

NAFTA at TEN  
Yesterday, Today, and Tomorrow  
Lessons Learned and Unmet Challenges

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# NAFTA at TEN

## Yesterday, Today, and Tomorrow

### Lessons Learned and Unmet Challenges

Michael Hart

This panel has been assigned a very wide remit: to look at the North American Free Trade Agreement from the perspectives of yesterday, today, and tomorrow, and to consider the lessons learned and the challenges left unmet. From where I sit, there are a considerable number of lessons that the past twenty years of involvement in the Canada-US Free Trade project have taught me. In the time available, let me share six of them with you today and draw out of them not only lessons learned, but some guidance for the future.

Three of the lessons are largely political in nature, and three of them are more intellectual in scope. They can be briefly summarized as follows:

1. Projects of this nature require a **unique partnership of political leader and policy entrepreneur**. Without political leaders of courage, conviction, and vision, it would not have proved possible to confront the deeply entrenched but false fears that are so critical to the continued appeal of protectionism and nationalism, and without policy entrepreneurs prepared to challenge the purveyors of conventional wisdom in government and academia, freer trade in North America would have remained captive of incrementalism and multilateralism.
2. Success on this project relied importantly on the **support of business** in all three countries who dared to dream big; it was important to listen to their diagnosis of the problems that needed to be addressed and equally important to ignore their prognosis of what to do about it.
3. So-called **civil society groups** added spice to this project and reminded us all that there is more to North America than trade and economics, but the project would not have succeeded if political leaders and negotiators alike had not learned to keep the views of the most trenchant civil society groups in perspective; theirs was usually a different agenda.
4. The last fifteen years demonstrated that the **economists were generally right** about the benefits of free trade, but have not always proved helpful in finding the best way to achieve it.
5. The last fifteen years equally demonstrated that more often than not, **political scientists were wrong** about the threats posed by freer trade, but can make an important contribution to designing the institutional underpinnings of freer trade.
6. Finally, over the past fifteen years, I have learned that it is important to **involve the lawyers**, but only if you keep them in their place.

Let me enlarge on each of these points in turn and see what lessons we can draw from them about the future. I will do so, of course, from the perspective of a former official deeply involved in the preparation for and negotiation of the bilateral FTA and trilateral NAFTA, but now freed of all responsibility as a teacher and academic analyst.

## **A Partnership of Vision and Knowledge**

For most people, the most admired politician of the 20<sup>th</sup> century was undoubtedly Winston Churchill. It is not difficult to understand why. Churchill exemplified the best qualities of leadership: vision, courage, and bulldog determination. He demonstrated that if a project is worth doing, it must be done, regardless of the politics of the moment. He also understood that leadership requires the ability to draw out the best in others and an understanding that most major projects can only be accomplished through the cooperative effort of many.

North American free trade was such a project. It required the vision of an exceptional generation of political leaders prepared to swim against the tide of the postwar Keynesian consensus, but it also took the dogged determination of policy entrepreneurs in all three capitals prepared to reject the conventional wisdom of entrenched bureaucracies. What was remarkable was that the 1980s produced both groups of people in Ottawa, Washington, and Mexico City: political leaders like Brian Mulroney, Ronald Reagan and George Bush Sr., and Carlos Salinas de Gortari prepared to reject the easy path of ever-growing statism, and advisors and policy entrepreneurs capable of translating their priorities and values into workable policies and programs. The result was a fundamental re-ordering of the relationship between government and society. Freer trade was an integral part of that re-ordering and one that may have the most enduring and successful legacy.

US scholar John Kingdon conceives the policy process as consisting of three separate streams – the identification or recognition of a problem, the generation of policy alternatives, and the pursuit of the political process – that flow through and around government, largely independent of one another. At certain critical times, the three streams come together, and at that juncture major policy change can occur, when policy windows – defined as opportunities to advocate particular proposals or conceptions of problems – are opened, either by the appearance of compelling problems or by happenings in the political stream. But the success of any policy initiative will ultimately depend on political leadership and vision backed up by expert knowledge and creative ideas.

Such junctures existed in Ottawa in 1984-5 and in Mexico City in 1990-1, and in both cases, despite the scepticism of experts in all three countries, US political leaders rose to the occasion and seized the opportunity to make a better world. I believe that we are again approaching similar junctures in Canada and Mexico, albeit for different reasons and under different circumstances, and again sceptics in all three capitals are dismissing the capacity of US political leaders to respond. I am one of those who believes they can and they will. I think that some time in the next few years, all three countries, either trilaterally or on two parallel bilateral tracks, will be engaged in defining the contours of the next generation of North American trade agreements.

Why? Because the NAFTA has proved an unqualified success and as such has generated new problems and issues that need to be addressed on a joint or co-operative basis. There is nothing startling or new about this assertion. The NAFTA is not a constitution, as one of its more trenchant Canadian critics claims, but an agreement that reflects a snapshot of the circumstances and problems that preoccupied the three countries and their governments a decade and more ago. Like all similar agreements, NAFTA needs to adjust to changing circumstances to remain relevant. The issue, therefore, is not whether we can adapt NAFTA, but whether circumstances have evolved sufficiently to warrant taking a new look at the kinds of rules, procedures, and institutions required to address current issues.

My conclusion is that, insofar as Canada and the United States are concerned, the gap between the reality of bilateral economic integration and the existing rules and institutions to govern bilateral trade and investment flows is growing. I leave it to Gustavo Vega and his colleagues to discuss the US-Mexico dimension. On the Canada-US front, some time in the next few years, Canada and the United States will need to sit down and take stock of the issues and decide how far they want to

go in revising and updating the rules — whether done through NAFTA or on another basis. In my view, the time is now to get ready for that discussion. To do that, it will again be necessary to forge a partnership between vision and knowledge, between political leadership and policy expertise. It will also require support from business, and astute management of public opinion and civil society.

### **The Critical Importance of Business Support**

Trade is an economic activity, driven by the everyday choices of individuals about what to buy and consume, but it is made possible by the willingness of some individuals to risk their capital on the bet that if they can do better than others in responding to people's needs and demands, they will also do well. Business is thus critical to informing politicians and policy entrepreneurs about the issues that stand in the way of markets functioning better. Their voices, of course, are informed by their interests, and these may not always be society's interests. Canadian dairy farmers, after all, stand four-square behind Canada's unconscionably high tariffs on cheese and other dairy products and the US softwood lumber industry continues to harass their Canadian competitors with anti-dumping and countervailing duty suits. These may serve their interests, but they do not serve yours or mine.

For business, the fundamental objective of any trade negotiation is to provide stability and predictability. Few business leaders are committed to the academic concept of free trade. Rather, they seek secure, open access to markets they believe they can profitably serve. How that is best done, however, is best left to the trade policy professionals, as long as the fundamental objectives of business are met, largely because the success of any trade agreement depends on the willingness and capacity of business to adjust and respond to the new challenges and opportunities.

The Canada-US Free Trade Agreement satisfied most of the requirements set by Canadian business. To be sure, there were disappointments, particularly as regards government procurement and trade remedy laws, but even here there was sufficient progress to provide room for optimism. The response of Canadian — and foreign-owned — businesses was strong and sustained.

The powerful stimulus provided by the FTA was consolidated first by the trilateral North American Free Trade Agreement and then by the expansion of the multilateral GATT into the World Trade Organization or WTO. Together, they helped to transform Canada into a genuine free trader. Public acceptance of the benefits of freer trade is now among the highest in OECD countries. The current Liberal government, originally opposed to the FTA and the NAFTA, is now prepared to negotiate free trade with virtually any country. And Canadian business, with very few exceptions, is now firmly committed to open markets and liberal rules. There is no interest in returning to the past.

Over the past twenty years, therefore, there has developed a remarkable convergence in the interests of Canadian business and Canada's more liberal trade policy objectives. And Canadian business is now of the view that the price of success is the need to address a new range of issues that stand in the way of taking fuller advantage of the adjustments they have made to serve the North American market. Government may not be there yet, nor society as a whole, but business leaders are signaling, as they did 20 years ago, that the administration of the border and the governance of the cross-border market is again at a sub-optimal level. What they think will be needed to improve the situation is less clear, but that is not where their comparative advantage lies. Getting there, however, will be an enormously more difficult project than it was two decades ago, if only because the easy work has been done. Now will come the hard part. And the political economy required to tackle the hard part is more difficult.

## The Need to Keep Civil Society in Perspective

The political economy of trade negotiations has changed fundamentally over the past 15-20 years. For nearly half a century, the political arithmetic of trade policy was a matter of mercantilist bargaining, i.e., of balancing the interests of export-oriented and import-competing industries. By the 1980s however, implementing the FTA, NAFTA, and WTO commitments required a new kind of political arithmetic. For the governments of most of the industrialized countries, support from the corporate sector was relatively strong, with import-sensitive industries only worried about the details of some agreements, such as those on antidumping or textiles and clothing, and with export-oriented firms strongly committed to the need for the whole range of agreements. Opposition came from populist and nationalist interests such as unions, church groups, human rights activists, and environmental protection lobbies. Finding the key to broad-based support required a different kind of public diplomacy.

Two different groups within these voices of so-called civil society compete for attention: the transformative and the anxious. The first group is relatively easy to understand. Theirs is a wholly different view of society. They are unhappy not only about trade agreements, but also about every thing else that defines modern life and governance. They are the voices of the statist, collectivist left who are working to transform the world into a new Jerusalem, whose watchwords are justice and compassion, and whose biggest worries are markets, corporations, and individual freedom. The internet and similar communication tools have given them an ability to make their numbers seem larger and to craft trans-border networks, but in the end, politicians have got their measure about right. They don't command many votes. There are not enough of them to matter and most people, while perhaps sympathetic to some of their ideals, are not prepared to adopt the measures they advocate, knowing full well that in almost every instance, the cure will be worse than the problem.

The anxious, on the other hand, are much more numerous and important, and the transformative have learned to exploit them. The anxious reflect a wide range of concerns, most of which are manageable, but all of which can move public opinion in ways that will undermine a productive negotiation. The pace of economic change, for example, is much faster today and thus may dislocate more lives and do so more quickly and unexpectedly than in the past, even if in the end we are all much better off. Many of the concerns raised by these groups are genuine, if perhaps sometimes overwrought. There is a reason why governments have approached trade liberalization as a progressive project; it provides the time and pace to address some of these anxieties. The move towards improving transparency and accountability in trade negotiations and agreements is a further part of addressing these anxieties. Fundamentally, therefore, the need here is for good political management.

The Canada-US FTA in Canada, the NAFTA in the United States and Mexico, and the WTO in all three, represented the first generation of trade agreements in which governments had to come to terms with the new political economy of trade negotiations. It proved a trying but ultimately successful experience, in large part because governments learned that the new opposition to freer trade, while it may have borrowed some of the language of old-fashioned protectionism, was based on very different values and concerns. Some of these values and concerns could be addressed and were, for example by pursuing a much more transparent and inclusive approach to trade negotiations, while others were, quite properly rejected. Given the extent to which freer trade is now accepted as the default position in Canada, Canadian politicians must have done something right.

The challenge to both politicians and negotiators in managing the issues raised by civil society groups, therefore, is to differentiate between these two sets of criticisms and address those that can be and dismiss those that can't. The fact that transformative NGOs have learned to make artful use of broader concerns may add spice to life but does not fundamentally alter this equation. In the

coming years, as we move to defining even more cooperative ways to managing cross-border integration, this lesson will need to be kept uppermost in people's minds.

### **Economists were generally right, but .....**

As British economist David Henderson once observed, economists have been among the least successful academicians in convincing the general public about the validity of their insights. Trade policy provides a good example. The benefits of an open economy, and the cost of a closed economy, are now among the most widely shared canons of economic orthodoxy, and yet public discussion of trade liberalization proceeds as if the issue remains an open question. Many in the media, for example, continue to report the views of skeptics as of equal intellectual validity. Or, to put it another way, the bad economic arguments of the amateurs continue to drive out the good economic arguments of the professionals.

The FTA/NAFTA experience of the past few years provides a compelling case. Over the past fifteen years, the contribution of trade and openness to growth and prosperity in all three economies has been astounding. Yet the CBC continues to interview me in tones that suggest I am making outlandish claims.

Nevertheless, for your benefit, let me repeat that the impact of freer trade has been impressive, particularly in the two smaller economies. Both Canada and Mexico have experienced substantial adjustments in orientation, in industrial structure, in specialization, in productivity, and in efficiency. Freer trade, as theory predicts, provided improved market signals leading to these adjustments. The NAFTA, and all similar agreements, did this in two important ways: by providing a body of agreed rules and procedures to govern trade among its members, and by removing as many barriers and impediments to exchange as was politically possible at the time. This is a recipe that works.

To be sure, there remain problems, but they are more the problems of success, and here the economists are proving less helpful. Increasingly, for economists, all issues have been reduced to those they can measure and all matters that can be measured are important and should be investigated.

Let me give you an interesting recent example. Andrew Rose at Berkeley has 'demonstrated' that membership in the GATT/WTO makes very little difference to a country's trade performance. He has done this by comparing trade patterns between pairs of countries using a gravity model. Predictably, he has demonstrated that for the majority of WTO members, membership makes little difference. What he fails to note is the fact that for some 110 of the WTO's 145 members, special and differential treatment, built into the rules from the start, virtually excuse them from taking any measure to liberalize their economies or discipline domestic or border economic measures. Membership does make a difference, a huge difference, to a country's economic performance by expanding the opportunity for trade, but only if it takes its obligations seriously and takes full advantage of the opportunities the regime offers. Most developing countries – and thus most WTO/GATT members – chose otherwise, while OECD countries and a few in Asia chose the politically more difficult route. The results speak for themselves. More than three-quarters of world trade and foreign direct investment is concentrated among the members of the OECD. The rest of the world is now scrambling to find the best way to catch up.

Now, coming back to the NAFTA, one of its impacts is deepening and accelerating cross-border integration, evident in a host of indicators, including not only increased trade in goods, but also trade in services, knowledge, and investment, cultural exchanges, the movement of people, deepening inter-corporate links, a growing number of personal relationships, and more. The result is a

deep and irreversible degree of cross-border interaction and interdependence, an interdependence that is, as always, very asymmetrical, and thus of particular concern and interest to Canadians and Mexicans.

Technological developments, ranging from communications and transportation breakthroughs to new forms of industrial organization, financing, and management techniques contribute importantly to this deepening and accelerating integration. E-commerce and just-in-time production technologies are just two of the many new ways in which Canadians and Americans are becoming ever more connected and interdependent.

Much of what is happening is not easily measured or modeled. As a result, economists are not devoting as much attention to what is happening as they might or analyzing matters on bases that are increasingly missing the mark. In my view, the bare trade statistics are under reporting the degree of bilateral integration we are now experiencing. And because it is not easily measured or modeled, we are also not fully grasping the extent to which border administration, and regulatory and institutional differences are hampering our ability to take full advantage of each other's markets.

In sum, integration is deepening and accelerating, while the rules and institutions to govern trade and economic relations reflect the circumstances and thinking of almost a generation earlier. Both need to adapt to the new reality.

### **Political scientists were generally wrong, but .....**

Which brings me to the political scientists. Economists study markets, how they work, and what we can do to make them work better. Political scientists, on the other hand, study governments, how they work, and what we can do to make them work better. Not surprisingly, economists exhibit a strong bias in favour of market solutions while political scientists prefer government ones. It took me a while to absorb this lesson and appreciate why some of the most persistent critics of the GATT, FTA, NAFTA, and WTO could be found in university political science departments and among officials they had trained.

Trade agreements, while negotiated in ways that political scientists understand, seek objectives that tend to be inimical to their values. They see the trade regime as too committed to letting markets determine outcomes. Whether the issue is human rights, the protection of the environment, the social preferences of a particular polity, or the cultural values of indigenous peoples, they are convinced that only national governments are capable of addressing them.

One of the most fundamental rules underpinning modern trade agreements is the rule of non-discrimination, a rule that is critical to letting markets work. Discrimination, on the other hand, is the essence of modern governance. Trade agreements, which discipline governments' ability to discriminate, are thus seen as a threat to the achievement of a host of policy goals dear to the hearts of political scientists. You can dress it up as concern about 'sovereignty' or 'national identity', but it boils down to concern about who governs, to what purpose, and with what toolkit.

I must confess that I am one of those people who see markets as profoundly democratic. I consider accelerating integration to be a natural process flowing from the impact of billions of discrete and seemingly unrelated decisions by individuals in their daily decisions about what to eat, wear, drive, read, and otherwise spend their resources. Overwhelmingly, those choices favour North American products and suppliers. For those concerned about democratic deficits, there is nothing more democratic than the market, where Canadians, Americans, and Mexicans vote every day and express their preferences. Canadians, for example, have demonstrated that they like Wal-Mart and

do not mourn the demise, for example, of Eatons. They tell the pollsters they are comfortable with integration, and they prove it in their everyday market decisions.

But many political scientists are not comfortable with these developments because this market-led integration undermines their ability to propose government-based solutions to a variety of socio-economic problems. I have found a new assignment, for them, however, that may appeal and yet be sensitive to my democratic preference for market-led integration.

For Canadians, asymmetry in power and resources has always been critical to seeking rules-based trade and steering clear of more flexible, institution-based approaches. The GATT and the WTO at the multilateral level, and the CUFTA and NAFTA at the regional level, were negotiated, in part, to offset Canada's natural disadvantage as a North American investment location and to help reduce the disparity in power between the two countries. They have worked to the mutual advantage of Canadians and Americans, but remain incomplete. The challenge is to build on the past but adjust rules, institutions, and procedures to the reality of both growing interdependence and heightened security concerns.

There is a growing array of issues on the Canada-US front that point to the need to find innovative ways to tackle them. The payoff will be as much social as economic. Well-conceived and implemented trade agreements provide a more secure framework within which governments can tackle evolving priorities on more than the trade front. By strengthening their confidence in each other as economic partners, Canada and the United States will also add to their confidence in each other in addressing a range of other mutual concerns from terrorism to the interdiction of illegal drugs.

In my view, reaping the full benefits of growing interdependence requires that we address three fundamental challenges:

- How to minimize the role of the physical border in conditioning trade and investment decisions, including the costs of compliance and the potential costs created by delays.
- How to limit the impact of regulatory differences, again involving costs of compliance; both intergovernmental agreements and the pressures of silent integration have accelerated regulatory convergence and narrowed differences, but they have neither eliminated existing differences nor discouraged new differences from emerging in regulatory design, objectives, implementation, and compliance.
- How best to manage the relationship and strengthen institutional and procedural frameworks to iron out differences, reduce conflict, and provide a more flexible basis for adapting to changing circumstances.

Key to meeting this challenge is the development of appropriate institutional mechanisms to resolve problems and promote dynamic rule-making and adaptation for the North American market as a whole. This is an area in which political scientists excel, and one in which they will need to work closely with the third leg of the intellectual tripod critical to successful trade agreements, the lawyers.

### **We need lawyers, but .....**

When I started in this business nearly thirty years ago, trade practitioners held a very jaundiced view of lawyers; they saw them as people who tended to complicate matters. That may have been true, but also short-sighted. In Canada, the involvement of lawyers in the negotiation, drafting, and implementation of trade agreements really did not become serious until the FTA negotiations. Before then, they might have been consulted, but often with some reluctance; they rarely formed an

integral part of the team. That changed with the Canada-US FTA. Canada's team in the final stages employed more than a dozen lawyers, as did the US team, and that pattern continued in the NAFTA and WTO negotiations. The result was generally beneficial. But it is important to keep the lawyers in their place.

People attracted to the practice of law like matters to be orderly, governed by clear rules, procedures, and institutions. Like librarians, a place for everything and everything in its proper place. Just ask my wife the librarian and my daughter the lawyer. But the market, the basis for the wealth we crave and enjoy and which trade agreements seek to enhance, is anything but orderly. Adam Smith's genius lay in his understanding that the market was chaotic and could only be ordered on the basis of its own inner logic, what he called the invisible hand. The law makes a critical contribution to the underpinnings for a well-functioning market, but it is also fundamentally at odds with the market. The law as guarantor of property rights, fairness, dispute settlement, and more is critical to making markets work, but too many rules and too much law can rob the market of its spontaneity and what Joseph Schumpeter called its necessary process of creative destruction.

The critical breakthrough in the 1980s and 1990s lay in putting the lawyers to work and creating a dense structure of rules and procedures to govern the further evolution of the market. I have already noted the economic success of these agreements. I want to also stress their success as rules. The institutional and dispute settlement provisions of the FTA, NAFTA, and WTO have proven indispensable to their success in meeting their fundamental purpose and object, i.e., to create a more stable, predictable, and open global economy and as such, foster prosperity through increased trade and investment.

But I am less sure that we need to continue down that path. As I noted earlier, we now need to explore the scope for more flexible institutions to govern the dynamics of deepening integration, institutions that are capable of responding to rapidly changing circumstances, that are sensitive to the need for small but symbolically important differences among jurisdictions, and that do not become captive of too many rules and procedures. We will need the lawyers, but even more we will need policy entrepreneurs and political leaders prepared to stare down bureaucratic rent-seeking and dismiss the tyranny of small differences. The lesson of the 1980s and 1990s is that we can.

### **So, where do we go from here .....**

The past two or three years of discussion and analysis in Canada of bilateral trade and economic relations is in many ways reminiscent of the lead-up to the bilateral free-trade negotiations in the early 1980s, with one big difference. During those earlier discussions, there was a clear analytical model around which to organize analysis and discussion. The concepts involved in a bilateral free-trade agreement were widely shared and well understood. At both political and analytical levels, communications were clear and direct. In the event, the negotiations proved that matters were a little more complicated than originally envisaged, but the results still involved an agreement that fit easily within well-defined definitions and models.

Discussion today is much less clear cut. To some extent, analysts are attempting to frame the discussion within the familiar academic labels of free-trade areas, customs unions, and common markets. But the results are not very satisfactory, because the challenge is to find solutions that do not fit easily into these categories. What the two countries need are rules and institutions appropriate to the circumstances in which they find themselves, and trying to fit the discourse within familiar labels may be more confusing than helpful. More work will be needed than I have seen to date, before we reach the point at which there is broad consensus at both the analytical and prescriptive levels.

That is one of the reasons why I believe it is important for Canadians to take the lead. The forces of silent integration are unlikely to abate over the coming years, but the pressures to address issues will be more keenly felt in Canada than the United States. The challenge of how to govern deepening bilateral is much more a Canadian than an American issue. For Americans, simple benign neglect is probably sufficient, because in many instances the default will be to rely on US policies and decisions. That is not satisfactory for most Canadians, but it will be up to Canadians to first define issues and solutions.

Some analysts conclude from the fact that the issues are of much greater interest to Canadians than Americans that Americans will never be sufficiently interested in pursuing innovative, visionary approaches. While it is true that in the United States, policy is often the result of painstaking coalition building that relies heavily on satisfying a range of often disparate special interests, it is also true that the US system can only be energized by creative and visionary leadership. Big ideas are needed to begin and end a journey with the United States; in between, there is need for a lot of tough coalition building to overcome the inevitable champions of special – read narrow – interests. Such special interests exist in part to convince everyone else that the national interest is synonymous with their own; leadership involves melding enough special interests into a broader, national vision. Canadians and Americans working together have succeeded in meeting this large challenge in the past and can do so again, but not if they start by accepting the conventional wisdom that the tough issues of the moment limit the agenda.

The issues are also largely bilateral rather than trilateral in nature. The successful conclusion of a trilateral North American Free Trade Agreement created expectations about the evolution of a North American community. This has not happened, nor is it imminent. In many ways, the NAFTA is little more than a joint agreement to manage two distinct bilateral trade and economic relationships. Like Canada, Mexico has issues with the United States, but they are not the same issues, reflecting the different natures of the two relationships. Trying to address either Canada-US or Mexico-US issues on a trilateral basis is likely to prove counter productive.

Over time, as issues and discussions ripen, the need to discuss them more widely will become clear. The essence of any negotiation involves resolving issues and finding mutually acceptable compromises. As was the case in the 1980s, Americans will have their own preoccupations and priorities. Security matters, for example, will loom much larger on their radar screen than on Canada's. The two governments must ultimately engage each other, analyze the issues as they emerge, and determine what can be accommodated and what can not. But first, Canadians will need to get their minds around what they want and why and what they will tolerate. Mexicans need to pursue a largely similar approach leading to parallel US-Mexico discussions. To the extent that the two bilateral agendas coalesce, they can in the end be joined and pursued trilaterally. At this stage, however, parallel bilateral exploration makes much more sense.