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ECONOMIC INTEGRATION IN NORTH AMERICA: CONSEQUENCES, OPPORTUNITIES, AND CHALLENGES FOR THE MICHIGAN FOOD SYSTEM

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The trend towards greater economic integration will present both expanded market opportunities and new competitive pressures for food and agribusiness firms in Michigan. With one of the nation's most diverse agricultural industries (ranging from grains to horticultural products, sugar beets, and livestock products) nearly every part of Michigan's food industry will be affected by the implementation of the North American Free Trade Agreement. This paper will examine the impact of economic integration on the Michigan food system. The competitive relationships between the United States and our North American trading partners will be identified and the potential consequences of integration for Michigan producers will be discussed.

Economic integration presents some unique challenges in the food industry. Harmonization of regulatory policies (e.g., food safety), coordination of agricultural policies, and the role of macroeconomic policies will all affect future trade relations among the members of the North American Free Trade Agreement. The impact of the expansion of NAFTA to include other Latin American countries will also be examined.

U.S. Agricultural Trade with Mexico and Canada

Canada is the United States' largest trading partner and Mexico is the United States' third largest trading partner (Japan is the second largest). Total U.S. exports to Canada averaged $81 billion annually during the past five years, and U.S. imports from Canada averaged $92 billion annually during the same period (Figure 1). U.S. exports to Canada have grown by 9 percent annually since 1984, while U.S. imports from Canada increased by 6 percent annually during the same period.

The United States exported an average of $29 billion of products annually to Mexico during the past five years, and total U.S. imports from Mexico averaged $30 billion annually during the same period. U.S. exports to Mexico increased by 17 percent annually since 1984, and the United States recorded trade surpluses with Mexico in 1991 and 1992 for the first time in the past decade (Figure 2). Mexico's exports to the United States increased by 9 percent annually since 1984. Growth in U.S. exports to Mexico accelerated after Mexico began to reduce its trade barriers in 1986.

Canada is the second largest buyer of U.S. agricultural exports. U.S. exports of agricultural products to Canada averaged $3.6 billion annually during the past five years, while U.S. imports of agricultural products from Canada averaged $3.2 billion annually (Figure 3). Vegetables ($1.1 billion), live animals and meats ($890 million) and grains ($770 million) were the United States' largest agricultural exports to Canada in 1992. Live animals and meats ($1.8 billion), grains ($778 million) and oilseeds ($320 million) were Canada's largest exports to the United States during 1992. U.S. agricultural exports to Canada have increased since the implementation of the U.S.-Canadian Free Trade Agreement in 1989, with vegetables, fruits and poultry products accounting for most of this growth. U.S. imports of live animals and grains from Canada also increased during the past five years.

The United States exported an average of $2.9 billion of agricultural products annually to Mexico during the past five years, while importing $2.3 billion of Mexico's agricultural products annually (Figure 4). Live animals and meats ($1.3 billion), grains ($1 billion) and oilseeds ($715 million) were the United States' largest agricultural exports to

Mexico in 1992. Noncompetitive products (bananas and coffee) represented nearly $400 million of Mexico's agricultural exports to the United States in 1992. Vegetables ($809 million), live animals ($372 million) and fruits ($321 million) were Mexico's largest exports of competitive products to the United States during 1992. Though Mexico's trade barriers are higher than U.S. tariffs for many agricultural products, U.S. agricultural exports to Mexico have increased by 14 percent annually since 1988. Excluding bananas and coffee, the United States' agricultural trade surplus with Mexico increased from $780 million in 1988 to $1.8 billion in 1992.

The volume of trade between Canada and Mexico is much smaller than U.S. trade with either of these countries. Canada's total exports to Mexico averaged $480 million during the past five years, and Canada's imports from Mexico averaged $1.6 billion during the same period (measured in U.S. dollars). In 1991 Canada exported $54 million of agricultural products to Mexico and imported $128 million of agricultural products from Mexico. Grains ($23 million), live animals and meat ($17 million) and dairy products ($12 million) were Canada's largest agricultural exports to Mexico during 1991. Fruits ($50 million), vegetables ($42 million), and tropical products (coffee, tea and spices, $15 million) were Mexico's largest agricultural exports to Canada.

Provisions of NAFTA Affecting Agricultural Trade

Prior to 1985, Mexico used tariffs and import licenses to impose tight controls on imports and protect its domestic markets. By limiting the number of import licenses issued, the Mexican government limited imports and maintained its domestic prices above the world level. In 1985, over 90 percent of Mexico's agricultural imports (including 320 different agricultural products) were controlled through import licensing requirements. Mexico's average tariff was 23.5 percent, and some tariffs were as high as 100 percent. Mexico began to reverse this policy after joining the GATT in 1986. The maximum tariff was reduced to 50 percent, and the average tariff on Mexico's imports was reduced to 12.5 percent. Import licenses were eliminated in many industries, but continued to be used on energy and agricultural products. The United States' import barriers on products shipped from Mexico are much lower than Mexico's barriers on U.S. exports. The average U.S. tariff on all products imported from Mexico was 3 percent in 1991, while Mexico's average tariff on products exported from the United States was 10 percent (U.S. International Trade Commission).

Mexico's barriers on agricultural imports were higher than U.S. barriers at the time NAFTA was enacted. The average U.S. tariff on agricultural products imported from Mexico was 8 percent in 1991. Nearly 25 percent of U.S. agricultural exports to Mexico faced import licensing requirements when NAFTA was enacted, and most of Mexico's tariffs on agricultural imports were higher than U.S. tariffs on the same products. The United States and Canada began removing most tariffs on agricultural products under the U.S.-Canadian Free Trade Agreement in 1989. This process will be completed in 1998, with trade barriers removed on all food products except dairy and poultry products.

Removal of tariffs: The North American Free Trade Agreement will phase out tariffs, quotas and import licenses between the United States and Mexico over a 15-year period. Under the tariff structure existing prior to the enactment of NAFTA, nearly 29 percent of

	U.S. imports from Mexico[1]	U.S. exports to Mexico[2]
Duty-free prior to NAFTA	29%	15%
Tariff removed in first year	35%	37%
Tariff phased out in 5 years	7%	3%
Tariff phased out in 10 years	25%	38%
Tariff phased out in 15 years	4%	7%

[1]Percent of total value of U.S. agricultural imports from Mexico.

[2]Percent of total value of U.S. agricultural exports to Mexico.

Source: U.S. International Trade Commission.

Table 1. Removal of Agricultural Tariffs Under the North American Free Trade Agreement.

U.S. agricultural imports from Mexico entered the U.S. on a duty-free (zero tariff) basis, and 15 percent of U.S. agricultural exports were admitted into Mexico duty-free (Table 1).

The United States eliminated tariffs on another 35 percent of its agricultural imports from Mexico in 1994, while Mexico eliminated its tariffs on an additional 37 percent of its agricultural imports from the United States during the first year of the agreement. Most of these commodities had low tariffs or are not traded in large volumes between the two countries.

The United States will phase out its tariffs on an additional 6 percent of its agricultural imports from Mexico over a 5-year period. An additional 25 percent of U.S agricultural imports will have their tariffs phased out over 10 years. Mexico will phase out its tariffs on 3 percent of its imports from the United States over a 5-year period, and an additional 38 percent of Mexico's agricultural imports will have their tariffs phased out over 10 years. Only 4 percent of U.S. imports from Mexico will have their tariffs removed over a 15-year period, and only 7 percent of Mexico's imports from the United States will have their tariffs phased out over 15 years.

Removal of import quotas and licenses: NAFTA will require the United States and Mexico to use a tariff rate quota (TRQ) system to phase out import quotas and import licensing requirements. Under a TRQ, the exporting country will be permitted to export a specified "in-quota" quantity to another member of NAFTA. The tariff charged on this in-quota portion will be lower than the pre-NAFTA tariff (and will be zero in many cases). All additional exports above the in-quota volume will be assessed a higher "over-quota" tariff (equal to the pre-NAFTA tariff). The in-quota volume will increase by 3 percent per year and the over-quota tariff will be phased down to zero by the end of the transition period. By allowing the in-quota volume to increase gradually and phasing out the over-quota tariff during the transition period, the TRQ mechanism allows trade to adjust gradually to the removal of the import quota or import license.

The United States will replace its Section 22 import quotas on sugar, dairy products, cotton and peanuts with TRQs. Mexico will replace its import licenses for corn, dry beans, nonfat dry milk, cheese, poultry products and potatoes with TRQs. Tariff rate quotas will also be used to provide additional transition protection for some fruits and vegetables. The TRQs on these products will permit a specified in-quota quantity to be imported at a reduced tariff (but not duty-free) and will assess the full over-quota tariff on all additional imports. The in-quota volume will increase by 3 per cent per year and the in-quota tariff will be phased down over a specified transition period. The over-quota tariff will be eliminated during the final year of the transition period. The United States will have tariff rate quotas for onions, fresh tomatoes, eggplants, chili peppers, squash and watermelons imported from Mexico. Mexico will have tariff rate quotas for pork products and apples imported from the United States.

Rules of origin: NAFTA includes rules of origin that specify product content requirements for products traded under the terms of NAFTA. Rules of origin are required in a free trade agreement to assure that the products traded among the members of the agreement originated inside the free trade area and are not shipped into the area from countries out the agreement (Kingston). These rules play a critical in assuring that only those goods produced within the free trade are eligible for free trade status. Three general rules will apply to all agricultural and food products, and specific rules will apply to some products.

First, bulk commodities must be produced in a NAFTA country to be traded under the terms of the agreement. Corn, for example, must be produced in a NAFTA country if it is to be traded under the terms of NAFTA. Second, agricultural commodities imported from outside the NAFTA region can only be traded under the terms of NAFTA if they have undergone a "significant transformation" in processing (defined as a change in the form of the product that will cause a change in its classification in the U.S. tariff schedule). Third, products cannot be traded under the terms of NAFTA if the value of inputs from outside the NAFTA region exceeds 7 percent of the total value of the final product.

In addition to these general rules, the agreement also includes specific rules of origin for some agricultural products. These include:

- Raw sugar from nations outside NAFTA cannot be used to produce refined sugar or molasses for shipment to other NAFTA countries. Confectionery containing sugar imported from outside the NAFTA region can be shipped to other members of NAFTA.
- Milk from nations outside NAFTA cannot be used to produce dry milk, cream, yogurt, cheese, ice cream or other milk-based drinks that are to be shipped to other NAFTA countries.
- Peanut butter shipped from Mexico to the United States must be produced from peanuts grown in Mexico. Peanuts from non-NAFTA countries may be used to produce peanut butter in Canada for shipment to the United States. The Canadian rule of origin is a continuation of the rule established by the U.S.-Canadian Free Trade Agreement.

- Citrus fruit from outside NAFTA cannot be used to produce citrus juices for shipment to other NAFTA countries.
- Cotton from outside the NAFTA region cannot be used to produce yarn or fabric for shipment to other NAFTA countries.
- Commodities from outside the NAFTA region cannot be refined to produce vegetable oils for shipment to other NAFTA countries. Imported vegetable oils also cannot be used to produce margarine for shipment to other NAFTA countries.
- Cigars and cigarettes cannot be traded under the terms of NAFTA if the value of tobacco from outside the NAFTA region exceeds 9 percent of the total value of the final products.

To enforce these provisions, U.S. companies will be permitted to request a U.S. Customs Service audit of the origin of products imported from Canada and Mexico. Foreign companies refusing such an audit or found in violation of the rules of origin will be denied access to the United States under the terms of NAFTA.

Other provisions: NAFTA also contains several other provisions affecting agricultural trade. These include:

- Members of NAFTA will be permitted to retain domestic commodity programs (including all existing U.S. farm programs).
- Members of NAFTA will be permitted to match export subsidies offered by countries outside NAFTA. For example, if the European Union (EU) uses export subsidies to ship agricultural exports to Mexico, the United States

would be permitted to match these EU subsidies with its own export subsidies on shipments to Mexico.

- Members of NAFTA will be permitted to retain quality grades and standards for agricultural products. Such standards must be applied to both domestic and imported products.
- Members of NAFTA will be permitted to retain sanitary and phytosanitary regulations that protect human, animal or plant health. Such regulations may exceed international standards if they are based on scientific evidence and are applied to both domestic and imported products. Any country challenging a sanitary or phytosanitary regulation must prove that the standard is a violation of NAFTA.
- Members of NAFTA will be permitted to retain existing border inspection policies.

Potential Impact of NAFTA on Agricultural Trade

Agricultural trade between the United States and Mexico is expected to increase under NAFTA. Excluding bananas and coffee, the United States has had a trade surplus with Mexico in competitive agricultural products since 1988, and this surplus is expected to continue under NAFTA.

Two factors will determine the impact of NAFTA on agricultural trade. First, Mexico's import licensing restrictions and tariffs create barriers that are much higher than U.S. tariffs on most agricultural products. U.S. agricultural exports to Mexico are expected to increase as these barriers are removed.

Second, Mexico's internal reforms, combined with the approval of NAFTA, are likely to increase income growth in Mexico. This income growth will increase the demand for food and, more importantly, will lead to changes in the diets of Mexico's consumers that will further expand U.S. exports. Several studies suggest that food consumption patterns begin to change significantly when income passes the $3,000 per capita level. At this level of development, consumers begin to reduce their consumption of grains and increase their consumption of meat. Such changes in consumption patterns result in an increase in the demand for meat, which increases the demand for feed grains and protein supplements for livestock feed. Consumption of fruits and vegetables also increases with income growth (Marks and Yetley; Cook, et al).

With a per capita income of $3,500 in 1991, Mexico is poised to undergo such a transformation in its diet. Income growth increased as Mexico's domestic reforms and reductions in trade barriers were implemented in the late 1980s. This growth is expected to continue in both the short term and the long term (Congressional Budget Office; Hufbauer and Schott). Studies suggest that the approval of NAFTA will increase Mexico's Gross Domestic Product by as much as 11 percent by the end of the agreement (U.S. International Trade Commission). Such growth will contribute to an increase in the demand for food in Mexico in the short run and will accelerate the transformation of Mexico's consumption patterns in the long run. Both factors will contribute to an increase in U.S. agricultural exports.

Most studies suggest that U.S. exports of corn, dry beans, soybeans, meat, nonfat dry milk, potatoes and apples will increase under NAFTA. U.S. imports of some agricultural products are also expected to increase under NAFTA. Those products with the highest tariffs are likely to experience the greatest increase in imports. U.S. imports of fresh asparagus, cucumbers, peppers, tomatoes, broccoli, melons and citrus fruit are expected to increase under NAFTA (Cook, et al; Grennes, et al.; Peterson; U.S. Department of Agriculture, 1992 and 1993; U.S. Department of Commerce; U.S. International Trade Commission; U.S. Congressional Budget Office; U.S. General Accounting Office). Mexico is not expected to increase its sugar exports to the United States during the early years of the agreement. U.S. imports of sugar could increase during the final five years of the agreement if Mexico converts to the use of corn sweeteners in its soft drink industry. Such a conversion will require additional increases in U.S. exports of corn or corn sweetener (Kessell, et al).

The U.S.-Canadian Free Trade Agreement began a 10-year process of removing most tariffs on agricultural products in 1989. This process will continue under NAFTA. Canada's imports of U.S. fruits, vegetables and poultry products have increased since the U.S.-Canadian agreement went into effect. U.S. imports of wheat and some livestock products have also increased since the agreement was implemented. These trends are expected to continue.

Continuing Issues in North American Agricultural Trade

Trade agreements provide a framework of rules within which trade takes place and in which trade disputes can be resolved. Such agreements cannot anticipate every trade dispute that will arise, nor can they address every policy that affects trade. Issues will continue to arise as the integration of North American agricultural trade proceeds, and these issues have a significant impact on the future of agricultural trade in the region.

Macroeconomic policy and exchange rates: By influencing exchange rates, macroeconomic policy is a major determinant of trade. The North American Free Trade Agreement did not contain provisions on the coordination of macroeconomic policies among the member nations, leaving each nation to pursue its own policy course. While there appears little prospect that any form of formal policy coordination will be pursued by the members of NAFTA, macroeconomic policy and fluctuations in exchange rates are likely to be a major issue in the future. This factor is often overlooked in trade disputes and is likely to remain a source of friction in trade relations. For example, while several other factors were raised in the 1994 U.S.-Canadian wheat dispute (in which the U.S. accused Canada of dumping wheat in U.S. markets), the depreciation of the Canadian dollar (from 1.16 Canadian dollars per U.S. dollar in 1990 to 1.38 Canadian dollars per U.S. dollar in 1994) was rarely identified in most public discussions of the sources that dispute. This change in exchange rate reduced the price of Canadian wheat by 15 percent between 1990 and 1994, contributing to increased U.S. imports of wheat from Canada. Similarly, the devaluation of the Mexican peso in late 1994 is likely to decrease U.S. exports of agricultural products to Mexico and increase U.S. imports of agricultural products from Mexico in the short run. Changes in exchange rates will be an increasingly important factor as the final trade barriers are removed under NAFTA.

Nontariff barriers: As tariffs, quotas, and import licenses are eliminated under NAFTA, non-tariff barriers are likely to become the focus of an increasing number of trade disputes. These regulations, ranging from labelling and packaging laws to food safely requirements to border inspection policies, will increase in importance as tariffs and quantitative barriers impose fewer limits on trade. Moreover, producers facing import competition may increase their lobbying efforts to receive protection using nontariff barriers. Because nontariff barriers are usually less transparent than tariffs or quantitative barriers and must often be dealt with on a case-by-case basis, such policies usually must be dealt with through resolution of specific disputes rather than negotiated through trade agreements. Definition of legitimate policies and elimination of nontariff barriers that are simply protectionist measures will require a continued attention.

The expansion of NAFTA: The expansion of NAFTA to include other Latin American countries is likely to be a major issue in the future. With other trade blocs forming throughout Latin America, the United States must determine whether it prefers to negotiate with individual countries or pursue mergers with other trade blocs. The Clinton administration has proposed admitting Chile to NAFTA, setting the stage for other nations to join in later years. The expansion of NAFTA will create both opportunities for increased exports and the potential for increased import competition, depending on the tariff structures of the new members and competitive relationship with U.S. production.

Conclusion

The integration of agricultural trade through the North American Free Trade Agreement creates both increased export opportunities and import competition for Michigan food producers. While NAFTA does reduce many barriers to trade, new issues will continue to arise. The continued evolution of trade policy will determine the extent to which Michigan farmers and food firms benefit from further economic integration in the Western Hemisphere.

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