C. Fred Bergsten, senior fellow and director emeritus, was the founding director of the Peterson Institute for International Economics (formerly the Institute for International Economics) from 1981 through 2012. He has authored, coauthored, edited, or coedited 45 books on international economic issues including *Currency Conflict and Trade Policy: A New Strategy for the United States* (2017) and *International Monetary Cooperation: Lessons from the Plaza Accord after Thirty Years* (2016).

The Trump administration has indicated repeatedly that the primary goal of its aggressive trade policy will be to reduce the large bilateral US trade deficits with several key countries. It reiterated that objective in its original draft approach to the renegotiation of the North American Free Trade Agreement (NAFTA), but not in its formal notification to Congress on May 18. The administration has not indicated how it intends to pursue the objective but would presumably seek to use the renegotiation primarily to reduce the bilateral deficit with Mexico, which totaled $63 billion in 2016 (far less than with China but about the same as with Japan and Germany), as trade with Canada is close to balance.

Several unique features surround the NAFTA renegotiation when seen from Trump’s perspective. Canada and Mexico, despite the latter’s bilateral surplus with the United States, both run large global current account deficits. The deficits of both countries have in fact been larger than that of the United States in three of the last four years (figure 1). They thus differ sharply from the three other trading partners about which the administration has expressed major concerns—China, Germany, and Japan—all of which run large global (as well as bilateral) surpluses and have no trade agreements with the United States. The administration appears to perceive Mexico and perhaps Canada as surplus countries whereas they (more accurately) see themselves as deficit countries, whose policies should seek to strengthen rather than weaken their external balances. The administration is starting with the wrong countries if it wants to pursue its goal of reducing the US trade deficit via trade agreements.

Mexico is in fact a prototypical example of the triangular trade that is characteristic of the world economy. (Canada is, too, to a lesser extent.) Most countries run a mix of surpluses and deficits with their major trading partners, based on their comparative advantage in production with respect to each. Even China, with its large global surpluses, runs deficits with a large number of countries that produce primary products (Saudi Arabia for oil, Australia for iron ore, etc.) and that supply inputs (such as Korea) for the finished manufactured goods that China sells to Europe and the United States. These patterns are an inherent feature of international trade and should be regarded as highly desirable as well as normal.

Triangular trade is particularly common in the context of global supply chains. Firms producing finished goods in higher-income countries typically import intermediate inputs from supplier firms in low-cost countries. German auto companies, for example, buy components from suppliers in the Czech Republic, Slovakia, and Hungary. Germany, with the world’s largest global trade surplus, runs a bilateral deficit with the Czech Republic about equal (as a share of their total trade) to the US deficit with Mexico (Amiti, Freund, and Bodine-Smith 2017).

The administration has not publicly recognized these key considerations, however, so may still pursue its bilateral trade balance goals in the forthcoming talks. But the strategy of the administration toward trade agreements in general, and toward NAFTA in particular, is fundamentally misplaced for two reasons: (1) its apparent desire to use trade policy rather than macroeconomic policy including exchange rate policy to reduce trade imbalances and

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1. In 2014, the more valid value-added measure of the bilateral US deficit with Mexico was about one-third lower than the traditional measure of the deficit (Bown and Johnson 2017).
(2) its focus on the bilateral rather than global scope of those imbalances. This Policy Brief outlines the dangerous and self-defeating implications for the negotiation of such an unusual approach. Accordingly, provisions that could be included in the agreement to pursue that purpose are not likely to be feasible.

**TRUMP’S (MISPLACED) STRATEGIC OBJECTIVES**

Trade imbalances are determined by underlying macroeconomic fundamentals. On the real side of the economy, the key is the relationship between domestic absorption (consumption, investment, and government spending) and domestic production: An excess of absorption produces a trade deficit, as the gap is made up by net imports, while an excess of production leads to a trade surplus as that excess is exported. On the financial side, the centerpiece is the relationship between saving and investment within each country: A shortage of savings generates a net capital inflow that finances a trade deficit while insufficient investment (or excess savings) requires a net capital outflow that is the counterpart of a trade surplus.

Most economists thus agree that the most effective, perhaps the only, policy initiative that would reduce the US current account deficit on a lasting basis would be a reduction in the US budget deficit, which would simultaneously reduce domestic absorption and the demand for foreign capital to finance it—especially with the economy near full employment as is now the case. By contrast, further increases in the budget deficit, perhaps driven by tax cuts as proposed by the Trump administration, would increase the external deficit whatever NAFTA or other trade partners might do. Virtually all agree that trade imbalances should continue to be addressed by macroeconomic and monetary policy instruments, including exchange rates, and by monetary officials in finance ministries and central banks.

Even the full achievement of bilateral balance with a major trading partner, such as Mexico, would be highly unlikely to significantly reduce the global trade deficit of the United States and thus have any favorable impact on its overall economy. This is because, as just noted, a country’s aggregate international balance is determined by the fundamentals of its own economy and their interaction with the rest of the world. Hence any reduction in the US deficit with Mexico that was not based on a change in those fundamentals would shortly be replaced by an increase in its deficit with other countries. US imports would simply shift from Mexico to other countries as production of the relevant products shifted, or US exports would shift to Mexico from other countries with little or no net impact on the overall balance.2 The apparent Trump approach to trade

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2. The United States should in fact prefer to import from Mexico than from other countries. Studies show that Mexico spends a much higher share of its export earnings in the United States (its “reflection ratio”) than do most other US trading partners.
agreements is thus rooted in two fundamental economic misconceptions.

These practical realities underpin the conceptual focus of trade agreements on increasing the level of trade rather than altering trade balances. Those agreements thus address the microeconomic factors that determine trade flows, especially border measures such as tariffs and quotas but increasingly behind-the-border measures such as competition policy and patent policy that affect international transactions as well. The goal of free trade agreements (FTAs) is to maximize the productive efficiency and economic welfare of the countries participating in them. They are negotiated by trade officials in the relevant ministries. The goal of trade agreements (and trade policy more broadly) should continue to be the reduction of barriers to international exchange and the writing of rules to govern that exchange, including to assure that trade is fair as well as free.3

...further increases in the budget deficit, perhaps driven by tax cuts as proposed by the Trump administration, would increase the external deficit whatever NAFTA or other trade partners might do.

Another way to conceptualize this distinction is to apply the basic theory of economic policy, which posits that the number of policy targets must equal the number of policy instruments and that each instrument should be assigned to the single target that it can address most effectively. In the case under discussion, this means that trade policy should be assigned to achieving the level of trade that will maximize national economic welfare and that the exchange rate should be assigned to achieve and maintain an external balance that is sustainable in both international financial and domestic political terms. The exchange rate will in turn reflect the internal balances (or imbalances) in the economy as described above.

“Fair trade” is of course in the eye of the beholder. The Trump administration, for example, seems to define a trade deficit itself as “unfair trade.” On that definition, both Canada and Mexico could regard themselves as major victims because of their large global deficits. However, most trade participants and observers accept the rules of the World Trade Organization (WTO) and other trade agreements as setting out the moral as well as legal foundation for global commerce. Those rules are both imperfect and imperfectly implemented but they provide an agreed framework within which international exchange has flourished, with major benefits for all countries, for the past 70 years. Careful studies show, for example, that the United States is $2 trillion per year richer as a result of the globalization that has occurred over that period (Hubbauer and Lu 2017).

Trade agreements are rooted in the principle of reciprocity: Each country balances its import “concessions” against its export gains to win domestic political support. Countries in practice, of course, jockey for mercantilist advantage, but it would be politically infeasible to explicitly base a trade negotiation on a goal of achieving an unbalanced outcome that favored one of the parties and thus disfavored the other(s).

There are two different definitions of “reciprocity”: equal reductions in trade barriers at the margin (“marginal” reciprocity) and achieving equal levels of barriers as a result of the negotiation (“level” or “mirror image” reciprocity). The former is the traditional modality of most trade negotiations, reflecting the political reality just noted. The Trump administration seems to be aiming for the latter, which would require Mexico to liberalize more because the United States now has a lower level of (mainly nontariff) barriers.4

In the particular case of NAFTA, pursuit of an improved US bilateral trade balance would be especially inappropriate. Mexico runs a substantial bilateral surplus with the United States but it simultaneously runs a substantial global trade and current account deficit (2.7 percent of its GDP in 2016). Mexico in fact wants and needs to run an external deficit in order to import capital that helps finance its development.

Under the standard rules and norms of the international economic system, as well as basic economics, Mexico is viewed as a deficit country rather than as a surplus country and is thus not expected to undertake initiatives—via its domestic economy, exchange rate, trade policy, or anything else—to weaken its international balance. To the contrary, it might be expected to take steps to strengthen its position. The United States would thus face both pragmatic and

3. A rare proposal for using trade policy to promote adjustment to trade imbalances can be found in Hufbauer (1986).

4. The World Bank’s 2009 Trade Restrictiveness Index, as updated in 2012, assigned an overall trade restrictiveness index of 15.2 percent to Mexico and 5.7 percent to the United States. The two countries’ tariff levels were very similar so the difference derived from nontariff measures. See Kee, Nicita, and Olarreaga (2012).

itiveness. In addition, Mexican growth would be adversely affected for at least a while. These macroeconomic effects would compound the increase in the bilateral US trade deficit with Mexico (de Bolle 2017). These flaws in the Trump approach to trade agreements do not mean that those agreements, or trade policy more broadly, cannot have important implications for the sectoral and geographical composition of US trade. Trade policy can affect the structure of that trade, another of its microeconomic features, as well as its overall levels. The profile of both border and behind-the-border barriers can promote or discourage US imports, for example, in steel rather than chemicals or, more broadly, in manufacturing rather than services. Likewise, typical FTAs provide preferential treatment to partner countries (as in NAFTA) and thus favor trade with them compared with countries that are not involved in such arrangements. (A country’s total trade is likely to go up when it enters into an FTA because the resulting trade creation usually exceeds the induced trade diversion, and its overall import protection declines.) But it would be a serious mistake, and probably futile, to try to significantly reduce the global US external deficit through (re)negotiating trade agreements and by emphasizing bilateral imbalances.

It might seem more logical for the three NAFTA countries to try to improve their global competitive positions together rather than attacking each other bilaterally.

It is also worth noting the potential impact on US trade with Mexico of a dissolution of NAFTA if the renegotiation were to fail and President Trump realized his threat to withdraw from the agreement. Mexico’s most-favored-nation (MFN) tariffs on imports from the United States would then average 7.4 percent and rise by that amount from their zero level under NAFTA if the United States lost its NAFTA preferences (whereas US tariffs on imports from Mexico would rise by only half as much). In addition, Mexico could legally raise its tariffs that cover most US exports to an average of 35 percent because it has bound its rates only at those levels under the WTO. Under either of these circumstances, the United States would face substantial discrimination against its exports in the Mexican market vis-à-vis the 19 others (including the European Union as a group, Japan, and several other major competitors as well as Canada, whose NAFTA preferences would continue) with which Mexico has FTAs (and potentially several others, including Korea, with which it is now negotiating). The result would almost certainly be a sharp increase in the US bilateral trade deficit with Mexico. At a minimum, US exporters would face huge uncertainty concerning their future trade relations with Mexico (Amiti and Freund 2017).

In addition, a US withdrawal from NAFTA would sharply lower confidence in the Mexican economy, which would presumably lead to a sharp fall in the exchange rate of the peso. This would of course strengthen Mexican competitiveness. In addition, Mexican growth would be adversely affected for at least a while. These macroeconomic effects would compound the increase in the bilateral US trade deficit with Mexico (de Bolle 2017). These flaws in the Trump approach to trade agreements do not mean that those agreements, or trade policy more broadly, cannot have important implications for the sectoral and geographical composition of US trade. Trade policy can affect the structure of that trade, another of its microeconomic features, as well as its overall levels. The profile of both border and behind-the-border barriers can promote or discourage US imports, for example, in steel rather than chemicals or, more broadly, in manufacturing rather than services. Likewise, typical FTAs provide preferential treatment to partner countries (as in NAFTA) and thus favor trade with them compared with countries that are not involved in such arrangements. (A country’s total trade is likely to go up when it enters into an FTA because the resulting trade creation usually exceeds the induced trade diversion, and its overall import protection declines.) But it would be a serious mistake, and probably futile, to try to significantly reduce the global US external deficit through (re)negotiating trade agreements and by emphasizing bilateral imbalances.

MANAGED TRADE UNDER NAFTA?

Suppose, however, that the Trump administration nevertheless pursues its stated goals. In that case, its pacts should be called “trade balance agreements” or “trade deficit agreements” rather than free trade agreements. One immediate implication is that its trade balance objective points toward breaking NAFTA into two bilateral agreements, at least de facto with two separate negotiations, rather than a continued trilateral arrangement, as in fact indicated publicly by Secretary of Commerce Wilbur Ross. US trade with Canada has been close to balance for the past couple of years, after running a substantial deficit a decade ago when energy prices were much higher, so the starting point with the two partner countries is fundamentally different on that metric. In addition, while the United States does have market access problems with Canada (and vice versa), the economies and trade policies of the two partner countries are very different. Canada is of course a high-income country on a par with the United States while Mexico, despite its enormous progress over the past two decades (due importantly to NAFTA), remains an emerging-market economy with a per capita income about one-fourth that of the United States and Canada. Hence the basic modality of the renegotiation would have to be considered at the outset.

The key operational question is what, if any, elements could be incorporated in a trade agreement to achieve, or
even credibly pursue, changes in the trade balance between the two countries. Following the logic of basic economics, there are two possible approaches, one based on quantities and the other on prices.6

The quantitative avenue would require some form of managed trade, perhaps along the lines the United States pursued with Japan from the late 1970s through the early 1990s (Bergsten and Noland 1993; Bayard and Elliott 1994; Bergsten, Ito, and Noland 2001) to counter the perceived costs to the United States of Japan’s government intervention in its economy and “unfair” trade policies. There are of course huge differences between Japan then and Mexico now. Japan was running large surpluses globally as well as with the United States bilaterally and was already the world’s largest creditor country, whereas Mexico, as noted, runs large global deficits and is a large debtor country. Japan was widely viewed as managing its economy, and especially its trade policy, to the disadvantage of foreigners whereas the major Trumpian critique of Mexico is simply that it is running large surpluses with the United States. Indeed, there is far greater integration between the US and Mexican economies today, including via their extensive participation in global supply chains, than there was then between the United States and Japan, with its very restrictive policies toward inward direct investment, so the costs to the United States of disrupting existing trade patterns would be considerably higher. The main similarity is the heavy dependence of the other country on the United States, Japan in secur-

Table 1:  Apparent and potential US gains from liberalization in Japan (millions of dollars)

<table>
<thead>
<tr>
<th>Product</th>
<th>Apparent gains from liberalization implemented to date</th>
<th>Potential gains from future liberalization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cigarettes</td>
<td>1,200</td>
<td>1,075</td>
</tr>
<tr>
<td>Beef</td>
<td>500</td>
<td>789</td>
</tr>
<tr>
<td>Semiconductorsb</td>
<td>415</td>
<td>750</td>
</tr>
<tr>
<td>Citrus</td>
<td>100</td>
<td>150</td>
</tr>
<tr>
<td>Fiber optics</td>
<td>33</td>
<td>30</td>
</tr>
</tbody>
</table>

a. Does not include an estimated $1 billion in US firms’ foreign-sourced products.
b. Does not include an estimated $715 million in US firms’ foreign-sourced products.
c. Includes gains attributable to Toys “R” Us only.

Source: Bergsten and Noland (1993).

6. The Trump administration might simply want Mexico to agree to a targeted reduction in its surplus with the United States and itself figure out how to achieve that goal. That would pass the same operational questions to Mexico, however, and additionally subject the outcome to macro-economic and global developments that could substantially affect Mexico’s ability to deliver even it tried to do so in good faith.

7. Although Japan, in the Strauss-Ushiba Agreement in October 1978, agreed “to make all reasonable efforts to reach equilibrium in its balance of payments” (Wolff 2017).
would be VERs and VIEs. VIEs are less undesirable from an economic standpoint, in that they expand trade rather than contract it as VERs do, but they raise the same inefficiency and discrimination issues as any policy-induced distortions of trade (Irwin 1994). They are also much more difficult to implement because the Mexican government would have to induce or force domestic purchasers to buy any agreed increase in US exports. (Japanese bureaucrats came to love VERs, which enhanced their power by enabling them to curtail activities of the private sector, and to hate VIEs because they required the bureaucrats to become supplicants to the private sector).

Mexico could nevertheless presumably shift some (particularly government) imports from third countries to the United States at some economic cost and by courting considerable problems with the countries involved (which, rather than Mexico itself, would then bear the heaviest costs of the US demands and might well retaliate as a result). Commerce Secretary Ross has reportedly proposed just that, suggesting that Mexico could “divert to US sources products they’re already buying abroad but from a country other than the US…. They could just as well give us a better market share than we have now.” Such blatant trade diversion would of course violate the most fundamental principles of trade comity.

Mexico could also presumably limit exports to the United States in particular sectors but might be required to compensate the Mexican firms for the economic losses they incurred as a result. The Trump administration could try to assist the Mexican government in this process by seeking to induce US firms to shift their production from Mexican affiliates to US plants, as it has already tried to do on several occasions with meager results, purposely disrupting the firms’ supply chains to return specific jobs and sales to the United States.

The third option, market share arrangements, appears to have been the “most successful” in Japan. It would seem to be of limited relevance in Mexico, however, unless sectors can be found that exclude foreign participation through restrictive practices that could legitimately be attacked through such devices. It must be stressed, however, that there is no evidence that the US economy derived any aggregate net benefit, defined in terms of its global trade deficit or even its bilateral deficit with Japan, from over a decade of intensive effort with Japan over all these trade policy issues—in stark contrast to the sharp changes in the aggregate imbalances that derived from the large changes in exchange rates promoted by the Plaza Accord.

**SETTING TRADE BALANCE TARGETS?**

No modern trade agreement has sought to set a target for the trade balances of the participating countries (although the House of Representatives passed a Gephardt Amendment in 1987 that authorized retaliation if countries with large bilateral surpluses did not meet specified deficit reduction targets). By contrast, targets for countries’ global current account balances have frequently been considered in international discussions of macroeconomic and currency policy but without tangible results either (Williamson 2011). The most recent case was the US effort to forge agreement by the G-20 in 2010 to limit surpluses to 4 percent of countries’ GDPs (which was rejected, primarily by Germany and China). On the unilateral front, the currency legislation voted by Congress in early 2016 requires the president to pursue “enhanced engagement” with any major US trading partner that runs a “material current account surplus,” which was subsequently defined by the Treasury Department as exceeding 3 percent of its GDP, and meets two other criteria. If a country fails to remedy the problem in a year, the legislation requires the president to adopt one of four designated retaliatory measures (Bergsten and Gagnon 2017).

Price mechanisms have been discussed more frequently but without noticeably different results. The United States pursued two such strategies with Japan, with components of the market-oriented sector-specific (MOSS) talks of the mid-1980s and the Structural Impediments Initiative (SII) of the late 1980s. Alongside their quantitative siblings during the same periods of time, as just described, those efforts sought liberalization in specific sectors and were unique to the perceived management and “unfairness” of the Japanese economic system. They did not explicitly address the bilateral, let alone global, imbalances of the two countries (although those imbalances were of course an important part of the context and rationale for the US efforts, and motivated the Plaza Accord on macroeconomic issues in 1985).

In the original draft of its NAFTA renegotiation plan, the Trump administration suggested several methods that might be pursued to reduce the bilateral imbalances (as well as, in some cases, sectoral grievances): tighter rules of origin, a general safeguard clause that would permit “rein-

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9. Nazi bilateral trade agreements in the 1930s and some of the European payments agreements immediately after World War II, and Soviet trade agreements with their satellites, did set trade balance goals but those aimed to avoid the need to finance deficits due to the shortages of reserves of the participating countries, hardly a problem for the United States today with the massive net capital inflows that have financed the US current account deficit and pushed the dollar up rather than down for the past six years.
statement of tariff against a flood of imports,” and achievement of a “level playing field” on tax policy. Trade actions already initiated by the Trump administration during its first 100 days—mainly covering softwood lumber, steel, and aluminum—could, if fully implemented, cover an estimated $20 billion of imports from Canada and $6 billion of imports from Mexico (Bown 2017).

The surge protection option could of course run afoul of WTO limitations and lead to retaliation against US exports. The tax alternative could be addressed via US adoption of a border tax adjustment of its own, as has been actively discussed in the current context of US tax reform, or a more conventional value-added tax. It could also be addressed by Mexican abandonment of its value-added tax, as implied by some Trump administration pronouncements, or more likely a reduction in its level and/or border adjustability, perhaps discriminatorily in favor of the United States; either is highly unlikely since border adjustment of such a tax is clearly legal under the WTO and the United States is virtually the only country in the world that does not employ it and because discrimination in favor of the United States would give it an advantage over domestic Mexican firms.

The most comprehensive price mechanisms for addressing a trade imbalance are tariffs and exchange rates. Increased tariffs, however, are demonstrably ineffective in improving a country’s current account (Bergsten and Gagnon 2017, International Trade Center 2016). This is partly because they are usually illegal under the WTO and can thus produce offsetting retaliation by trading partners, but even more importantly because appreciation of the exchange rate normally ensues and precludes any net aggregate improvement.

A more promising possibility would be for Mexico to further reduce its own trade barriers vis-à-vis the United States, under the renegotiated NAFTA, either in tandem with similar US reductions or unilaterally to promote a net expansion of US exports (in violation of the principle of marginal reciprocity discussed above but possibly under the principle of achieving “level” or “mirror image” reciprocity). Virtually all Mexican tariffs on US exports are now zero, due to NAFTA, but liberalization of nontariff measures might be enough in some sectors to divert trade flows and generate some expansion in US sales (though without necessarily improving the global US trade balance for the macroeconomic reasons outlined above).

Any steps that Mexico might take to reduce its bilateral surplus with the United States would of course be subject to the same macroeconomic considerations discussed above for the United States. Changes in its trade policies, whether reduced nontariff barriers or new VIEs in particular sectors, would be offset at least partially by depreciation of the exchange rate of the peso. The result would therefore include an improvement in Mexico’s trade balance with the United States in sectors not covered by the new policy initiatives and in its trade balances with other countries, which would at least partially offset any deterioration in its balance with the United States in the covered products. This would somewhat mitigate the costs of the policy action to Mexico but could exacerbate the problems of noncovered sectors in the United States and of other countries.

Many proposals over the years have targeted exchange rates to promote global economic equilibrium, some of which have been implemented for at least brief periods of time (e.g., the target zones or “reference ranges” adopted by the G-5 through the Louvre Agreement in 1987). Any such arrangements would of course relate closely to the underlying economies and economic policies of the countries involved, however, so have been addressed in a macroeconomic context by the economic policy officials of those countries rather than as part of trade agreements.

Such agreements have occasionally been worked out and implemented by major governments, including those of the United States and Canada, in the context of multilateral management of the international monetary system. The Smithsonian Agreement of 1971 carried out the first wide-ranging realignment of fixed exchange rates in the postwar period. The Plaza Accord of 1985 agreed to drive down the hugely overvalued floating dollar of the day, especially against the Japanese yen. The Louvre Agreement of 1987 installed (for a short time) target zones or “reference ranges” among the major currencies. These of course were all plurilateral rather than bilateral initiatives, although one or two foreign currencies (notably the yen and the deutsche mark) were central to the agreements. All such arrangements have been worked out by the monetary and financial, rather than the trade, officials of the relevant countries.

The major lesson from the US-Japan experience of the 1980s and 1990s is in fact the need to augment any trade policy steps with a major monetary initiative, in that case the Plaza Accord of 1985 on exchange rates, to gain traction on the international imbalances, both global and bilateral. This in turn requires pursuing the issue on a multilateral, or at

10. The Smithsonian Agreement on exchange rates in December 1971 was accompanied by a US demand that its major trading partners (Canada, European countries, Japan) unilaterally reduce their nontariff barriers to US exports. Secretary of the Treasury John Connally famously explained that all he wanted was a “fair advantage.” The other coun-

tries refused, but the subsequent talks paved the way for the launch of the Tokyo Round of multilateral trade negotiations in the GATT in 1973.
least plurilateral (G-5 in that case), basis rather than bilaterally. Doing so at the present time would of course take the administration’s current strategy well beyond a renegotiation of NAFTA but may ultimately become necessary if its trade balance goals are to be realized (Bergsten 2016).

The most likely contemporary counterpart within the NAFTA context itself would be for the member countries to agree to avoid any misalignment among their currencies (or even to push the Mexican peso and Canadian dollar to overvalued levels that would reduce their surpluses with the United States and further increase their global deficits). Since the dollar is the world’s key currency, and its exchange rate reflects its relationships with all of the major monies, such an agreement would essentially require commitments by Canada and Mexico to avoid any undervaluation of their currencies—whether caused by market forces, notably capital flows that did not accurately reflect underlying economic fundamentals, or government actions such as direct or oral intervention in the foreign exchange markets. The extreme version of this approach would be for both countries to peg their exchange rates to the dollar, as both did for extended periods in the past, at levels that were agreed to accurately reflect equilibrium. That “equilibrium” would of course reflect the global positions of the two economies so might well encompass continued bilateral surpluses with the United States.

Neither Mexico nor Canada have been accused of currency manipulation throughout the “decade of manipulation” (2003–13) when the practice was widespread in East Asia and some other parts of the world (Bergsten and Gagnon 2017). Nor has either been accused in recent decades of experiencing an undervalued currency due to market forces, except perhaps ironically in the case of Mexico when the peso sank sharply after the election of President Trump as a result of his sharp criticisms of the country (a move that had been largely reversed at the time of this writing). The Trump administration has nevertheless indicated that it will pursue an agreement on currency manipulation, primarily for precedential reasons, but would seem more likely to favor the managed trade approach if it wanted to use the NAFTA renegotiation to attempt to reduce the bilateral US trade deficit with Mexico.

CONCLUSION

A final, and much more constructive, alternative would be to try to use the NAFTA renegotiation to strengthen the Mexican economy and thus boost its imports from the United States (and everywhere else). A country’s growth rate is the dominant driver of its import expansion so achieving a more dynamic Mexico would be the best way to achieve the trade balance goal of the Trump administration. A stronger Mexican economy would probably also lead to appreciation of the peso, which would further improve US competitive-ness. Mexico could agree to implement more expansionary fiscal and monetary policies, in the same way that Germany could obviate much of the US (and others’) criticisms of its large global surpluses via such measures (including by the European Central Bank for the euro).

Faster growth could be fostered by maximizing the freedom of trade (in services as well as goods) between the two countries and writing new rules to promote that objective. The best “new NAFTA” to meet the new goals might thus be an updated and expanded “old NAFTA” to complete the goals to which the three countries committed themselves a quarter century ago.

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