Mexico vs. China

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China's Prime Minister Wen Jiabao visited Mexico December 12.

China is sucking away Mexico's jobs. Globalization is entering a fateful new stage, in which the competitive perils intensify for low-wage developing countries much like the continuing pressures on high-wage manufacturing workers in the United States and other advanced economies. In the "race to the bottom," China is defining the new bottom.

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The global trade landscape changes daily, but no more sweeping change occurred than that of the accession of China to the World Trade Organization (WTO) on September 17, 2001. And in the process, it is most ironic that Mexico, the nation with the most bi- and multi-lateral trade agreements was, up until the last moment, strongly opposed to China's membership in the worldwide trade body. In fact, it was because of their emergence as a major manufacturing platform as well as their external trade expertise through the 1990s and into the turn of the century that Mexico perceived China clearly as a long term threat. Their arguments and objections were not without merit.[1]

The darling of the investors during early 1990s, the "Mexican Miracle" had

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been touted as the model for the emerging markets and economies of the so called "newly industrialized" nations. The Mexican model, given the 2,000 mile border with the United States, is not a pure example or benchmark for the emerging world at large. Mexico inked the North American Free Trade Agreement (NAFTA), survived a radical peso devaluation in late 1994, made its political leap into a broader acceptance of democracy —witnessed by the election of Vicente Fox in 2000— and by 2000-01 began gradually to reap the benefits of its transitions to a more open economy, undergirded by a steady inflow of foreign direct investment, that averaged $12 billion plus per year from 1996-2002. NAFTA, for all its pre-approval hype, proved a major success for Mexico.

Before that, since the mid-1960s, there have been over a dozen changes in the Mexican off-shore investment laws as well as a new layer of international accords such as GATT-WTO and NAFTA that have modified the maquiladora sector. However, in its sum total, by the late 1990s the maquila industry was the number one hard currency generator in Mexico, surpassing revenues from both oil exports and tourism. Mexico's maquila experience was vital to its gradual steps toward globalization and abandonment of bankrupt policies such as the import substitution industrialization (ISI) regime of the 1950s and 1960s.

In concept and in fact, the maquila industry envisioned in the late 1960s was one of labor-intensive low-paying jobs. Taking advantage of tariff laws as well as abundant and inexpensive labor, foreign companies were able to do piece work and/or assemble and re-export the component parts, or garmets back to the parent company in the U.S. for final assembly and packaging. Driven by the global cost of doing business and the increasing need to lower cost and increase profit margins, Mexico gradually became a tremendous complement and/or option for companies looking for economical and cost effective high-volume off-shore production in order to take advantage of tariff laws. Herein lies the paradox as noted by James Gerber, "If the maquiladora sector indeed represents purely comparative advantage-based development, then it is simple to predict the evolution of the industry. As Mexico workers gain skills, incomes are likely to rise, and unskilled assembly production will move to a lower cost environment."[2]

As the years passed the Mexican work force proved to be both highly trainable and cost effective for high volume repetitive production operations. As the cross-border infrastructure into Mexico by road and rail improved, as well as the addition of more attractive investment laws, foreign firms flocked south of the border. The number of off-shore foreign plants in Mexico grew from 160 operations in 1970 with 20,300 employees, to 1,789 by 1990 with 460,283, and in mid-2002 numbered over 3,200 with 1.1 million workers. By 2002, virtually all of the Fortune 1000 (some 700 companies) had a portion of their operations, production components or affiliates in Mexico. The proximity to the growing U.S. market has been an overwhelming comparative competitive advantage which the NICs of Asia could not replicate without locating operations in Mexico.[3] However, during the early 2000s it became apparent that due to a combination of factors (including entry into GATT in 1987, NAFTA, changes in the investment and tax laws as well as the impact of FDI and technology transfer to Mexico) the role and scope of the competitiveness of the maquila industry had begun to gradually change. Furthermore, tremendous progress had affected competitive advantage offered via the foreign maquila operations due to the direct impact on the expansion of the domestic Mexican industrial base.[4]

Technology transfer via the maquilas as well as the growth and development of indigenous Mexican firms gradually changed the nature of production worker skills and demands on labor as well as intensive automated processes.

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Examples of emerging companies that made major strides via the direct and indirect exposure to foreign technology transfer include Grupo IMSA, Grupo Alfa, Cemex, Vitro, and Apasco. While labor costs have remained relatively low in terms of the U.S. and European market rates, the foreign-owned plants in Mexico were gradually moving toward more value-added jobs due in large measure to the increased specialization of machinery and production processes as well as new means to compensate workers, such as pay-for-knowledge. In essence, fewer workers were needed, while output increased —due to the changing technology— allowing both high quality and cost effectiveness.

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Production Shifts

The shift to more high-tech manufacturing operations is evident at such firms in Mexico such as Visteon, Emerson, AT&T, GM, Delphi, and Caterpillar. For example, efforts to enhance both production and quality were augmented by pay-for-knowledge programs in place of old style longevity-seniority models. While time on the job is considered for certain benefits and vacations, the stress gradually shifted to knowledge-based quality production. This shift to a values-based management style is a clear indication of ongoing changes throughout both the foreign-owned maquilas as well as domestic Mexican operations. One key measurement of the pay-for-knowledge programs is that, while production and quality are expected to be high and rejected parts low, the average hourly pay is often double the average pay in other old style plants. Furthermore, this compensation model may be a key element to also reducing employee turnover.

Since the early 1990s Mexico has fully known that as long as investors felt safe in the country and labor remained competitive, they would be attractive to foreign direct investment, due in large part to the proximity of the U.S. market and plants in the mid-west. While FDI remained steady and actually increased over the 1990s, it became apparent that the low-end labor-intensive jobs were in jeopardy of being lost to other countries. Initially, lower paying jobs shifted from the U.S.-Mexican border region to southern Mexico. Gradually the exodus of low wage jobs was global in scope, and not just in Mexico. The transition was primarily in three industry sectors —textiles, electronics, and any low-tech labor-intensive assembly, i.e. paper products, packaging material, furniture or bicycles. Generally the primary reason for relocation of a labor intensive process is wages. The most volatile and price sensitive sector has been the textile and garment industry. Thus, by the early 1990s, companies began to look for areas of lower wages, minimal industrial restrictions and adequate infrastructure. In terms of Asia, a production shift occurred as companies flocked to Thailand, Malaysia, and Indonesia. For some labor-intense firms in Mexico, the gradual change was first to the Caribbean Islands, Honduras and El Salvador followed by Costa Rica and Nicaragua and to a lesser extent in Guatemala and Panama. By 2002, some 250 off-shore operations in Mexico moved to El Salvador. In Honduras, U.S. and Korean firms have established the majority of the over 200 maquilas with an estimated workforce of 100,000. Thus, much of the shift of jobs out of Mexico predates both NAFTA and China's WTO membership. Furthermore, as select companies departed Mexico there has been a net positive inflow of new investment to establish new operations as well as expand existing facilities. This is further evidenced by the fact that the number of maquiladoras in Mexico has grown from 2,300 in 1995 to over 3,200 in 2002.[5]

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The increase in higher paying, more technical jobs was welcomed in Mexico, yet there was a fear of the impact due to the loss of lower wage positions. The downturn of the U.S. economy, which began in early 2001, signaled a change (in the wake of the 2000-01 dot-com melt down in the U.S.) as demand declined for automobiles, textiles and electronics. It is important to note that the U.S. economic downturn and the impact of the sluggish growth in cross-border trade with Mexico predates the September 2001 terrorists attacks, as also do Mexico's concern with the entry of China in the WTO.[6]

In the eyes of Mexico, China has been the problem primarily of the United States and to a lesser degree of the old Soviet Union, both in terms of global strategic posturing dating from the Cold War as well as the thawing of commercial relationships. By the 1990s, U.S.-China relationships hinged around the yearly review of the "most favored nation" (MFN) status. MFN, fueled primarily by non-trade items such as human rights, dominated discussions that in turn shaped trade policy. The Clinton administration attempted to demystify the MFN concept —which is, despite its name, a nondiscrimination clause— by calling it "permanent normal trade relations." However, China's primary intent, above and beyond MFN, was to be a member of the WTO. Since the inception of GATT in 1947, forerunner to the WTO, China had been shut out of the mainstream of global trade accords. Not until the transfer of Hong Kong by the British back to the Chinese on June 30, 1997, did they begin the final push for membership.[7]

China Knocking at the Door

Mexico's concerns about the impact of China —primarily expressed in their worry that low wages and relatively high productivity could quickly undercut any competitive advantage enjoyed with the U.S. market— resulted in its efforts to block WTO membership or at least negotiate for terms that would prevent China from dumping products in Mexico (or the U.S.) and displacing workers by offering lower wages. Fears of a sudden impact on the manufacturing sector and the resulting job loss as well as the potential flight of FDI were well founded.[8]

In less than two decades China went from essentially no workers in "foreign-owned" domestic manufacturing operations to over 18 million by 2002 —more than either France or Italy. Thus, while most observers in the Western world credit China with both its large land mass and vast population, few realize the potential magnitude of the impact of China not only on trade with the U.S. and Mexico, but also worldwide implications of a new and redefined Chinese new millennium version of the "Open Door" —opened and targeted at the world, and hallmarked by an export-led growth strategy.

For over two centuries, and some argued maybe as many as 10 centuries, China has been wrapped in self imposed isolation. In the last 20 years, China has grudgingly opened to the world. Coupled with the forces of communism and the Cold War through 1989, the fall of the Berlin Wall ended in the collapse of the old Soviet Union in 1991 and unquestionably opened discussions among hard liners in Beijing on the future course of interaction with the West. The Chinese strategy, a nation with a population over 1.3 billion, to reclaim a place on the world stage is marked by contrasting features and dynamics —political, economic, and cultural— that the world at large has yet to fully grasp.[9]

The very country that will host the 2008 Summer Olympics in Beijing has over 70 million people in abject poverty and another 100 million —equal to the total 2001 population of Mexico— living on less that U.S.$1 per day. As the seventh largest economy in the world at the turn of the century, China is currently second only to Japan in Asia. Agriculture still dominates the Chinese domestic economy. Of the many East-West dissimilarities is China's struggle with open market economics and the old line insular communist planned economy model —so often flaunted, yet so long a domestic failure.

In retrospect, one of the most pivotal moments for China was the return of Hong Kong and the emergence and creep toward a market economy via the theme "one county - two systems." Fully aware of the economic, technological, and industrial gains in the West, with the return of Hong Kong, China now lay claim and ownership to a true and enduring icon of a free market success. The economic impact and dynamic nature of the few square miles of capitalist Hong Kong was a marvel even the communist People's Party leadership could not deny. China wanted entry in the broader global economy via the

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WTO primarily on their terms. For example, shortly after the return of Hong Kong, China took its first significant plunge into the world capital markets— albeit on a very modest scale— by raising U.S.$3.9 billion in an offering of a mere 10 percent of PetroChina, the world's fourth largest petroleum company.

Fashioned by the aging Deng Xiaoping, architect of China's modern reform era in the wake of the disastrous years under Mao, China in terms of its economy —not political structure— turned, albeit gradually, to more western oriented open market policies.[10] The Four Tigers of Asia were obvious models in the area of export-led economic development and growth, attraction of FDI, generation of hard currency and domestic job creation. During the 1990s GDP per person rose 5 percent annually in the developing countries, such as Mexico and South Korea, opening their economies to international trade and the attraction of FDI. By 2001, the GDP per person in Mexico was over twice the output of China. Thus, China's strategy has been to develop its coastal areas into a world class trade zone —called Special Economic Zones (SEZs). Much like the wave of development along the U.S.-Mexican border in the late 1960s to create an investment-friendly region, China would foster the new industrialization in an effort to absorb surplus labor migrating from the interior, encourage technology transfer and increased FDI, which in 2002 reached a record U.S.$52.7 billion, surpassing the United States as the world's leading recipient. During the decade of the 1990s, inflows of FDI increased tenfold as China grew at an average annual rate of 9.7 percent. In spite of the tremendous FDI, the country has relied on massive government spending for domestic growth. And in the process government debt has spiked sharply up.[11]

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The Western influence on the industrial areas of the Chinese coast has not been without pain and conflict ever since the Treaty Ports of Europe imposed their influence in the 1850's. In spite of the economic activity, hard liners in the communist party today routinely express concern about the political impact. Not unlike those who were concerned about President Fox getting too close to the United States, the old guard in China are concerned about China getting too close to the western world. Privatization —or as it is referred to in China "corporatization"— of state-owned companies has been difficult. The demise of these inefficient and overstaffed wards of the state have given the party reason for concern due to the loss of millions of jobs as well as the loss of revenue for the central government. Furthermore, the banking system remains underdeveloped and overextended; corruption persists; reform is needed for the creation of property rights; and the dismantling of export subsides will prove controversial in a state-run society. While the Chinese yuan is in effect loosely pegged to the U.S. dollar, concerns persist about both the dynamics of the world markets with regard to the weakness or strength of the dollar as well as the impact on domestic inflation which has periodically hit China. To maintain stability in the wake of change and foreign influence will be critical as more and more of the population has contact with the West and the Internet. Thus, for all the apparent hype of the "new" China, as a challenge to other nations for manufacturing investment and job creation increases with the sudden surge of growth and euphoria with WTO membership, there will also be risk. A risk that the political dynamics and transition in China will not keep pace with the rush to globalization. A very close observer of China's transition noted: "Policy making in Beijing is like steering a supertanker —it takes a long time before a policy gets approval and becomes a reality, and even then the central government has limited power over a vast country."[12]

The Mexican Response

Mexico is truly at a crossroads. Official figures indicate employment in the maquila sector down nearly 18 percent in 2002, and tending to further decline in the next decade. The move to high-tech jobs and the challenge posed not only by China but a host of low-wage countries, spells a clear signal that there will be a flight of low-tech labor-intensive jobs in the garment, electronics, some automotive components and footwear industries. The recession of the U.S. economy in 2001-2002, coupled with a strong peso, caused concern about the fundamental direction of the Mexican economy. President Fox

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noted that Mexico's export-led model, that had been underpinned by decades of investment in off-shore assembly plants, "to some degree is worn out." While Fox urged more home-grown research and design, little mention was made that domestic Mexican companies have seldom invested adequately in that area. What looms as more critical to the health of the Mexican economy is the increased dependence on the North American market. By 2003 the United States bought between 80 to 85 percent of all Mexican exports.[13]

Fox took office with the promise to maintain the nation's steady growth and declared rather dramatically that the target for his administration was a 7 percent GDP growth. The dynamics of the world markets had already begun to shift jobs out of Mexico. In spite of the continued positive flow of FDI, the banking sector was unable to provide the level of local financing needed to expand the domestic base and industrial sector. While the large corporations were able to go to the international financial markets, their new found capital sources increasingly were used outside of Mexico to expand or acquire new markets.[14] Thus, a program was needed to address the dynamics of the region.

A pre-inaugural meeting with Fox and the presidents of Central America, representatives of the Inter-American Development Bank (IBD), the Central American Bank of Economic Development (CABEI) and the Economic Commission for Latin America and the Caribbean (ECLAC) on November 30, 2000 resulted in a bold proposal to create a framework for sustainable region-wide economic development projects and attraction of FDI stretching from central Mexico to Panama. The proposal was named the Plan Puebla-Panama (PPP).

PPP and Taxation

Little attention was given to the PPP during 2001. However, with the recession in the United States and the flight of jobs from Mexico, the plan received greater attention. By early 2002, the NGO development banks and funds had set aside U.S.$42 million for the first phase projects in the region. However, in the words of President Fox, in mid-2002 the plan moved from an idea to a "reality" with a pledge of a line of credit of U.S.$4 billion from a group lead by the Inter-American Development Bank. The multi-year funding package could take as much as a decade to fully implement. Thus, it its initial stage the PPP is divided into eight key areas referred to as the "Meso-American initiatives" to include: sustainable development, work force development and training, prevention and mitigation of natural disasters, promotion of tourism, facilitation of commercial activity to include the attraction of foreign investment, development of the regions, infrastructure (roads, ports, and airports, expansion of electrical services) and enhancement of the telecommunications network. The idea is to link the region with the economic and commercial zone of the future —not unlike the Special Economic Zones on the coast of China.

By one estimation the six Mexican northern border states employ 29 percent of the active work force, comprise 77 percent of the maquila sites in Mexico and produce 23 percent of the nation's GDP.[15] In order to address the need to maintain the critical role of the northern production area, Fox swiftly created the Northern Border Region Development Program. In large measure, Fox's border czar, Ernesto Ruffo, noted this program marks the first time federal funds have been earmarked for the development of the border, and thus were sent as a signal that the region is important to the national economy. However, in recent years it has not been the desire for attention from Mexico City, but instead a cry for the central government to finally clarify the role and treatment of taxes and duties for the maquila sector. By all appearances, via a constantly changing and reissuing of rules, the central government has undertaken the taxation of the maquilas at whatever maximum level they can extract. These efforts have gained gradual momentum, giving existing operations and potential foreign investors the impression that Mexico is squeezing more and more taxes out of the maquilas to cover declines in other areas. The confusion and concern began in January 2001, when the NAFTA duty waiver was eliminated and no clearly defined import tax regime was developed. In short, three key areas of taxation impact the competitiveness of the maquila sector: import taxes and the impact of NAFTA's Article 303, changes in the confusing and inconsistent taxing of income and assets to include concerns with avoiding double taxation, and, third, antidumping duties or tariffs on imported goods that are deemed to be a threat to the domestic market because they enter the country below fair market value. Prior to 2001, the maquila sector was exempt from such antidumping duties. Is it possible that the tax authorities at the Finance Ministry think there is no end to the number-one hard-currency-generating sector of the economy? One observer noted, "Despite tax uncertainties and real wage increases over the past five years, maquiladora employment grew at an annual rate of 14.4 percent between January 1995 and October 2000. The pace of growth has been remarkable and contrasts sharply with the notion of a fragile industry teetering on the edge of uncompetitiveness due to higher taxes and rising wages."[16] Nevertheless, past performance does not in any way portend the future growth of the maquila sector, especially given the lack of transparency in the bureaucratic and taxation regime.

Conclusion

Mexico and the world need to maintain a continuous watch-and-wait attitude because China's rise will in fact prove highly disruptive in the next two decades as it attempts to come to grips with a rules-based international system they have long exploited for their singular gain. The very targets and goals of China's global penetration signal a fundamental shift in trading patterns, labor concerns and environmental dynamics few can predict. By its own measure, China intends to double GDP by 2010 and its share of world trade will triple to 10 percent by 2020, surpassing Japan at 5 percent and standing second only to the U.S. in the range of 12 percent.[17]

Mexico is faced with the possible destabilizing task of dealing with lost jobs, a threat to FDI and the ongoing issue of cross-border immigration with the United States. Nevertheless, Mexico will continue to be critical to the growth and stability of the region. The dynamics of this regional cross-border relationship will be vital to U.S. commercial interests. VM

Notes

[1] William Greider, "A New Sucking Sound," *The Nation*, December 26, 2001; Supachai Panitchpakdi and Mark L. Clifford, *China and the WTO: Changing China, Changing World Trade* (New York: Wiley and Sons, 2002), pp. 1-98; Juan José Ramirez Bonilla, "Asia Pacific and the Challenges for Mexico," *Comercio Exterior*, October 2002, pp. 860-865; Ralph Watkins, "Mexico Versus China: Factors Affecting Export and Investment Competition," *Industry Trade and Technology Review*, USITC, pub 3534, July 2002, pp. 11-26.

[2] James Gerber, "Uncertainty and Growth in Mexico's Maquiladora Sector," *Borderlines* (San Diego), March 2001, p. 1.

[3] Michael E. Porter, *The Competitive Advantage of Nations* (New York: Free Press, 2002), pp. 11, 383-712; Ralph Watkins, "Production-Sharing Update: Developments in 2001," *Industry, Trade and Technology Review* (Washington, D.C.), USITC, Pub. 3534, July 2002, pp. 27-42.

[4] "Maquila Scoreboard," *Twin Plant News* (New York), August 2002, pp. 54-55.

[5] James Gerber, "Uncertainty and Growth in Mexico's Maquiladora Sector," *Borderlines*, (San Diego), March 2001; "Trabajadores hondureños agradecidos con empleo de maquiladoras taiwanesas," *Nacionales* (Honduras), 676, 22 May 2001.

[6] Ginger Thompson, "Fallout of U.S. Recession Drifts South into Mexico," *The New York Times*, 21 December 2001.

[7] Kenneth W. Dam, *The Rules of the Global Game* (Chicago: University of Chicago Press, 2001), p. 139; Joseph P. Quinlan, "Ties That Bind," *Foreign Affairs* (Washington, D.C.), July 2002, pp. 116-126; Bill Gertz, *The China Threat: How the People's Republic Targets America* (Washington, D.C.: Regnery Publishing, 2000), pp. xx-13.

[8] Sergio L. Ornelas, "Mexico's Reaction to the China Challenge," *Mexico Now* (Chihuahua), January 2003, pp. 17-21.

[9] Daniel Yergin and Joseph Stanislaw, *The Commanding Heights: The Battle for the World Economy* (New York: Touchstone, 2002), pp. 189-199; Gerald Segal, "Does China Matter?" *Foreign Affairs* (Washington, D.C.) September 1999, pp. 24-36.

[10] James Kynge, "China's capitalists get a party invitation," *Financial Times* (London), 16 August 2002.

[11] "GDP per person," *The Economist* (London), 24 August 2002, p. 74; Dong Fu and Jahyeong Koo, "Latest Economic Developments in China," Federal Reserve Bank of Dallas, *Expand Your Insight*, 31 January 2003, http://www.dallasfed.org/eyi/global/0302china.html.

[12] Yergin and Stanislaw, Ibid., 205-210; Simon Cantledge, "The Other Side of China's Success Story," *Financial Times* (London), 20 January 2003, p. 11; Peter Wonacott, "China Shuns a Financial Overhaul," *The Wall Street Journal*, 20 January 2003, p. a14. See also Minxin Pei, "China's Governance Crisis," *Foreign Affairs* (Washington, D.C.), September 2002, pp. 96-109.

[13] See Bibiana Gómez Muñoz's article "Ten Years of NAFTA" in this same issue of *Voices of Mexico*. [Editor's Note.]

[14] The global reach of Cemex is a prime example. The Monterrey cement company expanded operations not only in the Philippines, Spain and South Korea but also Texas.

[15] *The News* (Mexico City), 14 February 2002.

[16] See James Gerber, "Uncertainty and Growth in Mexico's Maquiladora Sector," *Borderlines* (San Diego), March 2001; J. Watkins, "Production-Sharing," *Industry, Trade and Technology Review* (Washington, D.C.), July 2002, pp. 27-32.

[17] World Bank, *China 2020: China Engaged* (Washington, D.C.: World Bank, 1997), p. 36.

Trends: Mexico vs. China

China is indeed a threat to the stability of the global markets and Mexico with regard to adequate jobs between now and 2010. Furthermore, as China gains an increased market share of the world manufacturing demand via low wages and a failure to adhere to WTO covenants, further FDI will be channeled away from Mexico. Mexico will in fact forfeit its competitive advantage in low-skilled and low-paying jobs at a time between 2010 and 2020 when it will have one of the largest 19-26-year-old work forces in the world outside of China. Fears of China's entrance in the WTO are probably somewhat exaggerated due to the fact that low wage jobs began exiting Mexico prior to 2001; however, in the minds of those who have lost and will lose their jobs the threat is real and lasting.

Danger and Impact

Increased amounts of funding will be needed both as a social safety net and for the training of value-added jobs in the next generation of manufacturing operations that will demand a higher skilled trainable workforce. The lack of jobs in Mexico can lead to domestic unrest and increased migration northward.

The Plan Puebla-Panama or a similar program will need to be developed for both southern Mexico and Central America in order to provide an additional job outlet for a growing regional labor market. Environmental concerns and impediments need to be resolved as quickly as possible given the lead time needed to develop infrastructure. The absence of multi-modal facilities, improved seaports and roads will slow the attraction of private investment in the region.

Danger and Impact

Reluctance to act now to encourage smart development of southern Mexico will pose grave immigration problems for the United States on the northern border, and thus, strained relations with not only Mexico but also with Central America.

To ensure the competitive nature of the existing maquiladora sector, the continued creation of value-added jobs and the lasting attraction of foreign direct investment, legislative measures need to be taken by the Mexican Congress to remedy the lack of coherent decision-making authority at the Finance Ministry and clearly define an understandable and transparent taxation and duties policy that reduces the administrative burdens at the same time that it supports and fosters the enhancement of the maquiladora sector.

Danger and Impact

Investors will look elsewhere to establish operations and, thus, have a tremendous impact on job creation and government revenues as well as diminish the prime source of hard currency.