NAFTA and Industrial Policy In Mexico

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The expectation of widespread benefits under the North American Free Trade Agreement (NAFTA) was contingent on industrial restructuring. Manufacturing needed to be modernized to adapt it to the new competitive environment, thereby expanding production and employment as well as increasing wages. The first restructuring model that the government tried to promote after the 1983 economic crisis proposed orienting part of the manufacturing industry toward the business of supplying intermediate goods to the country's export industries, mainly *maquiladoras*. NAFTA's Article 303 reinforced this goal by providing a negative tariff stimulus that would encourage the substitution of international sourcing with local production.

In other words, NAFTA was supposed to encourage the restructuring of manufacturing industries, changing them into suppliers of intermediate goods for export industries. More

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specifically, Article 303 was designed to substitute temporary imports from third-party countries with regional intermediate goods. In order to do this, Article 303 taxes duty-free, temporary imports from non-member countries after a seven-year transition period. In other words, after January 1, 2001, Mexico had to collect its general tariffs (that are much higher than those the United States imposes on third-party countries) on temporary imports of raw material, component parts and machinery coming from third parties, instead of allowing them to be temporarily imported without tariffs.

This change in the temporary-import regime created an incentive to substitute third-party goods for goods of North American origin: from Mexico, the United States or Canada. Supposedly, Mexico would have an advantage in this production, by turning pre-existing companies into suppliers of these intermediate goods or attracting foreign suppliers to Mexico. Thus, NAFTA opened a window of opportunity for restructuring part of the manufacturing industry into suppliers of raw materials and intermediate goods for the country's export industries. This could have promoted a new industrialization model, similar to that implemented several decades earlier in South East Asia.

However, it was not taken advantage of. Its place was taken by a different industrial development program that is reinforcing the technological disparities among manufacturing plants in NAFTA countries instead of reducing them, thereby specializing the Mexican manufacturing industry in the assembly of imported intermediate goods and in unskilled labor-intensive activities similar to those in the *maquiladora* industry. Without upgrading and expanding the productive base, and still far from general conditions of full employment, there was no longer reason to suppose that the price of labor would increase in Mexico.

Starting November 14, 1998, the Mexican government issued the first of a series of "Decrees Establishing Programs for Sectoral Promotion" (PROSEC) to neutralize the effects of Article 303. The PROSEC reduce tariffs on the products they cover to between zero and five percent, in order to match them with U.S. rates, instead of charging Mexico's general tariff for countries without preferential agreements on these products. Since the PROSEC eliminate the difference between U.S. and Mexican tariffs, there is no remainder to pay in Mexico; hence they neutralize the tariff incentive that NAFTA had created to substitute temporary importation from third-party countries. Though issued previously, these PROSEC did not need to come into effect until just before Article 303, at the end of 2000.[1]

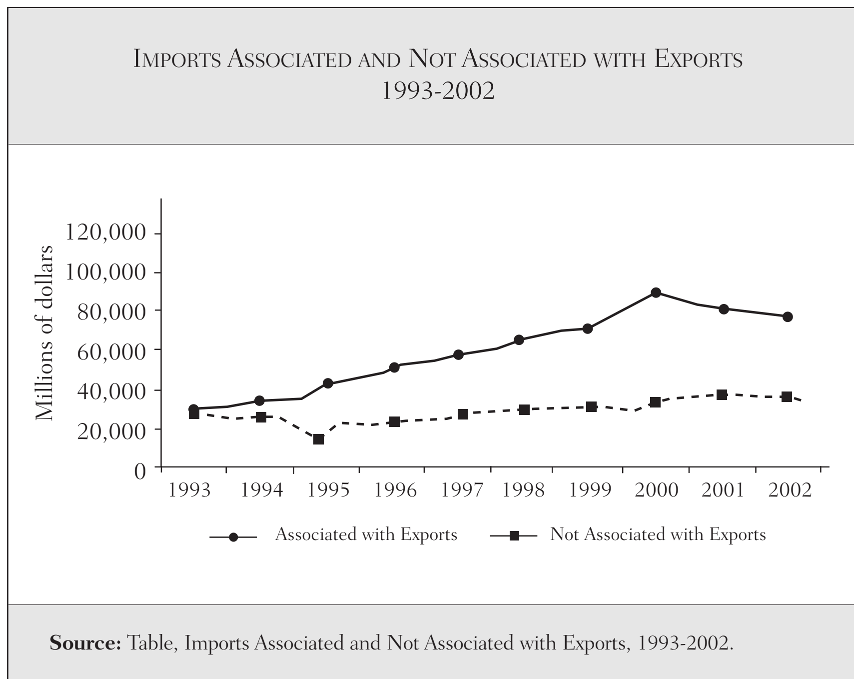
The Ministry of Commerce (Secofi), which then changed to the Economics Ministry (SE), decided that duty-free temporary imports from third-party countries were cheaper and safer than trying to source these goods from Mexican companies. The *maquiladora* industry had opposed Article 303 and the response of the manufacturing industry to the opportunity created for it had been weak; neither foreign

IMPORTS ASSOCIATED AND NOT ASSOCIATED WITH EXPORTS, 1993-2002
(MILLIONS OF DOLLARS)

YEAR	ASSOCIATED WITH EXPORTS	NOT ASSOCIATED WITH EXPORTS
1993	24,388.3	22,079.9
1994	31,299.0	25,214.8
1995	40,752.7	17,668.4
1996	49,675.2	22,214.5
1997	59,402.7	25,962.8
1998	67,830.0	29,105.2
1999	78,358.4	30,911.2
2000	96,096.0	37,541.3
2001	86,778.0	39,370.8
2002	85,927.8	40,580.2

Source: Bank of Mexico Annual Report, 2002.

NAFTA provided an opportunity for restructuring part of the manufacturing industry into suppliers of raw materials and intermediate goods for the country's export industries that could have promoted a new industrialization model.



Source: Table, Imports Associated and Not Associated with Exports, 1993-2002.

With duty-free importation from third parties, instead of turning the manufacturing industry into a producer of intermediate goods, PROSEC is turning it into assemblers of imported goods, thereby disintegrating their productive chains.

suppliers came *en masse* to Mexico nor did an important number of Mexican companies reconvert to take advantage of this alternative. The December 1994 financial crisis was probably the single factor that most complicated the situation.[2] Without credit and without government support, it was no longer feasible to continue waiting for temporary imports to be substituted by domestic production. Therefore, the government reopened the supply of low-cost goods coming mainly from Asia by issuing the PROSEC decrees.

It is important to note the range of industries covered by the PROSEC decrees. Not only do they benefit the same export-oriented companies previously authorized to import temporarily but also the rest of the manufacturing industry, including those that do not export, the only requirement being that they transform the intermediate goods that they import. Therefore, it would not be exaggerated to say that the PROSEC constitute the centerpiece of the government's industrial policy for the entire manufacturing industry and, as such, are the basis for the new industrial development model. Their objective is to raise industrial competitiveness through the supply of world-class machinery and intermediate goods not only for export-oriented manufacturing and *maquiladora* industries but also for the rest of the manufacturing industry oriented toward the domestic market.

The first industry to benefit from the PROSEC was the electrical-electronics sector; and then, between November 1998 and 2001, the program expanded many times to include another 22 branches of industry.[3] Hence, the PROSEC cancelled the opportunity created by NAFTA's Article 303 to give tariff protection to Mexican producers of intermediate goods. Now, with duty-free importation from third parties, instead of turning the manufacturing industry into a producer of intermediate goods, what it is doing is turning it into assemblers of imported goods, thereby disintegrating their productive chains.

In the post-NAFTA period, between 1994 and 2002, the *maquiladora* industry increased the percentage of national intermediate goods incorporated into their final products from 1.5 to 3.8 percent of its total value. Even though this shows a little progress, it does not represent a foundational change because the percentage of national intermediate goods has always fluctuated within this range.[4] That is why it can be said that the NAFTA stipulations, potentially favoring the development of regional suppliers, were not taken advantage of. Instead of substituting temporary imports, this new model constantly increases imports of intermediate and capital goods, although more dramatically in export-oriented companies than in those oriented toward the domestic market.

In the graph entitled "Imports Associated and Not Associated with Exports, 1993-2002", the line that rises more steeply represents the intermediate imports associated with exports, not only in manufacturing but also in the rest of the economy. It represents what companies import in order to be able to export. On the other hand, the line below it, which also rises from

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1996 onward, represents imports that are necessary in order to compete in the domestic market.

In 1993, just before NAFTA came into effect, there is no substantive difference between one line and the other but, starting with the 1995 financial crisis, imports associated with exports began to grow. Even though they went down in 2001, this should be attributed to the recession in the United States, not to a change in Mexico's industrial policy. In total, imports associated with exports increased 252 percent, in contrast to the 84-percent increase in imports not associated with exports. Both lines reveal the same tendency toward increasing dependence on these intermediate goods, but they grew earlier and faster in the export-oriented companies. So, despite efforts to increase national suppliers for the *maquiladora* and PITEX industries, they did not counterbalance the opposite tendency toward increased importation of intermediate goods.

These tendencies are worrisome because national content incorporated into the country's exports is not growing as a percentage of the total. Not only does this increase the risk of a new balance of payments crisis but it also tends to reduce the quality and quantity of Mexico's industrial exports. As a result of the lack of backward linkages, industrial employment does not expand as expected. While national exports specialize more and more in assembling imported intermediate goods, it is the imported intermediate goods that contain higher levels of value added. This gives way to a productive structure in Mexico that is essentially different from that of its main trading partners. It permits no convergence within North America: not in the price of the goods they manufacture nor in the wages they pay. There is a structural disadvantage between Mexico's export of productive services, in exchange for the importation of high-tech intermediate goods; and this disadvantage restricts the ability of the manufacturing industry to pay higher wages. Such a scenario suggests inequality will increase instead of decreasing in North America.

This model of industrial restructuring could be categorized as the "*maquiladorization*" of the manufacturing industry. Within the worldwide fragmentation of productive processes, Mexico is assigned the role of assembler of imported parts and pieces. However, this is no longer a predetermined function of those U.S. non-tariff barriers that used to regulate what *maquiladoras* could export to the U.S. Under NAFTA rules, this productive function is now open to change. The irony is that Mexico continues limiting itself mainly to assembly, not just in the *maquiladora* but now increasingly in the manufacturing sector, too, due to the accumulated inertia of three decades of previous *maquiladora* experience and the lack of consistent industrial policies. Still, it is important to recognize that the opportunity is there because it cannot be taken advantage of if it is not recognized. VM

NOTES

[1] This first PROSEC Decree was substituted by another on May 9, 2000; this one was reformed on October 30, 2000 and again substituted December 31, 2000 in order to increase the number of industrial branches included in each revision. After NAFTA Article 303 came into effect in early 2001, the PROSEC were reformed on March 1, May 18, August 7 and December 31; then it was substituted by a new decree on August 2, 2002, each time with the same objective of expanding its scope.

[2] It is worth noting that manufacturing companies did not have access to the kind of financing that they would have needed during the NAFTA transition period in order to restructure as regional suppliers of intermediate goods. In this period, the real variation in loans given by commercial banks to the manufacturing industry has been negative in 45 of the 49 industrial branches: for example, in the clothing industry it was -83.3 percent; leather and its products, -83.3 percent; vehicles and automobiles, -79.3 percent; plastic products, -78.5 percent, etc. (*Reforma*, April 5, 2003, p. 35A); and the financial crisis translated into a fiscal crisis of the state that made it impossible for the government to finance alternative incentives.

[3] The PROSEC cover diverse sectors, like furniture, toys and games, shoes, mining and metallurgy, capital goods, photography, agricultural machinery, chemicals, rubber and plastic, steel, pharma-chemicals, medicine and medical equipment, transport (except automobile and auto-parts), paper and cardboard, wood, leather and skins, automobiles and auto-parts, textiles and garment, chocolate, sweets and similar products, coffee and others.

[4] The sale of domestic intermediate goods to the *maquiladora* industry are not irrelevant sums even though the percentage is low; its volume went from 1,039,000 pesos to 20,320,434 pesos. Measured in dollars to control for inflation, its total increased by a factor of 10, from U.S.$195,100 to U.S.$1,970,500 between 1994 and 2002. But even so, the percentage is so low that it cannot be said that a there is a symbiotic relation between the *maquiladoras* and the manufacturing industries. INEGI, *Estadística de la industria maquiladora de exportación* (Mexico City: 1994-1999 and 2002).