apparatus
2. Machinery, except electrical	668.5	1-Computers; 2-Engines/Turbines
3. Transportation equipment	436.3	1-Aircraft/Parts 2-Space vehicles/Parts
4. Petroleum and	297.1	1-Petroleum refining
5. Fabricated metal products	260.2	1-Struct. metal prod.; 2-Screw machine prod.
6. Chemicals and allied products	236.7	1-Drugs; 2-Industrial chemicals
7. Rubber and misc. plastic product	217.1	1-Misc. plastic prod.
8. Lumber and wood	205.9	1-Saw/Planning mills; 2-Logging
9. Primary metal industries	183.8	1-Nonferrous rolling; 2-Blast furn/steel
10. Misc. manufacturing	166.9	1-Toys/Sporting goods; 2-Jewelry
Total	3 687.6	
Percent of total exports to Mexico:	79	

Source: MISER, 1991.

ous difficulties In estimating the state of origin of exports, and the methodologies are still experimental. In tables 5 and 6, MISER'S (Massachusetts 'Instltute for Social and Economic Research) state exports program Is used, whereas tables 2 and 3 come from the United States Census Bureau's Survey of Manufactures, Exports *from* Manufacturing Establishments. Each has Its own strengths and weaknesses, and, although the Survey Is probably the more accurate, It is only conducted every 5 years and the data ls published wIth along lag. In February of 1991 the data for 1987 was released. Neither program estimates service sector exports by state. Both data sources are available from the United States Department of Commerce's National Trade Data Bank In CD-ROM format.

prospects: (1) computers and office automation, SIC 357; (2) electrical components and accessories, SIC 367; (3) telecommunications equipment, SIC 366; (4) aircraft and parts, SIC 372; (5) measuring and controlling instruments, SIC 382; and (6) surgical, medical, and dental instruments, SIC 384 (California State World Trade Commission, 1989).

Exports to Canada and Mexico also reflect the state's overall trade pattern with minor variations; for example, the Canadian market is important for fresh California vegetables, and fruits and nuts, while Mexico is a major competitor. Since the enactment of the U.S.-Canada FTA in January of 1989 there have been noticeable increases in overall U.S. exports to Canada of items originating in California. For example, fresh fruits and nuts and fresh vegetables increased in export value by 120 and 130 percent, respectively, from 1989 to 1990.

Industrial machinery other than electrical (SIC 35), and electrical machinery, equipment, and supplies (SIC 36) rose 30.2% and 19.0 percent, respectively (MISER, 1990 and 1991). Together, these constitute the top three exports to Canada.

Interpretation: Mexico shares with Canada 3 of the top four and seven of the top ten export categories in roughly the same order of importance. The primary difference in the two markets is that Mexican imports from California are less influenced by the state's agricultural sector, while Canada imports heavily of both fresh and processed agricultural pro ducts.

The largest category of exports to Mexico -electronic and electrical equipment and supplies (SIC 36) - indicates the strong linkage between Mexico's *maquiladora* program and California's high technology sector. The border corridor across from California (Baja California) contains 932 plants and employs 101,302 persons. Overall, Mexico's border maquilas number 2 080, employ 464,338, and produce 80% of the nation's manufactured exports (Twin Plant_News, 1991). This sector of Mexico's economy is well integrated into the economies of California and the U.S.

In addition, the bi-national integration of the maquila industry along the length of the U.S.-Mexico border has an impact on California's economy that extends beyond the plants located in Baja California. The state with the largest Mexican trade is Texas, but it is estimated that 90% of the Texas' manufactured shipments to the maquilas along its border originate outside the state. There is, consequently, a strong likelihood that California will benefit from any growth in the maquila sector, whether the growth is along our border or not (MISER, 1991; Perryman, 1991).

Issues for California: *Canada.* It is well known that Canada is the number one trading partner of the U.S. (number two after Japan for California) and that the two nations' bilateral trade is the largest anywhere. Despite the recessions that began in both countries in 1990, the U.S.-Canada FTA has increased trade flows. From 1989 to 1990, total trade grew by 10.7% (from $ 153 billion to $ 169.4 billion in current dollars). In real terms, U.S.-Canadian trade grew well over 9% while total real U.S. trade grew at a 4.5% rate (MISER, 1990 and 1991; U.S. Bureau of the Census, 1991).

The rapid expansion of U.S. Canadian trade illustrates the fact that there are few points of contention in our trade relations with Canada. This is not to say that there are no issues, but that the issues that remain tend to be product or sector specific rather than issues relating to trading regimes, or economic structure and philosophy. The Office of the U.S. Trade Representative cites five (mostly) product specific barriers that it is seeking to clear up. These concern wine and spirits, wheat and barley, fruits and vegetables, plywood, and certification of testing organizations and laboratories (OUSTR, 1991). Canadian provinces impose a 14.9% "cost of service" charge on non-Canadian wines and spirits and some provinces have packaging requirements for fresh fruits and vegetables that appear to be discriminatory. The other barriers are not likely to have much of an impact on California's trade. All of these issues are under discussion.

Issues for California: *Mexico.* In many respects, the creation of a free trade area with Mexico is a unique event in modern economic history. In no other instance have two nations with such differing levels of industrial development attempted to establish a free trade zone. For example, the gap between German and Portuguese per capita GNP (probably the closest comparison) was approximately $9 200 in 1984 when Portugal entered the EC, while the U.S.-Mexico gap in 1989 was over $18 500. It is not surprising, then, that the NAFTA negotiations should have a lengthy agenda of items that go far beyond the treatment of specific products.

In 1990, the California State World Trade Commission surveyed California businesses regarding the issues that most concerned

14 There Is also an ongoing dispute over provincial subsidies of the forest products Industry. As part of the signing of the FTA. Canadian provinces agreed to Impose export taxes to compensate for subsidized costs of production. Recently the provinces dropped these and the United Slates timber Industry *has* demanded a reinstatement of tariffs on Canadian products.

them about the NAFTA. The summary of their survey results (Table 7) emphasizes two main points. First, a relatively large share of complaints about specific Mexican practices come from agriculture. And second, a number of the problems, as perceived on this side of the border, are general in nature and do not relate to specific government policies or practices.

TABLE 7 ISSUES RAISED BY CALIFORNIA BUSINESSES CONCERNING THE PROPOSED NAFTA
1. Border issues
A. Delays
B. Transport costs, quality, restrictions
C. Infrastructure: housing, roads, waste treatment
2. Tariffs
–agricultural products
3. Non-Tariff Barriers
A. Recognition of intellectual property rights
–entertainment, biotechnology, high tech. R & D
B. Product registration requirements
–wine
C. Import licensing
–agricultural products
D. Health and safety issues
– livestock, crops and agricultural chemicals
4. General Business Issues
A. Bureaucratic unresponsiveness
B. Overloaded legal system
C. Enforceability of contracts
D. Dispute settlement
E. Rules of origin
F. Tax policy

Source: California State World Trade Commission, 1991a; OUSTR, 1991.

Taking the issue of agriculture first, it is important to recognize that Mexico has begun significant agricultural restructuring in recent years. Subsidies to the farm sector have been cut from $2.5 billion in 1985 to $ 1 billion in 1991, and the number of agricultural products requiring import licenses has been cut, although approximately 40% of U.S. agricultural exports (by value) are still covered by licensing requirements (OUSTR, 1991). Import licenses and tariffs adversely affect fresh apples, peaches, and pears, and canned peaches and pears.

Negotiations can make further inroads in opening Mexico's agriculture since licensing is directly under central government control. The best hope in the long run is that a greater market orientation of U.S., Mexican, and Canadian agriculture will channel future investment in the direction of each nation's comparative advantage. However, it should be noted that the reorientation of Mexican agriculture will impact migration flows to the U.S. Over time, as some U.S. products expand into Mexico (e.g., peaches, pears, apples, and grain and oilseeds) some job loss will occur. At the same time, an expected increase in U.S. investment in Mexican agriculture, and the anticipated consolidation of small scale ejido holdings into larger production units, will create a period of transition and disruption. Add to this the fact that there are 25 to 30 million rural Mexicans, that in some parts of the country as many as two-thirds of the adult males have U.S. work experience, and it seems likely that in the short to medium run emigration to the U.S. will increase. Further opening of Mexico's agriculture without increasing emigration will be tricky (Martin, 1991).

The second major point about California business concerns with the proposed NAFTA is that they may not be subject to successful resolution through negotiation. The enforceability of contracts, for example, stems from the absence of anything comparable to the U.S.' Uniform Commercial Code, and bureaucratic unresponsiveness may result from a lack of well denned channels of authority. Some of these issues may respond to pressure exerted through the negotiating process, but many may not. In the final analysis, the higher transactions costs generated by a number of the general business issues could simply remain as an added burden of doing business inside Mexico.

Beyond general business issues, agriculture, and the related issue of migration, several important sector-specific concerns remain. Recognition of intellectual property rights in the form of copyrights, trademarks, and patents is an important issue in California. In the spring of 1991, Mexico passed its Law for the Promotion and Protection of Industrial Property which has increased trademark protection. Mexico also grants 14 year patents on process technology, and, in 1997, product patents will be extended to cover chemicals, pharmaceuticals, alloys or foods. Furthermore, no protection is planned for biotechnology. Copyright laws do not extend to films, sound recordings or computer software (OUSTR, 1991). The

Bank of America forecast that among the big winners in trade with Mexico will be R&D and especially biotechnology (Bank of America, 1991). Without patent protection, this is questionable. The same consideration applies to a number of other potential winners: software products and consulting, films, and entertainment, for example.

The Salinas administration has introduced a new patent law to the legislature and has proposed changes in Mexico's copyright laws. The administration appears to be sensitive to the need for changes in these areas of Mexican law, and the proposed new rules will address many of the concerns of U.S. businesses. To date, however, the laws have not been enacted (OUSTR, 1991).

Winners and Losers in California: The Bank of America (1991) forecasts a tripling of U.S.-Mexico trade in the 1990s. Mexicans spend 15 cents of each additional dollar of income on U.S. goods, many of which are supplied directly or indirectly by California. In the long run, the most significant impact on this side of the border will result from the rise in Mexican incomes and the expansion of their market. In the short to medium run, however, there will be some dislocations.

The United States International Trade Commission has predicted that the most severely affected sector in the U.S. will be horticulture. As the nation's largest producer and exporter of horticultural products, California will feel the effects of opening trade. Crops that will be affected include tomatoes, asparagus, broccoli, cauliflower, and, depending on the outcome of the negotiations around agricultural pests, citrus and avocados. Tomato growers have pressured the U.S. to enact a "snapback" provision which immediately triggers a re-introduction of tariffs if imports hurt domestic producers. In the Canadian case, horticultural interests were granted 20 years of tariff protection if domestic prices are depressed by imports. Hinojosa-Ojeda, Robinson, and Moulton (1991) have estimated that removal of the U.S. 14% ad valorem tariff on tomatoes will raise imports by approximately 15%. Similarly, the U.S. removal of tariffs on frozen broccoli and cauliflower might drop prices 15-20 percent and lead to a similar increase in imports (although these crops increased their imports by 60% between 1988 and 1989 with the tariff in place).

A more interesting, and perhaps more ominous issue concerns food processing (SIC 20). California's comparative advantage in fruits and vegetables has supported an important food processing industry in the manufacturing sector. The removal of U.S. tariffs on processed tomato products, to take one example, would allow Mexican producers to undersell California in the East Coast market by 10%

(Hinojosa-Ojeda, et al. 1991). Meanwhile, however, removal of Mexican tariffs and licensing on canned peaches and pears may, in the long run, offset some of the losses of the tomato processing and frozen vegetable industries.

Food processing, as well as furniture and apparel, tend to manufactured in standardized, high volume lots. Consequently, they are at a point in their product cycles where it is common to observe production moving offshore to low wage countries. Already a number of U.S. food processors have relocated to Mexico (Green Giant has moved from the Saunas Valley, for example) and, given Mexico's comparative advantage in labor intensive horticultural products, a significant number of California's food processing firms must be considered candidates for relocation.

Furniture, which has been moving for environmental reasons, and apparel may be similar candidates. Until Mexico becomes more concerned about its air quality and begins to provide the resources to act on its concerns, we expect the furniture industry to continue its migration with or without a NAFTA.

In the apparel industry there are special circumstances that may keep it more firmly located in California than a comparison of U.S.-Mexican labor costs would indicate. This industry has successfully exploited a market niche for California leisure wear products and market share in this niche depends at least partially on a fast response to an ever changing market. Relocation of production to Mexico may slow a firm's response time and offset any gains in labor cost savings. In addition, the NAFTA is not likely to result in a complete dismantling of trade barriers in the textile and apparel industries. Rather, it is more likely that quotas for Mexico may be Increased at the expense of third countries, minimizing the overall effects (Clement and Jenner, 1987). Furthermore, as long as the flow of foreign immigrants continues to provide a supply of low wage labor, apparel may continue its modest expansion in California.

Overall, however, the border maquila program, has grown at the expense of low wage employment in the U.S. A more dynamic economic environment along the border might lead to a greater sourcing of inputs in Tijuana, Mexicali, and so forth.

California's winners in the NAFTA will be concentrated in the high technology, export oriented, rapidly changing manufacturers of computers, electrical equipment, aircraft and parts, telecommunications equipment, etc. For example, a recent survey of Mexican businessmen indicated that the growth of the computer market was likely to be around 18% per year for the foreseeable future, even without an FTA. The U.S. has a 75 percent market share of Mexican computer imports and 83 percent share for peripherals and software (Perryman, 1991). Average annual real growth in the Canadian market for computers and peripherals is expected to be around 10 percent, and the U.S. market share is 90 percent (D'Angela, 1989). Similar, if slightly less dramatic, conditions hold for other major California technology products.

Firm Flight and Investment in Mexico: Liberalization of the Mexican economy under Salinas has begun to pay off in the attraction of foreign direct investment. The flow from the U.S. was nearly two billion dollars in 1990 after a decade in which significant negative flows were not uncommon *(Survey of Current Business,* 1991). A major concern for many, especially organized labor, has been the fear that these investment flows will cause California and the U.S. to suffer significant job losses as firms rush to relocate in a Mexican economy with low wages and lax environmental enforcement. Although it is undeniable that a chance to escape U.S. wages and regulatory agencies may be irresistible for some firms, we do not believe that there will be a significant job loss in California (or the U.S.) as a result of the NAFTA. There are several factors that will mitigate against such job flight.

First, it is important to bear in mind the relative ability of Mexico to absorb new investment. Mexican GDP of around 200 billion dollars (1989) simply will not find productive uses for huge amounts of capital. The U.S. routinely Invests well over 10 billion in Europe (nearly 18 billion in 1989) and any slight shift of these funds towards the NAFTA would more than saturate Mexico's ability to absorb outside investment. A related point is that the relocation likely to occur will happen with or without the NAFTA only it may be to Taiwan or Singapore instead of Mexico (where the U.S. at least retains management level jobs) if there is no agreement. Second, direct labor costs are a relatively small share of the total costs of U.S. manufacturing firms. The percent varies by industry, but for most it is between 10 and 20 percent. If location in Mexico incurs higher costs elsewhere in production (e.g., interest, transportation, or inventory) or interferes with a firm's turnaround time, any savings in labor might be offset. Third, there is a widespread concern about the problems at the border, including delays, lack of infrastructure, and the difficulty of finding and keeping a suitable labor force. And fourth, Mexico has been wide open to foreign investment for several years, but we have not seen the massive exodus of U.S. jobs that many predict for the future. Signing of the NAFTA is not likely to alter significantly the opportunities that presently exist for foreign firms.

Implications for Public Policy in California: It should be clear at this point that California's economy will, over the next decade be significantly affected by increased North American integration. The extent to which this will occur, however, depends on whether the NAFTA is ultimately ratified by the three countries and the specific terms of the agreement itself. In summary we see the major impacts as follows:

-The prospect of high economic growth rates in Mexico during the 1990s and the existence of high tariff rates there Increase the likelihood that California's exports to Mexico will expand much more rapidly during the 1990s than to Canada where the free trade agreement (phased implementation began in 1989) has already had a marked impact.

-Exports to Mexico will tend to be concentrated in high tech manufactured goods and services, and certain agricultural products; however, some California Industries could be negatively impacted through trade. These include: horticulture; certain other agricultural crops; the food processing industry and furniture, which already has experienced significant exodus to Mexico.

-Investment flows from California to Mexico can be expected to Increase in that California's advanced technology is badly needed in Mexico. However, there is no reason to expect that California firms would immediately rush to Mexico upon the ratification of a free trade agreement. California firms already account for the lion's share of Investment in Baja California's *maquiladora* industry (Clement & Jenner, 1987) and have extensive experience with off-shore sourcing throughout the Pacific Rim area. A number of factors make Mexico an attractive location for California firms, including: availability of infrastructure; proximity to California; high quality, low cost labor;
access to the U.S. and Canadian markets; the size and growth of the Mexican and Latin American markets and the existence of a hospitable climate for foreign investment. Signing the NAFTA would in itself affect directly only the last factor.

Investment flows from Canada to Mexico can be expected to Increase and the California-Baja California border region could become an important player as it already has with Asian firms vis-a-vis the *maquiladora* industry. Whether or not San Diego-Tijuana becomes the next "Hong Kong", however, depends on a very complex set of factors, not the least being initiatives emanating from the binational metropolitan area Itself aimed at creating a truly "world city". Within the Califomla-Baja California border corridor we can expect to see some relocation of retail and wholesale firms to "the other side" as barriers to trade and investment fall and relative costs change.

As to the role of public policy in California vis-a-vis the NAFTA, there are several actions we feel the state should take. While the state certainly has had its hands full with the drought, the budget crisis, and a recent outbreak of "California bashing" in the national press, there are some who think that more should be done (San *Diego Tribune*, 1991). California initially took the lead among states when, in 1989, the state World Trade Commission undertook a survey of businesses in order to understand the concerns they had about the proposed NAFTA. The results of the survey were published in 1991 (California State World Trade Commission, 1991b). The strategy adopted in 1989 was to identify areas of concern and to communicate these to the negotiators while, at the same time, disseminating information to the business community. These efforts are commendable and we feel that there is a need to go further. To our knowledge, with the exception of agriculture there are no detailed studies of the impact of the agreement on specific sectors of the state economy. Other states have jumped ahead in this area. Texas, for example, made the FTA a priority item on its policy agenda and, using the expertise of teams from Texas' academic and business community, has carried out major studies designed to identify problem and opportunity areas, pinpoint specific strategies, and follow up with lobbying efforts in the nation's capital and in the country affecting them most (Texas Department of Commerce, 1991). The New York State Department of Economic Development has also used available academic and business expertise to conduct technical analyses of the likely effects on its state economy (Gandi, et al., 1991).

Our own view is that In addition to mounting a major effort to ascertain both the likely effects of a NAFTA and what can be done to benefit from increasing North American integration in the short run, a long run strategy for improving the state's overall international competitiveness generally must be conceived and implemented. In an earlier paper (Gerber & Clement, 1991) we pointed out that there are two paths to North American integration. One, the least desirable, builds on the old-fashioned, cost-cutting model of global production sharing (i.e., low wages) and while perfectly capable of yielding short run productivity increases, will not stimulate long term improvements in living standards, skill levels and technology. The second path builds on the unique set of factor endowments present in the new, integrated market space to come up with new, Innovative products and production processes which sets in motion a self-reinforcing process of rising living standards, skill and technology enhancements.

As our analysis indicates, North American economic integration, with or without the NAFTA Itself, presents some interesting challenges that can properly be confronted in only one way: by channeling resources into productivity-enhancing education and infrastructure while providing incentives for firms to adopt a long term perspective. Additionally, it is important to keep in mind that California's "war" to increase international competitiveness will only be won by "building on the best", which translates into supporting sectors which have, or are likely to have, a comparative advantage. Protecting non-competitive sectors are simply "minor skirmishes" in comparison and as such should not consume an inordinate share of the state's energies.

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