Mexico's Foreign Trade in Trouble China's Impact

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The Causes of Mexico's Economic Slowdown

NAFTA is already 10 years old. Its tenth anniversary last January 1 has naturally stimulated much debate on its benefits and costs to Mexico. But whatever the assessment, there is no doubt that during the last three years, Mexico's export growth model, largely based on NAFTA, has been running into serious problems. After growing at reasonable rates for a number of years following the 1994 debacle, in 2001 Mexico's gross domestic product (GDP) fell by 0.3 percent while its exports slumped by 5 percent. At first glance, these results looked very much like the price of Mexico's high level of integration to the U.S. economy because even if in contrast to Mexico the U.S. managed to achieve some minimal growth (0.5 percent) in that same year, its imports fell by 6.4 percent. This last fact could plausibly explain the drop in Mexican exports, and, given the weight and the role of exports in the Mexican economy, probably most of the drop in Mexico's GDP.

Indeed this is how the Mexican government and many other institutions and analysts explained Mexico's slowdown.[1] But it soon became clear that Mexico's problems, even if mainly caused by the downturn of the U.S. economy, did not stop there. If in 2002 Mexican exports to the U.S. grew in tandem with total American imports, in 2003, total U.S. imports grew by 8.4 percent, but Mexican exports to the U.S. only by 1.6 percent. Moreover this slight rise was mainly due to high oil prices. These figures suggest that Mexico has been suffering not only from the slowdown in the U.S. economy but also from a loss of competitiveness. This mostly explains why the U.S. recovery is not pulling the Mexican economy as it was expected to. While in 2003 the U.S. achieved 3.5 percent growth, Mexico grew by only 1.2 percent. The fall of Mexico's exports to the U.S. has not been counteracted by its exports to the rest of the world, which in any case account for a very small share of the total. So all in all, because of the double impact of a slowdown of the American economy and a loss of competitiveness, Mexico's total exports in 2003 were lower than their 2000 peak.

Mexico has been losing a share of the U.S. market to East Asia, but mainly to China, with whom it directly competes in two of its main export niches: electronic goods and apparel. Exports from Mexico and China to the U.S. grew in tandem during the second half of the 1990s, but starkly diverged in 2000. While during the last three years U.S. imports from China were on average 26.6 percent higher than their 2000 level, those coming from Mexico were on average 0.8 percent lower.

The trends I just described are summed up in Graph 1 that plots recent growth in U.S. imports of goods from Mexico, China and the whole world (total imports). Take first the curves that show total U.S. imports and imports from Mexico. See how during the 1990s, Mexico's exports to the U.S. grew at high rates and constantly increased their share of the U.S. market (the distance between both curves shows the gain or loss of market share). See how the view of Mexico's slowdown that entirely blames the U.S. economy stands up nicely until 2002. Up to then, Mexico's exports to the U.S. fell in tandem with U.S. total imports so no year-to-year loss in market share was involved. Finally, see how during 2003 these two curves strongly diverge, suggesting that Mexico's slowdown and weak recovery have to be explained by additional factors. Now bring in China. During the 1990s, even though it received no favorable NAFTA treatment but faced serious trade barriers, China's rates of export growth to the U.S. were similar to Mexico's. But from 2001 onward as those barriers contracted when China was admitted to the World Trade Organization (WTO), they diverge drastically.

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Given the fact that Mexico and China are direct competitors, such development clearly signalled that something harsh was brewing for Mexico. This has become evident as China has toppled Mexico as the second largest exporter to the U.S. and has been eating into Mexico's share of U.S. imports.

Mexico's Trade System And Its Competitiveness Problem

In principle, a country's competitiveness can shift for three reasons: changes in its domestic economic and political environment; changes in the environment of its competitors; or changes in the trade system. Without arguing that the first two causes are not present or are not important, I will focus on the third.

An important and on-going shift in Mexico's trade regime has been a major cause of its loss of competitiveness. Now it looks clear that since NAFTA, Mexico enjoyed a window of opportunity of preferential access to the U.S. market that is now beginning to close. The window was kept wide open for a number of reasons, among them: a passive U.S. trade policy; limited implementation of NAFTA rules of origin; the exclusion of China from the WTO; and an especially advantageous treatment by the U.S. of Mexico's textiles and apparel. I shall briefly comment each of these in turn.

1. After the adoption of NAFTA, the U.S. Congress did not renew President Clinton's fast track authority (now called "trade promotion authority") to negotiate new trade agreements.[2] So in practice, for many years, the U.S. administration could not offer other less developed countries (LDC) similar advantages to those Mexico got in NAFTA (an exception to this is the Caribbean Trade Partnership Act that I mention below). But now this has changed. In August 2002 President Bush received this authority, and he has been adamant in promoting bilateral and regional agreements, even more so after the failure of multilateral talks in Cancún. In fact, the U.S. recently signed its first post-NAFTA bilateral agreement in Latin America with Chile. On the other hand it has encountered problems in advancing its own vision of a Free Trade Area of the Americas, which as Robert Zoellick, the U.S. representative for Mexico, recently put it, should

Table 1. Mexico's Trade with Regional and Bilateral Free Trade Agreement Partners (Millions of dollars)

FTA	Date when FTA was launched	Number of countries	Exports before FTA	Imports before FTA	Trade balance	Exports 2003	Imports 2003	Trade balance
1. Chile	1992	1	127 (91)	50 (91)	+77	323	1,082	-759
2. Costa Rica	1995	1	95 (94)	28 (94)	+67	332	584	-252
3. G3[1]	1995	2	480 (94)	418 (94)	+62	849	972	-123
4. Bolivia	1995	1	13 (94)	19 (94)	-6	24	29	-5
5. Nicaragua	1998	1	73 (97)	11 (97)	+62	111	38	+74
6. European Union	2000	15	5,203 (99)	12,743 (99)	-7,540	5,592	17,862	-12,270
7. Israel	2000	1	38 (99)	172 (99)	-134	57	314	-257
8. AELC[2]	2001	3	587 (2000)	857 (2000)	-270	707	921	-214
9. Northern Triangle[3]	2001	3	984 (2000)	124 (2000)	+860	1,009	242	+766
10. Uruguay[4]	2001	1	108	83 (2000)	+25	142	102	+40

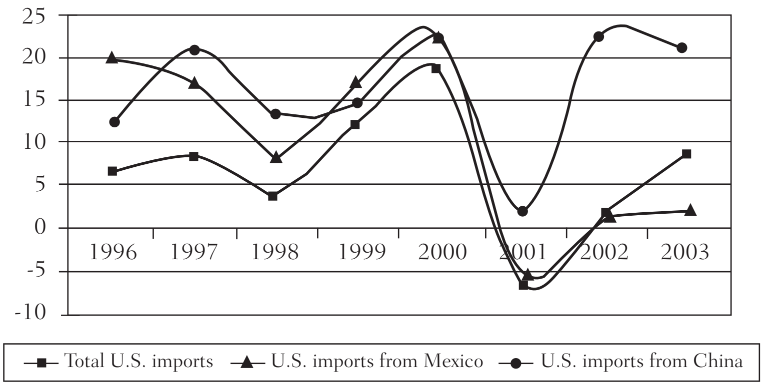
[1] Colombia and Venezuela.
[2] Norway, Liechtenstein, Switzerland and Iceland.
[3] El Salvador, Guatemala and Honduras.
[4] In 2001 Mexico launched a so-called "Supplementary Economic Accord" with Uruguay. Mexico signed a formal FTA with Uruguay, November 15, 2003.

Source: The list of FTAs taken from Gobierno de México, *Examen de las políticas comerciales de México*. Document presented before the WTO, March 15, 2002, p. 11. WTO document: WT/TPR/G/97. Data from Ministry of the Economy and the National Statistics Institute (INEGI).

be "an extension of NAFTA" to the whole hemisphere. So far, with the exception of apparel, the United States' renewed regionalism does not seem to have played a significant role among Mexico's exporters.

2. Until recently, NAFTA rules of origin had not been strictly applied. But since 2001, NAFTA article 303 has prohibited Mexico from allowing non-regional imports into the country duty free. If the final product will be sold in a NAFTA country, exporters must now pay Mexican import duties on their non-NAFTA inputs.[3] The implementation of article 303 entails a decrease in Mexico's preferential terms of access to U.S. markets.
3. Since NAFTA, Mexican privileged access to the U.S. market in apparel surpassed that until then enjoyed by Caribbean and Central American countries under the Caribbean Basin Initiative (CBI). This advantage shrank in May 2000 when the U.S. Congress gave the green light to the Caribbean Trade Partnership Act (CBTPA), which enhanced the CBI and effectively gave NAFTA privileges to those countries.[4] Moreover, the edge in apparel and textiles that Mexico has enjoyed for years and which allowed it to win a U.S. market share from CBI countries and East Asia is bound to deteriorate further due to the new U.S. bilateral and regional trade activism, but more importantly, because the Multifiber Arrangement is scheduled to expire by the end of 2004. So far, with respect to the North American market, Mexico has been exempted from this quota agreement designed to protect the developed world's domestic apparel and textile markets. But soon it will have to share a much more levelled field with a host of other less developed countries.
4. The last and so far more important factor is that China was relatively kept out of the U.S. market (and elsewhere) by not being a WTO member. This meant that it faced high tariff and non-tariff barriers. Sensing the troubles that China would cause, Mexico was the last country to keep China from joining the WTO. When Mexico finally gave in and China joined in 2001, its worst nightmares came true: Chinese competition not only threatened its exporters but also its local producers. I shall come back to this point below.

Graph 1. U.S. Imports (growth rates)



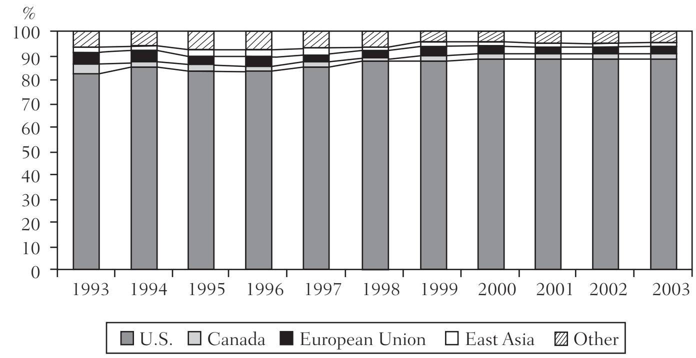
Source: Based on data from Ministry of the Economy (Mexico) and the U.S. Census Bureau.

Mexico's Changing Trade Pattern and Trade Policies

As Mexico's trade environment deteriorates and is likely to deteriorate even more in the near future, it is not clear where Mexico's trade policies are heading. Since NAFTA, Mexico focused on completing as many bilateral and regional trade agreements as possible. By early 2002, Mexico had the most comprehensive network of free trade agreements in the world, embracing 31 countries with a total market of 850 million consumers.[5] This strategy had three objectives. First, to diversify Mexico's trade in order to reduce its dependence on the United States. Second, to attract foreign investment by marketing Mexico's preferential access to the U.S. under NAFTA. Third, to open new markets to Mexico's exports. At the time, then-Mexican Trade Minister Herminio Blanco, argued that Mexico's trade policies in the early 1990s, both in multilateral and regional-bilateral terms, aimed at "guaranteeing reciprocity to Mexico's liberalization".[6] The idea was that since our markets were already quite open mainly due to a policy of unilateral liberalization, the trade agreements would more than anything benefit our exports.

But just when the regional and bilateral strategy was becoming fashionable elsewhere, Mexico lost enthusiasm for it. In November of last year, Fernando Canales, current Mexican minister of the economy, announced that Mexico was not going to engage in any new talks leading to bilateral or regional agreements. Talks with a num-

GRAPH 2. MEXICAN EXPORTS
(%)



Source: Based on data from Ministry of the Economy (Mexico).

ber of countries are still on-going. But Canales stated that Mexico would only sign a bilateral agreement with Japan and a regional one with the Americas (the Free Trade Area of the Americas) if it considered it in its interest to do so. Canales did not go deeply into the reasons for this sudden about-face in policy. But it may be that Mexico is having second thoughts about the usefulness of these free trade agreements, especially in the new, more challenging circumstances. On the one hand, you do not always need these agreements to promote foreign investment. In fact Mexico has investment agreements that do not involve trade. On the other hand, it does not seem that these agreements have helped to diversify Mexico's trade. Let's analyze this last issue in more detail.

During NAFTA's first seven years (1994-2000), Mexico's foreign trade expanded rapidly at around 20 percent a year. At the same time, the share of this trade that took place with the U.S. also grew: from 82.7 percent to 88.3 percent of the total in exports and from 69.1 percent to 73 percent of the total in imports (see graphs 2 and 3). Thus if in 1993, on the eve of NAFTA, 75 percent of all Mexican trade took place with the U.S., by 2000 that share had grown to 81 percent. Up until then NAFTA tended to concentrate Mexico's trade.

From 2001 onward, however, just as the Mexican economy was abruptly cooling down, Mexico's trade began to diversify rapidly. By the end of 2003, the U.S. share of Mexico's total trade fell back to 75 percent, the same share it had on the eve of NAFTA. Finally, Mexico was getting some trade diversification, not through exports as Blanco had expected, but through imports. While Mexico's share of total exports to the U.S. reached 88 percent in 2000 and stayed there up to the end of 2003, its share of imports from the U.S. fell in more than 10 points: from 73 percent to 62 percent of the total. Since during these years of virtually no growth, total Mexican imports have been falling, this means that Mexico has been buying less from the U.S. and more from other countries.

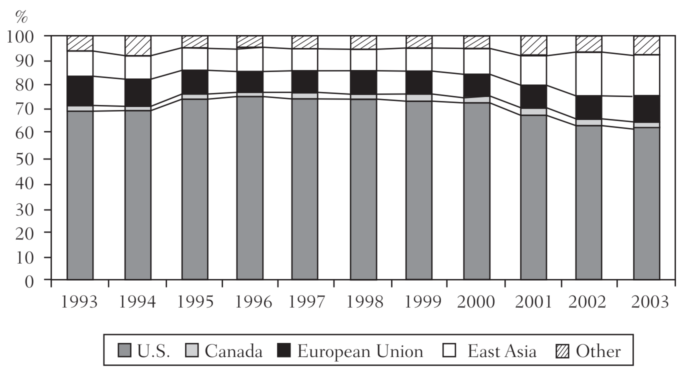
Graph 3 divides Mexico's trade partners into 5 groups, the United States, Canada, the European Union (15), East Asia (Japan, China, South Korea, Hong Kong, Singapore, Thailand, Indonesia, Philippines and Malaysia) and "other". Throughout the 1990s, all these trade partners' shares remained remarkably stable in the midst of rapid growth of Mexico's total imports. But this pattern changed quite abruptly in 2001, when every trade group except Canada grabbed market share away from the United States. By far the main winner has been East Asia, which raised its share of the Mexican market from 10.6 percent in 2000 to more than 17 percent in 2003, and accounts for almost two-thirds of this shift in trade away from the U.S.[7] Within the East Asia group, China is by far the most dynamic. Since 2000 China's share of Mexican total legal imports more than tripled from 1.6 percent to 5.5 percent. In fact, since 2001, China's exports to Mexico have grown at even a higher pace than China's exports to the U.S.

So East Asia, and particularly China, is to a large extent behind both these new trends in Mexico's foreign trade that have taken shape in the last three years: a loss in competitiveness of Mexican exports and the diversification away from the U.S. of Mexican imports. In fact, these two phenomena are two sides of the same coin. To state that Mexico buys less from the U.S. and more from East Asia is just another way of saying that, in relation to the Mexican market, the U.S. has lost competitiveness to East Asia and particularly to China. In fact, since China entered the WTO, its legal exports have been strongly boosted and have gained market share in every other economy around the world. In other words, the "Asian Challenge", which includes China but also other East Asian countries as well as India, is a worldwide phenomenon and Mexico (and the U.S.) is certainly not alone in having problems to adjust to this new major factor of the world economy, though it is especially vulnerable to it.

But what are the relations between these recent trends in Mexico's trade patterns and its regional and bilateral trade strategy that is now coming to an end? The former analysis of those patterns points to three conclusions:

1) As Graph 2 suggests, Mexico's "other" free trade agreements (i.e., all except NAFTA) have failed to diversify exports. Between 1994 and their peak in 2000, exports to other countries doubled while those to the U.S., which sprang from a much larger base, almost tripled. It might be true that without these agreements NAFTA would have tended to concentrate Mexico's exports even more. Nevertheless, it is disappointing to notice that Mexico's second most ambitious trade agreement signed with the European Union in 2000 has failed to hike Mexican exports to Europe. In fact, exports to the European Union fell in 2001 and 2002 and even though they grew in 2003, they did not regain their 2000 level in spite of having the advantage of an overvalued euro.[8] Moreover, as we shall see, this relatively muted reaction of Mexican exports to a free trade agreement has not been an exception.
2) As Mexico has so far not signed any bilateral or regional agreements with any East Asian economy, its network of free trade agreements has not been the driving force behind the diversification of imports that has taken place in the last three years.
3) Nevertheless, it can be argued that these free trade agreements have played a subsidiary role in diversifying imports. This can be sensed by the fact that nearly 40 percent of the diversification in the last three years took place with non-East Asian economies, many of which are Mexico's partners in bilateral or regional agreements (see graph 3). Table 1 shows Mexico's bilateral-regional trade balance with its "other" partners (i.e., excluding the U.S.) before adopting a free trade agreement in 2003. It is quite compelling that with few exceptions Mexico's trade balance with most of these partners has deteriorated.[9] This means that these trade agreements have been more successful in promoting imports than exports. In the extreme case of Chile, a surplus of U.S.$77 million turned a decade later into a deficit of U.S.$759 million. In the case of the European Union, just three years after the agreement was endorsed, Mexico's trade deficit jumped by 62 percent.

Graph 3. Mexican Imports
(%)



Source: Based on data from Ministry of the Economy (Mexico) (World Trade Atlas).

These results suggest that Mexico's trade partners have taken more advantage of these free trade agreements than Mexico's exporters. But this in itself need not be a problem. Whatever the composition of exports and imports, these agreements have promoted not only trade (which also means more cheaper and/or better imports) but also investment and cultural as well a political ties, important outcomes in themselves especially in the case of Mexico's relations with Latin America or with the European Union. But if the net gain of a free trade agreement with Chile or with Costa Rica, which represent a tiny portion of Mexico's total trade, goes beyond the (negative) trade balance issue, this cannot be said of every other agreement that could be signed in the future. In the present delicate circumstances, the size and breakdown of trade in exports and imports do matter.

Mexico is in the process of negotiating a free trade agreement with Japan,[10] and South Korea has asked for one. But are these agreements a good idea? A decade of free trade agreements with "other" countries tells the U.S. that Mexican exporters have been slow to respond to the opportunities opened up by them. If Mexican exporters have been unable to increase their sales to Europe, where they have close cultural, linguistic and commercial ties, why would they turn out to be more successful in breaking into much more complicated and restrictive markets, such as Japan or South Korea? The final result would depend, of course, on the details of such agreements, but given the historical facts and current trends it should be a safe bet that if they were adopted, they would boost Mexico's already bulky trade deficits with these countries.

The fact is that further growth of Mexico's increasing trade deficit with East Asia is problematic. It will certainly not be welcome by Mexico's already battered domestic producers. Neither will it be welcome if it results in a further increase of Mexico's total trade deficit, a perennial obstacle to growth that has not disappeared with the adoption of an export-oriented economic model. But it could turn out to be problematic even if such deficits are compensated, as they have been for the last few years, by larger trade surpluses with the U.S.

Graph 4 plots Mexico's exports and imports to the U.S. and to other countries. It illustrates the recent trends in Mexico's foreign trade mentioned above. But what I want to emphasize here are the contrasting trends of Mexico's trade balances, increasingly in deficit with other countries (the distance between the first and the second curves) and with a growing surplus with the U.S. (the distance between the third and the fourth curves). The growth of Mexico's trade surplus with the U.S. has accelerated since 1999 and has more than quadrupled in five years. By the end of 2003 it reached U.S.$41 billion. As exports have remained flat, this spiralling trade surplus has come about by the aforementioned diversification of imports. Up to September 2003, Mexico's goods trade surplus accounted for almost 8 percent of the U.S. trade deficit; almost three times lower than China's, but still a substantial share.

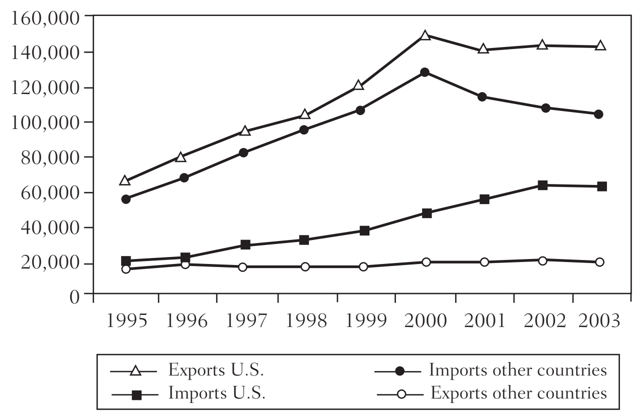
Mexico is becoming part of the problem of the United States' huge, growing and ultimately unsustainable trade deficit. In these circumstances, the game of diversifying imports without also diversifying exports has its limits. If Mexico wants to buy more elsewhere, it should start selling more elsewhere too. While it learns to do so and works on mending its competitive problem, the decision to halt its regional and bilateral trade strategy seems reasonable and timely.

Final Remarks

Mexico is struggling to emerge from three years of stagnation under the pressure of enhanced competition from East Asia and particularly from China. But as I said, it is not alone in facing the "Chinese challenge." Most economies in the world, in one way or another, have been affected by it. China is in the midst of a veritable industrial revolution that even if it half succeeds, given its sheer size, will change the shape of the world economy. As year after year it achieves astonishing GDP and trade growth rates, it is already doing this. But China has not only been exporting intensely, but also increasingly importing. In fact, the day when it generates substantial trade deficits might not be far away. China demands large amounts of capital goods and natural resources to fuel its industrial revolution. It has thus been swallowing large amounts of imports from capital goods producers such as Japan and from raw material producers such as Russia, Chile and Brazil.

But Mexico is neither a large exporter of raw materials (except for petroleum) nor of capital goods. On the contrary, it specializes in some export niches of manufactured items such as electrical goods and textiles, in which

Graph 4. Mexico's Foreign Trade
(millions of dollars)



Source: Based on data from Ministry of the Economy (Mexico).

China's competition is fiercer. Thus while in 2002, Brazil sold U.S.$2.5 billion in goods to China, Mexico's sales amounted to only U.S.$0.5 billion. And while in that year Brazil ran a trade surplus of U.S.$0.96 billion with China, Mexico ran a deficit of U.S.$5.7 billion. That China is turning out to be an opportunity for Brazil but a menace for Mexico is a matter of chance, not of strategy. In spite of the good performance that raw materials have had in the last couple of years, it would be absurd to blame Mexico for having left behind its old profile of exporter of raw materials. But it can and must be blamed for allowing time to pass without enhancing its export profile. The Mexican government is clearly aware of this. As former Minister of the Economy and current Minister of Foreign Affairs Luis Ernesto Derbez recently stated, "Mexico will not compete with cheap labor anymore, and must compete with education, research and development to achieve a different type of growth."[11] Since by 2002, China's wages were still a quarter of Mexico's, the problem is how to regain competitiveness at a higher level.

Mexico's competitiveness problem has inevitably increased attention to NAFTA's results on its tenth anniversary. Many observers agree that NAFTA was on balance a good thing, but that it turned out to be "not enough." Others argue that, from Mexico's perspective NAFTA is flawed in important ways.[12] Whatever the diagnosis, Mexico's competitiveness problem has to be tackled with reforms at home. But it should be clear that whatever these are, they are hardly going to give instantaneous results. In the very short run, unfortunately, almost the only measures that can ease some pain and save jobs are of a *defensive* character. This is why some observers have suggested that Mexico should strengthen ties within NAFTA in order to differentiate itself more from those countries that now enjoy or will soon enjoy more access to the U.S. market. This is also why Mexico secretly relishes it when the U.S. government adopts protectionist policies that excludes NAFTA partners (as was the case with the recent steel tariffs) and even more so when it clamps down on Chinese products and insists in the revaluation of the renminbi. Much to Mexico's relief, the U.S. is applying and planning to apply "safeguard tariffs" to a number of Chinese goods including apparel and color television sets. In the latter case, the tariff is supposed to favor a tiny community of local U.S. producers. In fact, however, it is likely to give much more relief to Mexican workers in Tijuana, not long ago the undisputed production capital center of TV sets destined for the U.S. market. VM

Notes

1 Mexico's Finance Ministry and Central Bank took this view. Secretaría de Hacienda, *Criterios Generales de Política Económica para 2003*. Banco de México, *La política monetaria para 2003*. See also OECD Economic Survey, Mexico 2002/7, p. 34.

2 Under trade promotion authority (TPA) Congress restricts itself only to approving or rejecting a negotiated trade agreement, within strict time limits and without amendments. On Bush trade policy see Fred C. Bergsten, "A Renaissance for U.S. trade policy?" *Foreign Affairs* (Washington), November-December 2002, pp. 86-98.

3 John Sargent and Linda Matthews, "Boom and Bust: Is It the End of Mexico's Maquiladoras?" *Business Horizons*, March-April 2003, p. 59, www.cba.cmich.edu

4 Even though if the privileges granted to the CBI were watered down in December 2001, they remained significant. Fred C. Bergsten, op cit., p. 92.

5 Gobierno de México. *Examen de las políticas comerciales de México*. Document presented to the WTO, 15 March 2002, p 11. WTO, WT/TPR/G/97.

6 Herminio Blanco, *Las negociaciones comerciales de México con el mundo* (México City: Fondo de Cultura Económica, 1994), p. 84.

7 During the late 1990s, within this group, Japan had been losing market share to China and other East Asian economies. This is partially why Japan wants a trade agreement with Mexico.

8 It is true that since it was going through a mild recession, Europe was bound to import less in 2001-2003. However, Mexico failed to increase its exports even to Britain, which maintained a relatively dynamic economy and an increasingly strong pound. Moreover, even if Mexico's recession was deeper than Europe's, it managed to substantially increase its European imports during that period.

9 The most notable exception is the AELC. This was due to a jump in 2003 of more than 50 percent in our exports to Switzerland. This export boom of U.S.$244 million was concentrated in a small group —4 in fact— of export products.

10 Just as this essay was going to the press, Mexico and Japan finally reached a trade agreement. Japan is virtually starting a strategy of bilateral trade agreements and more than anything wanted the deal with Mexico as a spring-board for more ambitious ones in Asia (and so to offset China's growing influence). This explains why Japan eventually made important concessions in agricultural matters. Let's hope that Mexican exports make the most of these exceptional circumstances and take advantage of this trade agreement as they have not done with previous ones.

11 *NAFTA Works*, vol. 8, no. 1 (Mexico City), December 2002-January 2003, p.1.

12 As NAFTA's anniversary neatly coincides with the full disclosure of the "Chinese menace," some observers have naturally given in to the temptation to refer to China's experience. Not surprisingly many of them attribute China's success precisely to the reforms they consider vital for Mexico to push forward. In fact, however, China followed a very different reform path from day one. While Mexico has pursued a quite radical and liberal reform strategy inspired in the Washington Consensus, China has followed a gradual *dirigiste* strategy inspired by the experiences of Japan and South Korea. These are separate roads toward a modern export-oriented economy, not variants of the same one.