Anticipated Access: Producer Coalitions in the Negotiation of NAFTA

Ipek Cinar and Robert Gulotty

University of Chicago

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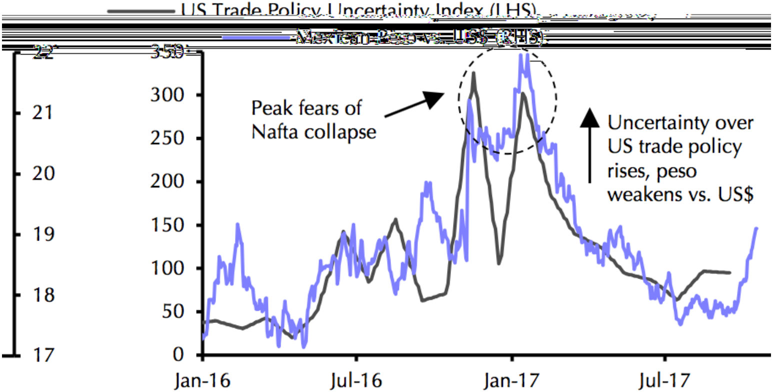
Uncertainty in North America

- Donald Trump has indicated that he would be willing to walk away from the NAFTA agreement.
- Critics have said that this raises uncertainty, undermining a principal advantage of having the agreement.
- For Canada, we would revert to US-Canada, for Mexico the conditions are more dire.

Chart 1: Mexican Peso vs. US$ & US Trade Policy Uncertainty Index



Sources: Thomson Reuters, Economic Policy Uncertainty, CE

Conventional account of NAFTA negotiations

- In the 1980s, the Mexican government initiated a series of economic reforms to attract international investment.
- However, the Mexican government faced new competition from Eastern Europe.
- Trade agreements reduce uncertainty, so the Salinas governments proposed a trade deal with the US.
- NAFTA was heavily lobbied, but upon signature acted to reassure businesses.

Puzzle

- The negotiations raised uncertainty over the future of the US-Mexico market access.
- Trade rose substantially before the uncertainty was resolved.

Previous Literature

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Uncertainty promotes investment and trade: Hartman(1972), Eaton (1979), Abel (1983, 1985)

Positive Effect of Uncertainty

How does uncertainty lead to increased investment and trade?

- Trade is usually a small share of an industry's sales.
- Companies can substitute domestic markets for international markets.
- If they can adjust their export sales, they can take advantage of the good times and avoid the bad times.
- Thus creating convex profit functions. By Jensen's inequality, this convexity means that uncertainty increases expected profits.

Distributional Effects of Uncertainty

- We argue that uncertainty can profit some firms and hurt others, within an industry.
- We develop a Cournot model with firm heterogenity which exhibits convexity in fixed cost.
- We predict that firm's supply linkage determine whether they win or lose from this uncertainty.

Cournot Result

- One low cost firm, endogenous N high cost firms, uniform uncertainty over fixed costs of entry F.
- $F_1 \sim U(0, \bar{F})$:

$$\mathbb{E}_{F_1}[\pi_L] = \frac{2}{3}\bar{F}^{\frac{3}{2}}$$

- $F_2 \sim U(\epsilon, \bar{F} - \epsilon)$:

$$\mathbb{E}_{F_2}[\pi_L] = \frac{2(\bar{F} - \epsilon^{\frac{3}{2}}) - \epsilon^{\frac{3}{2}}}{3(\bar{F} - 2\epsilon)}$$

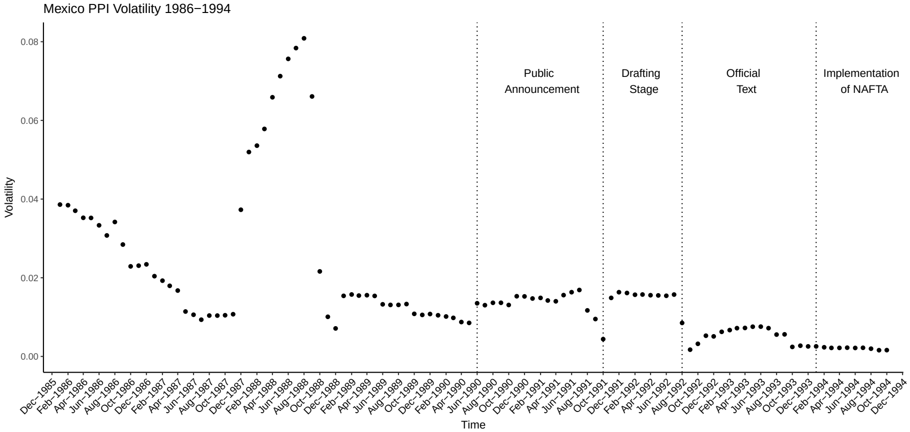
- $\mathbb{E}_{F_2}[\pi_L] < \mathbb{E}_{F_1}[\pi_L]$!

Players in the NAFTA auto sector negotiations

The Big Three: High North American supply chain investments. Particularly concerned about Japanese competition. Supported the tightening of the rules of origin to be negotiated in NAFTA as a way to deter entrance into the auto sector.

The Foreigners: Lack local suppliers and so advocate for a lower rules of origin requirements.

Mexican Auto Parts Producers: Want to maintain the high national value added (NVAp) regulations.



Mexico PPI Volatility 1986−1994
Volatility
0.08
0.06
0.04
0.02
0.00
Public Announcement
Drafting Stage
Official Text
Implementation of NAFTA
Time
Dec−1985
Feb−1986
Apr−1986
Jun−1986
Aug−1986
Oct−1986
Dec−1986
Feb−1987
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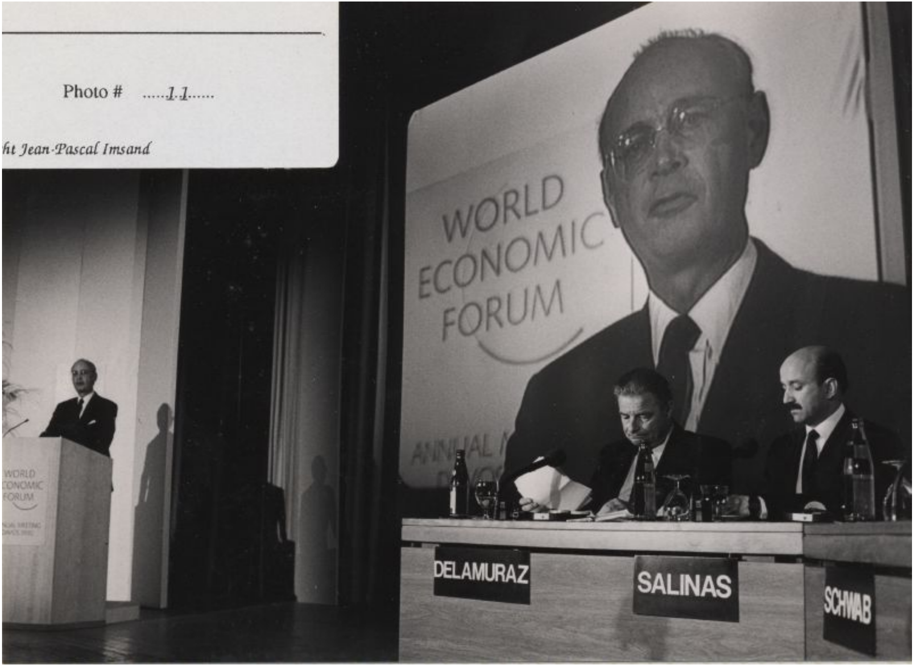
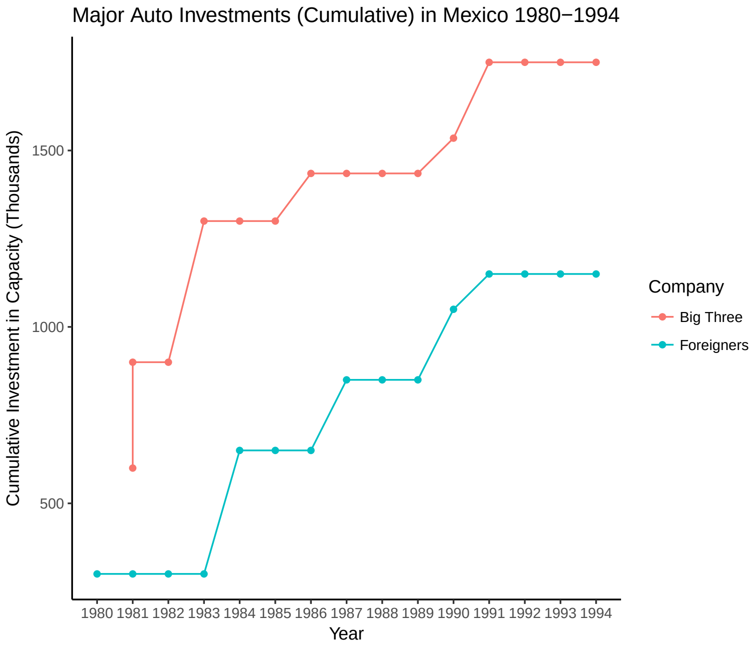
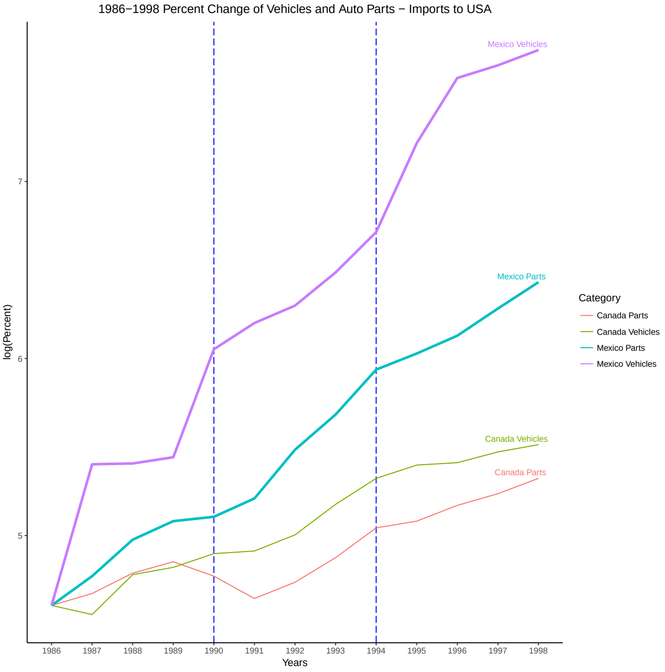


Periods of negotiations

- January 1990 meeting of business and political elites to discuss the creation of the European Economic Community.
  - Salinas, President of Mexico, attended the meeting to pitch his economic reforms and attract investment.
  - He got a lukewarm response, and approached the US about a bilateral trade agreement.
- June 1990 President Salinas and Bush issue joint statement about initiating bilateral comprehensive trade agreement.
- October 1991, negotiations begin drafting deal.
- August 1992, official text released.
- January 1, 1994 NAFTA is adopted.


Major Auto Investments (Cumulative) in Mexico 1980−1994
Cumulative Investment in Capacity (Thousands)
1500
1000
500
1980 1981 1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994
Year
Company
Big Three
Foreigners



1986−1998 Percent Change of Vehicles and Auto Parts − Imports to USA
Mexico Vehicles
Mexico Parts
Canada Vehicles
Canada Parts
log(Percent)
7
6
5
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
Years
Category
Canada Parts
Canada Vehicles
Mexico Parts
Mexico Vehicles

Closer analysis of kind of investment

Company	Period	Kind of investment
Nissan	Pre announcement	Two assembly plants
Nissan	Post Announcement	Nissan invests in parts in the US
Volkswagen	Post Announcement	1 billion in Puebla plant. (focused on Mexican market)
Nissan	Drafting stage	Nissan invests in Parts in Mexico and US

Conclusions

- Negotiation period is important for long run investments.
- The benefits of trade agreements depend on prior investments in supply chain.
- Uncertainty is not an unalloyed negative regionally integrated firms.