Introduction: NAFTA, What Is It And Where Did It Come From?

The North American Free Trade agreement or more commonly known as NAFTA is a trilateral trade agreement between the United States of America, Canada and Mexico. It is one of the most extensive and comprehensive multilateral trade agreements in the world and today the NAFTA countries have a combined output of US 17 trillion and total trade between NAFTA partners reached US946.1 billion in 2008 (NAFTA now, 2013). Through the joint efforts of Canadian Prime Minister Brian Mulroney, US president George Bush Sr. and Mexican president Carlos Salinas de Gorteri, this landmark trade agreement became a reality in November 1993 after years of political negotiations. Some of the major highlights of this agreement expanding on the Canada-US Free Trade Agreement (CUFTA) included; elimination of tariffs on all industrial goods in periods of less than 15 years, unrestricted agricultural trade within 15 years between the US and Mexico and an exceptionally high standard of protection of intellectual property (Weintraub, 2004). NAFTA demonstrated that nations of very different cultures, languages and levels of development could come together to increase economic opportunities for citizens of all three countries.

From a Mexican perspective this was a major step in creating economic growth and industrialization as it forever linked Mexico’s developing economy with two developed nations. Within the first ten years of NAFTA’s inception, the Mexican economy saw its GDP per capita double and it’s market flooded with foreign direct investment (Weintraub, 2004). This increased economic movement across the US-Mexican border would have a lasting effect on the industrial sector. On a political level, NAFTA has been seen as major driving force behind Mexico’s move towards democracy and has played a major roll in US-Mexican Relations. However, with all benefits of NAFTA there have been several point of controversy which have constantly been at the center of

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1 See appendix I

2 See Appendix II
several WTO, WB and IMF summits since 1993. Therefore, an analysis of NAFTA’s effect on trade and investment, industry and social political reform in Mexico will be made.

**The Effects on Trade Policy, Investment and industry**

At the time of NAFTA’s inception in 1993, the main objectives were to facilitate trade, expand investments (both direct and portfolio) and the improve the international competitiveness of Mexican, Canadian and US firms (Thomas et al, 1994). To capitalize on these new found objective, the Mexican government implemented many policy changes which pushed the latin American nation to change it’s development strategy from import substitute industrialization to an export oriented approach to development. A loosening of capital controls coupled with NAFTA saw Mexico’s foreign investment to return in droves after being scared away by the 1994 “peso crisis”. The largest free trade agreement in the Americas also played a pivotal role in the inter-industry cooperation seen between US and Mexican firms. All these factors contributed to Mexico’s annual average GDP percent growth to reach approximately 3.7% from 1997 to 2007\(^2\), a far cry from the 6% contraction experienced during the Mexican pesos crisis of 1994 (WB Databank, 2013).

**The Move To An Export Oriented Economy**

Up until the 1982 debt crisis Mexico saw a relatively successful import substitution policy which was fuelled by oil revenues and government subsidies towards the manufacturing sector. Mexico’s industrial sector saw strong government support through four main channels. Firstly, due to trade protection, wholesale prices of final products sold on the domestic market were abnormally high. Secondly, government subsidies allowed for cheap key inputs. Thirdly, credit was made readily available by both public entities and private banks for Mexican businesses. Fourthly, tax exemptions

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\(^2\) See Appendix II
on certain imports of machinery and equipment allowed Mexican firms to produce at a much lower cost (Moreno-Brid and Ros, 2004). With these economic policies, Mexico saw its manufacturing component rise from 15 percent in 1940 to 25 percent in 1977 of GDP (Weintraub, 2004).

Transforming Mexico from a mainly agrarian society to an urban, semi-industrial society. The Mexican government of José Lopez Ortillo, than implemented an ambitious development program to take advantage of Mexico’s fast growing manufacturing sector funded by oil exports. Once the oil market collapsed in 1981 and US interest rates rose, Mexico quickly became part of what came to be known as the 1982 Latin American Debt Crisis (Moreno-Brid et al, 2005).

The economic policy reversals which followed the debt crisis under the De la Madrid administration would mark the beginning of Mexico’s EOI strategy and the first steps towards free trade with the rest of north america. Trade liberalization began in 1984 through elimination and reduction of tariff and non tariff barriers to foreign commerce and in 1985 Mexico signed the Bilateral Agreement on Subsidies and Countervailing Measures with the US, firmly committing itself to leaving it’s ISI policies in the past. Mexico joined the General Agreement on Tariff and Trade (GATT) in 1986 and began to implement man other pro-trade policies and deregulate Foreign Direct Investment (FDI) (Thomas et al, 1994). The deregulation framework saw the elimination of restriction on foreign capital in approximately 75 percent of all branches of economic activity by 1989 (SECOFI, 1994). The negotiations for NAFTA, which began in 1990 and ultimately lead to the creation of the agreement have said to have been a “direct consequence” of the Mexican economic strategy since 1982 (Thomas et al, 1994).

NAFTA, the Outflow of exports and the inflow of investment

NAFTA was able to formally institutionalize the Mexican EOI policies which allowed for the export sector to boom and created. When NAFTA was first created in 1994, total exports represented
15 per cent of Mexico’s GDP, six years later total exports represented 30 percent of Mexico’s GDP\(^3\). Similarly, foreign direct investment swelled from under 5 billion USD in 1994 to over 25 billion USD in 2001\(^4\) (WB Databank, 2013). In this section, and in depth analysis of the different forms of investment in Mexico, the export sector and the role of NAFTA in cementing the Mexican economy into an EOI powerhouse.

Since NAFTA the majority of FDI has gone primarily into the manufacturing and services sectors, with 63% of the FDI from 1994 to 2002 coming from the US from and continues to be Mexico’s largest source of FDI to this day. Approximately 30 percent of manufacturing FDI was used to design factories to produce labor intensive products such as clothes and with American intensive inputs such as machinery and processing equipment. The goods produced in Mexico were then sent back to the US for sale (Waldkrich, 2010). These manufacturing operations originally found across Mexico’s northern border came to be know as *Maquiladoras*, the word coming from the Spanish meaning referring to the practice of millers charging a *maquila*, or "miller's portion" for processing other people's grain (Wilson, 1992). The cheap labor of Mexico and its shared border with the US created low transportation costs and the removal of tariffs under NAFTA generated the perfect economic climate for investment in the *maquiladoras sector*. Within the first five years of NAFTA the employment rate in maquiladoras increased by 86% (Canas et al, 2011). The removal of tariffs by NAFTA allowed firms to not be limited to the northern Mexican border and soon *maquiladoras* began sprouting up in central and coastal areas of Mexico, bringing job creation and economic activity to regions of Mexico which had previously not felt the economic benefit of the assembly plants. This US investment in Mexican *maquiladoras* led to Mexico greatest source of international trade, where over 54% of Mexican-US trade was from *maquiladoras* and contributed to

\(^3\) See Appendix III

\(^4\) See Appendix IV
over half of Mexico’s exports (Hausman, 2003). The inpouring of FDI generated by NAFTA is what allowed Mexico to generate the capital to cement its shift to an EOI economy and let the *maquiladora* sector flourish. Ultimately intertwining the capital intensive US manufacturing with the labor intensive Mexican manufacturing sector.

The deregulation of the financial sector after the 1993 “tequila crisis” coupled with the ease of capital flow provided by NAFTA allowed for major increases in FDI in the services sector. The two major areas of service sector FDI in Mexico in 2005 were in banking and insurance, which accounted for 42.4 percent of the overall FDI in Mexico and the Retail trade and wholesale trade which accounted for approximately 22.3 percent. The US was again the largest contributor to all these sectors with American investors contributing 66.5 percent, 82.7 percent and 66.2 percent of the FDI in the wholesale trade, retail trade and Banking and Insurance, respectively (Waldkirch, 2005).

The most significant area of deregulation in the financial sector was the relaxation of foreign ownership rules on Mexican firms, which finally allowed for majority foreign ownership. This initiative was pushed heavily by the need for foreign capital to meet the Balance of payment deficit during the crisis. On a parallel level, chapter 14 of NAFTA entitled “financial services” laid out a clear framework to ease the movement of capital between the three nations. This Mexican banking system has seen an influx of US dollars, culminating in the 2000 take over of the Banco Nacional de Mexico (Banamex) by US banking giant Citibank for 12.5 billion US (Weintraub, 2004).

The effects of NAFTA on both FDI and the export sector are evident as investment has been intertwined into the export sector through the *maquiladoras* industry. The growth of exports in Mexico can be clearly seen as it has been among the top ten countries in terms of increasing its share

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*See Appendix V*

*See Appendix VI*
in the world (non-oil) market (Moreno-Brid et al, 2005). It is evident that Mexico’s preferred access to the largest goods market in the world through NAFTA has given a distinct advantage in terms of attracting FDI and strengthening it’s export sector.

**NAFTA: The social and Political effects**

*US-Mexico Relations, NAFTA’s Contribution*

The original intention of NAFTA was to create a purely economic agreement with the two other major North American nations. By no means was it supposed to create an institution with political and cultural dimensions such as the European Union. Which boasts a much more integrated economic union through a common market and currency as well as political institutions such as the European parliament or cultural ones such as the European Commissioner for Education, Culture, Multilingualism and Youth. In this section, the spillover affects of NAFTA on Mexico-US relations and the role it has played in the democratization of Mexico since talks of NAFTA began in 1990.

To judge the level of impact of NAFTA as an international regime on bilateral relations between Mexico and the US an analysis of three major criteria must be made. Firstly, is there an increase in the interest shown by governments in the relevant issues? Secondly, the level of transaction costs and uncertainty , and thirdly the capacity for both governments to make decisions (Hass, Keohane, Levy, 1994)

NAFTA obviously raised the level of interest in free trade in all three governments. This interest was particularly seen on the Mexican side, where the creation of NAFTA became the main foreign policy objective of President Carlos Salinas de Gortari. After the creation of NAFTA in 1993, the ratification became a top priority for the Clinton administration from the beginning (Weintraub, 2005). The Clinton administration’s dedication to North American integration was solidified when it put together a financial rescue package totaling 48.8 billion USD (Camdessus, 1995) to help Mexico
through its severe economic crisis at the beginning of 1994 (Lustig, 1998). Another high point of US-Mexican government cooperation was reached during the 2000-2001 fiscal year, when Mexican president Vicente Fox came to power in December of 2000 and US president George W. Bush took office in January 2001. At the same time they simultaneously took power Mexico and the US had already been enjoying a jump in trade causing increased GDP growth rates. Leading president Fox to propose a North American Economic Community, using NAFTA as a foundation to create further “deepening” of free trade and adding a labor component to the agreement. Unfortunately after the events of September 11th 2001, US foreign policy along with the special relationship shared between president Fox and Bush changed drastically. Disenchantment between the two nations soon followed, most notably when Mexico refused to support the position of the United States in the UN Security council with regard to Iraq (Dominguez, Fernandez de Castro, 2001). Throughout the years it is clear that NAFTA has been able to draw nations together for greater economic good such as what was seen in the late 1990’s. However, NAFTA’s intrinsic value to keep Mexico and the US working to deepen free trade and regional integration since the September 11th attacks and the idea of proposal of a North American Economic Community has left the list of foreign policy priorities of all three nations.

Democracy and NAFTA

For the majority of the 20th century the Mexican electoral system has been constantly plagued by corruption and fraud, where the *Partidó Revolucionario Institucional* (PRI) won every election from 1929 to 1994 however the 1990’s marked a change in Mexican politics. It was during this period where the major reforms in the electoral system were finally made possible, culminating in the first electoral victory by a party other than the PRI. With serious talk about NAFTA beginning in the early 1990’s it is undeniable that this major economic agreement helped create the conditions necessary for the democratization of Mexico.
From 1940-1970 Mexico was marked by a time of unprecedented growth, where a sixteen fold increase in GDP with only a doubling of population, leading many to dub the first few decades of PRI government as the “Mexican Miracle” (Crandel et al, 2005). Although, economically the PRI did well, electoral fraud and corruption was evidently rampant where every election was won with at least a 70% majority. Political unrest soon turned to civil unrest which led to the 1968 Tlateloco Massacre. The massacre was a result of the deadly force used to surpress student protestors while they demonstrated against social and electoral injustice under the PRI government, using the 1968 olympics in Mexico as a way to bring their cause to the world. According to eyewitnesses, the military crackdown on the protesters resulted in hundreds of death and thousands of arrests (National Security Archives, 2006). Issues with democracy continued with a lack of electoral competition in 1976, when there was only one presidential candidate from the PRI, who received 100% of the vote. This would be become an all too familiar sight for Mexican elections during the next decade.

It was not until the Salinas de Gorterí administration came to power that change began to be seen. After the 1982 debt crisis, the Mexican Business elite were anxious to see a better handling of Mexico’s finances. With talk of NAFTA between Mexico and the US beginning in the late 80s, one of the major impediments to the agreement was the feared wide spread corruption in Mexico. Therefore the Salinas de Gorterí created the Instituto Federal Electoral (Federal Electoral Institute) in 1990, whose main political function was to remove the lack of confidence in the electoral system and process (weintraub, 2005). This allowed for more positive legislative elections in 1994 than years before, where over 70% of the population participated in the elections compared too less than 50 percent in 1988. In a rare turn of events the PRI actually had a much stronger opposition which wash held by the Partidó Acciòn Nacional PAN.

Once NAFTA came into effect in 1994, subsequent years saw major electoral changes, most notably in 1996. The major changes to the Mexican electoral system were the creation of
independent electoral entities, major electoral tribune reforms and formulas for representations in the chamber of deputies was adjusted. During the same period Mexico experienced exceptional growth and increased employment due to the booming export industry created by NAFTA. This economic prosperity brought a new dynamic of confidence to the Mexican political system which had not been seen before. All these reforms and new political attitude led the path to the first so called “free elections” in 2000, where for the first time in 71 years another party besides the PRI was able to win a Mexican federal election. The leader of the PAN, Vicente Fox was able to lead Mexico after winning 42.52 percent of the popular vote (Nohlen, 2005). This break away from the authoritarian regime of PRI has largely been attributed to the new confidence in the political and electoral system as well as transparency brought by the 1996 reforms and the new economic prosperity.

Although the push for democratization in Mexico began long before even talk of NAFTA began, it is evident that NAFTA played a major in establishing the conditions to enable democracy to take off. The idea that “money talks” when choosing public policy is evident as the economic incentives of free trade with the US were a major player in electoral reform throughout the 1990’s. As NAFTA began to take flight so did democracy in Latin America’s second most populous nation.

**Conclusion**

Since 1993, the North American Free Trade Agreement has proven to be an international agreement incorporating not just an economic dimension, but a strong political spillover. The fact that 90 percent of Mexico’s trade was inter-NAFTA in 2002 is proof of it’s continuing importance to Mexican economy. The economic benefits are clear as the boom in FDI and the creation of Mexico as a major export economy and it’s amazing economic development have all been at least partly attributed to NAFTA. However, this major linkage between the US and Mexico have made the Mexican economy dependent on the US market. Where the Mexican economy has been mirroring the
US economy in terms of GDP growth since NAFTA\textsuperscript{7}. This leaves the Mexican economy vulnerable to any possible financial crisis which the US could encounter in the future.

On a political level, the greatest gift of NAFTA has been its assistance in accelerating the democratization process in Mexico. There is very strong evidence that the economic incentive of preferred access to the US economy was a motivator in the push for transparency and reform in the electoral system. The historic 2000 election of Vicente Fox was a major victory for the Mexican people. However since than, Mexico still faces many economic and political issues associated to NAFTA, including the effect on the Mexican agricultural Sector and the social disparity supposedly caused by NAFTA which continue to impede further North American integration at both economic and political levels. Nonetheless, it is evident that Mexico today has made leaps in in the past two decades in terms of economic and political development.

\textsuperscript{7} See Appendix VII
APPENDIX 1

GDP per Capita of Mexico from 1993-2003 (Current USD)

![Graph showing GDP per Capita of Mexico from 1993-2003](image)

APPENDIX 2

GDP Growth Rate in Mexico From 1997-2007

![Graph showing GDP Growth Rate in Mexico from 1997-2007](image)

APPENDIX III
Export of goods and services from Mexico from 1993-2002 (% of GDP)

APPENDIX IV

FDI Net Inflows in Mexico from 1993-2002 (Current USD)
APPENDIX V

FDI in Selected Manufacturing and Service Subsectors

<table>
<thead>
<tr>
<th>Sector (CMAP code in parentheses)</th>
<th>Share Overall(b)</th>
<th>Share(^a) US</th>
<th>Share(^b) Canada</th>
<th>Share(^b) UK</th>
<th>Share(^b) Spain</th>
<th>Share(^b) Japan</th>
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Notes:
CMAP is the Mexican Industrial Classification System.
\(^a\) ‘Share Overall’ is share of total manufacturing FDI for the manufacturing subsectors and share of total services FDI for services subsectors.
\(^b\) ‘Share’ by country is this country’s share of FDI in that subsector.

APPENDIX VI


<table>
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Source: Own calculations based on ECLAC, CAN 2003.
Manufactures covers items 6, 7 and 8 of the CAN classification.

*Courtesy Moreno-Brid et al, 2005
APPENDIX VII

Correlation of Mexican GDP Growth to U.S. Growth (percent)

Figure 15.2. Correlation of Mexican GDP Growth to U.S. Growth (percent)

Pre-NAFTA
Percent
12
10
8
6
4
2
0
-2
-4

Post-NAFTA
Percent
10
8
6
4
2
0
-2
-4
-6

Source: Data from U.S. bureau of the Census and Instituto Nacional de Estadística, Geografía e Informática.

Note: 1981.1 = first quarter of 1981, etc.
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