The Giant in Mexico's Rearview Mirror

Mexico is growing increasingly concerned about its ability to compete with China in North America. The stakes, admittedly, could hardly be higher. The United States accounts for nearly 90 percent of Mexico's exports.

On several occasions, the Fox administration has accused China of luring investors away from Mexico with practices that violate international trade agreements. Along the U.S.–Mexico border, anecdotes abound of trade officials offering investors financial incentives to move their operations to China. Mexican manufacturers also complain that their labor costs are rising faster than those of their Chinese counterparts. These concerns were compounded two years ago, when the six-year expansion of Mexico's exports came to a screeching halt. Since then, half a million manufacturing jobs have been lost.

In reality, the current weakness of Mexico's industrial sector has little to do with China. In fact, Chinese exports to the United States have not fared much better than Mexico's in most sectors. Similarly, although foreign investment has weakened, this is largely due to the tapering off of U.S. investments of all types in fall 2000. The United States accounts for three-quarters of all foreign investment in Mexico.

The truth is that Mexico remains an attractive place to do business. In spite of the peso's supposed overvaluation and the relative rigidity of the country's labor markets, there is no evidence that labor costs have risen faster than labor productivity (*Chart 1*). By that measure, Mexican labor is not more expensive today than it was eight years ago. Additionally, in the past 10 years endemic fiscal and monetary uncertainty has been replaced by a remarkable commitment to policy discipline, in jarring contrast to other Latin American nations. Inflation is near historical lows, and recent Mexican administrations have spared no effort to bring fiscal deficits down to less than 1 percent of gross domestic product. Finally, Mexico continues to offer unbeatable access to North American markets and a workforce more qualified than China's.

There is little doubt that in sectors where transportation costs, skill requirements and added value are low, China's expanding capacity will erode Mexico's market shares in North America. In textiles, for instance, Mexico has benefited from prohibitive tariffs the United States has imposed on non-NAFTA imports, but those tariffs are to come down under the aegis of the World Trade Organization (WTO). No country stands to benefit more from this opening than China, the WTO's latest member.

Like industrialized nations a generation ago, Mexico may have to concentrate on sectors in which its competitive advantage is strongest. In the automotive and household appliance industries, to name two, transportation costs remain a significant deterrent. China does not appear ready to overcome Mexico's 40 years' experience in sectors where skills and supply networks require time to develop.

To preserve its edge in those areas, it would serve Mexico well to address chronic weaknesses that, unlike the elusive Chinese threat, are within its control. These old problems include the high cost of electricity and the fiscal uncertainty that plagues the export sector, particularly maquiladoras. Because competition is restricted at all levels of the supply chain, electricity demand outpaces capacity. This issue has become a priority for the Fox administration, but no progress has been made yet. As for fiscal uncertainty, the recently approved budget makes permanent some of the privileges of maquiladoras, which is a step in the right direction. Structural reforms of this sort will help Mexico's export sector pick up where it left off in fall 2000.

—Erwan Quintin

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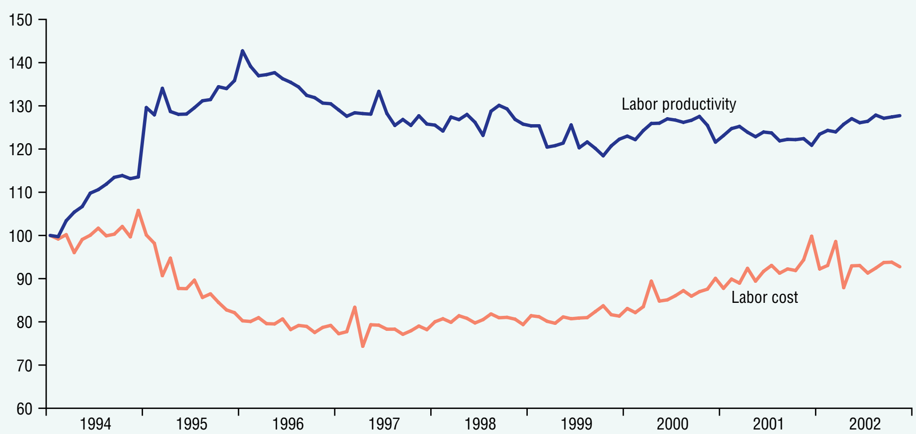
Chart 1

Labor Productivity and Costs in Mexican Manufacturing

Index, January 1994 = 100 (in 2002 pesos)



NOTES: Labor productivity is the real value of production divided by hours worked. Labor cost is the total real compensation divided by hours worked.

SOURCE: Instituto Nacional de Estadística Geografía e Informática.