# NAFTA, Mexico and The China Factor

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The North American Free Trade Agreement (NAFTA) came into effect in January 1994. The parties, Canada, the United States and Mexico, thereby formed the world's largest free trade area.[1] This agreement was unique in other respects insofar as it was the first formed between a so-called undeveloped country like Mexico and highly developed countries such as Canada and the United States.

From the Canadian and U.S. business perspectives cheaper labor in Mexico looked inviting, and for Mexico, with its population of 105 million and a GDP only 5 percent of that of the U.S., the lure of the U.S. market was an attractive magnet. U.S.-sourced and other foreign direct investment (FDI) initially flooded into Mexico, often into *maquiladora* companies along the U.S.-Mexico border. These compa-

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nies, frequently in assembly industries, were seen by many on the northern side of the border as repositories of low cost labor where menial tasks could be outsourced, or resourced more cheaply by FDI. Soon after these kinds of investment were made the businesses were very quickly impacted by the People's Republic of China's (PRC's) emergence as a manufacturing base and some of this FDI was uprooted and relocated to China.[2]

Since 2000, according to Farrell, Puron and Remes, more than 270,000 Mexicans have lost assembly jobs, hundreds of factories have closed their doors and Mexico's trade deficit with China has grown to more than U.S.$5 billion. These authors report on research which shows that non-*maquiladora* investments have generated a wide range of benefits for Mexico's economy by creating jobs, boosting competition and productivity, lowering prices and enhancing consumer choice. Economists at the Federal Reserve Bank of Dallas have shown that increases in Mexico's wage costs relative to non-Chinese competitors and the decline in the Mexico-based U.S. industrial production together account for 80 percent of the *maquiladora* jobs lost since their peak in 2000. Rather than fixating on jobs lost to China, Mexico should focus on creating jobs that add higher value. That is Mexico's primary strategic industrial challenge.

As an example of value added strategies in Mexico, Delphi, a maker of car-parts, once part of General Motors (GM), is the largest foreign-owned manufacturer in Mexico, with 55 factories. It is especially proud of its research and development unit at Ciudad Juárez, on the Mexico-U.S. border close to El Paso, Texas. This, the largest of 31 such centers around the world is attributed with having developed 50 American patents, with others pending. According to *The Economist*[3] this is proof, given its mainly Mexican workforce, that the country can compete in high value, high-technology businesses. However, this recommendation stems from a less than credible source: Delphi Corp. filed for bankruptcy in October 2005 and lost a further U.S.$127 million in the remainder of 2005. Its former parent GM declined to provide a financial bailout and is posting its lowest share price in two decades.

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Yet, Mexico's short term successes were not limited to the type of problems that beset the U.S. auto industry. Rather quickly, China developed its relative competitive position and some types of investment quickly migrated swiftly from Mexico to China.[4] China's U.S. exports grew 20 percent during 2004, and it passed Mexico as the second largest exporter to the U.S. behind Canada.[5] Exports of Mexican products such as textiles, toys and even religious icons have been hard hit after China took over these profitable markets in the United States. And, seemingly Canada will have to grow accustomed to no longer being the largest trading partner of the U.S. as it cedes that position to China.[6]

According to the U.S. Department of Commerce, China overtook Mexico as the second largest exporter to the United States during August 2002 to January 2003. In this period, China exported U.S.$72.2 billion in goods to the United States, while Mexico exported U.S.$69.4 billion.[7] As Dobson reports, Canada and China are to a large extent complementary; however China and Mexico have similar export baskets, especially in terms of light manufactures. It is apparent that after the NAFTA trade agreement was created, Mexico's exports increased rapidly, but since 2000, some sectors' imports have been decreasing following China's accession to the World Trade Organization (WTO) inducing Mexico's economy to stagnate.

Mexico's close links to the United States' economy through NAFTA means that just as it benefited from an earlier boom, it is now suffering from the slowdown across its northern border. Moreover, Mexico's transport network remains so bad that A.T. Kearney estimates that proximity to the United States now yields an advantage over China of no more than five cents for every dollar of product.[8] Many of the obvious logistical border challenges have not been dealt with. For example in the consumer products industry a 500-kilometer truck journey would normally involve a 5-8 hours transit time with normal cost of transportation and a necessity for basic documents. Should that 500-kilometer journey involve crossing the U.S.-Mexican border, transit time increases to 10–24 working hours and shippers incur further demurrage delays, excessive paperwork and concomitant costs.[9] Further, Tim Bennett, of the American Electronics Association trade group, argues that Mexico is already years behind China in its efforts to attract higher-value manufacturing.[10]

The issue is a matter of concern for Mexico. It was aptly expressed by a panel of economic experts which addressed the American Chamber of Commerce (Amcham) National Convention in November 2004. They expressed views that Mexico must improve its education system, undertake radical economic reforms and use the threat of China as an impetus if it is to compete effectively on the international stage. Much of this was beyond Mexico's immediate control. As one expert observer put it, "NAFTA was well-intentioned, but I do think we've had two major punctuations since then: one of them is China and the other one is 9/11 .... The call went out [to subsidiaries and departments]: cut costs however you do it. So investment that had already gone to Mexico was reevaluated; and investments that may have gone to Canada were also reevaluated."[11] The imperative that Mexico must respond by moving higher up the value-added ladder is reinforced by Fitzgerald.[12]

According to Oppenheimer,[13] what makes countries progress in the twenty-first century, is not simply signing trade agreements, but becoming more competitive *per se*. The competition that Mexico and other emerging economies are facing with the expansion of China in the global markets is not only a reality, but an inevitable and progressive process. Its impact on global economic activity should awaken those who are lagging behind and serve as an example for intelligent policy implementations and restructuring of internal business, niches of production and markets. Perhaps we are witnessing such an awakening, for as Bussey reveals,[14] Mexico has begun to evolve a strategy to counteract its progressive replacement by China by focusing in particular niches in the U.S. market and applying high duties to protect Mexican industry. Bussey informs that Mexico's Foreign Trade Bank has also opened an office in Beijing to boost Mexican exports.

In theory, countries will export products that are intensive in the relatively abundant factors of production.[15] It follows that countries where cheap labor is abundant will export labor-intensive goods, and similarly for capital intensive goods. According to the Inter-American Development Bank, many Latin American countries, Mexico included, have a greater comparative advantage in capital-intensive rather than labor-intensive markets.[16]

Mexico is evidently losing competitiveness in all areas and has been since the beginning of the decade. Oppenheimer described Mexico as "the country that has fallen asleep." In the world ranking of competitiveness, from the World Economic Forum, Mexico slipped from forty-fifth place in 2002 to fifty-fifth in 2005. This ranking is a measurement that takes into account economic, institutional and technological strength. Oppenheimer reveals that in the Confidence Index for Foreign Investment, developed by the multinational consultancy A.T. Kearney, Mexico plummeted from fifth to twenty-second place in the world ranking in the past five years. In the ranking from the Center of Worldwide Competitiveness, Mexico dropped from number 14 in 2000 to 56 in 2005. Clearly Mexico is seriously challenged in halting an irrevocable decline.

> China's accession to the WTO has not only left Mexico lagging behind, but it has also rendered insignificant the slight benefits gained after NAFTA.

As of 2003, China's labor force totaled 791 million people, whereas Mexico had 43.4 million.[17] Clearly, China has a comparative advantage due to its abundant low-wage, high quality labor market, which has been one of the key drivers of its economic boom.[18] The wage differential in Mexico and China is noteworthy. "The average compensation for Chinese manufacturing labor is about one quarter that of Mexico's."[19] The Chinese government has supported and made strong investments in higher education and research and development to counterbalance its relative disadvantage in capital intensive goods. Farrell, Puron and Remes argue that since capital-intensive production is highly sensitive to factor costs, Mexico must invest in infrastructure similarly to China.[20] Increases in research and development of technology have relatively greater effects on capital-intensive manufactures than on labor-intensive goods. The Chinese boom has affected Mexico and other countries in Central America that specialize in light manufacture.[21] That China's manufacturing sector has been the primary impetus behind its economic growth demonstrates the PRC government's strategy has been effective insofar as investment in education and technology have boosted growth. If China has succeeded and developed in sectors for which it did not have a recognized comparative advantage by reinforcing investment in infrastructure and development, then the formula may also work for those countries that have more capital-intensive niches. Furthermore, it may not be too late for Mexico to begin restructuring.

In terms of attracting foreign direct investment (FDI), China has become the leader among developing nations.[22] Its stock of FDI has risen 400 times since 1990.[23] In 2004, it even surpassed the United States as the preferred destination for FDI,[24] while Mexico's FDI inflows have been decreasing since 2001. The annual gross domestic product (GDP) for China has far surpassed Mexico's. That is without taking into account the understatement of the economy's growth in the official statistics. Some estimates say that China could become the world's largest economy by 2025 in terms of purchasing power parity or PPP,[25] others by 2040,[26] and that its share of global output will rise from 11 percent in 2001 to 20 percent in the next two decades.[27]

Given the critical nature of this issue, especially with respect to Mexico, it is surprising that, based on ABI-Inform and EBSCO database searches, there is little treatment in the literature, beyond news reports. In fact a dearth of in-depth analysis exists. So, by way of redressing this issue, in some small way, and given that Mexico's advantages relative to China are so slender, indeed negative,[28] as a first step we developed these propositions:

*Proposition 1:* After the formation of NAFTA, Mexico's exports into the United States would accelerate across many sectors.

*Proposition 2:* China will intrude into the NAFTA arrangement by utilizing its competitive advantage over Mexico, despite Mexico's tariff and apparent proximity advantages. These will show clearly in the U.S. import trend lines by way of a decline in Mexican exports contrasted to increases in China's.

> Canada and China are to a large extent complementary; however, China and Mexico have similar export baskets, especially in terms of light manufactures.

*Proposition 3:* Analysis of these trade patterns may suggest some areas of focus whereby Mexico may develop competitive advantage.

Our intention is to use these propositions as a framework for appraising, from a Mexican perspective, the impact of China on trade experience within NAFTA and the implications for competitive policy on the part of Mexico.

## METHODOLOGY

In order to explore the above propositions we obtained import statistics from the Office of Trade and Industry Information, a branch of the International Trade Administration within the U.S. Department of Commerce. The data were specifically gathered from the site http://tse.export.gov/ in the form of a program called TradeStats Express. This program allowed the gathering of aggregate merchandise imports from any selected global market. The data is categorized by the "Harmonized System (HS)" or "Harmonized Commodity Description and Coding System," developed by the World Customs Organization. We chose this classification because of its broad use in over 177 countries as a basis for custom tariffs and collection of international trade data.

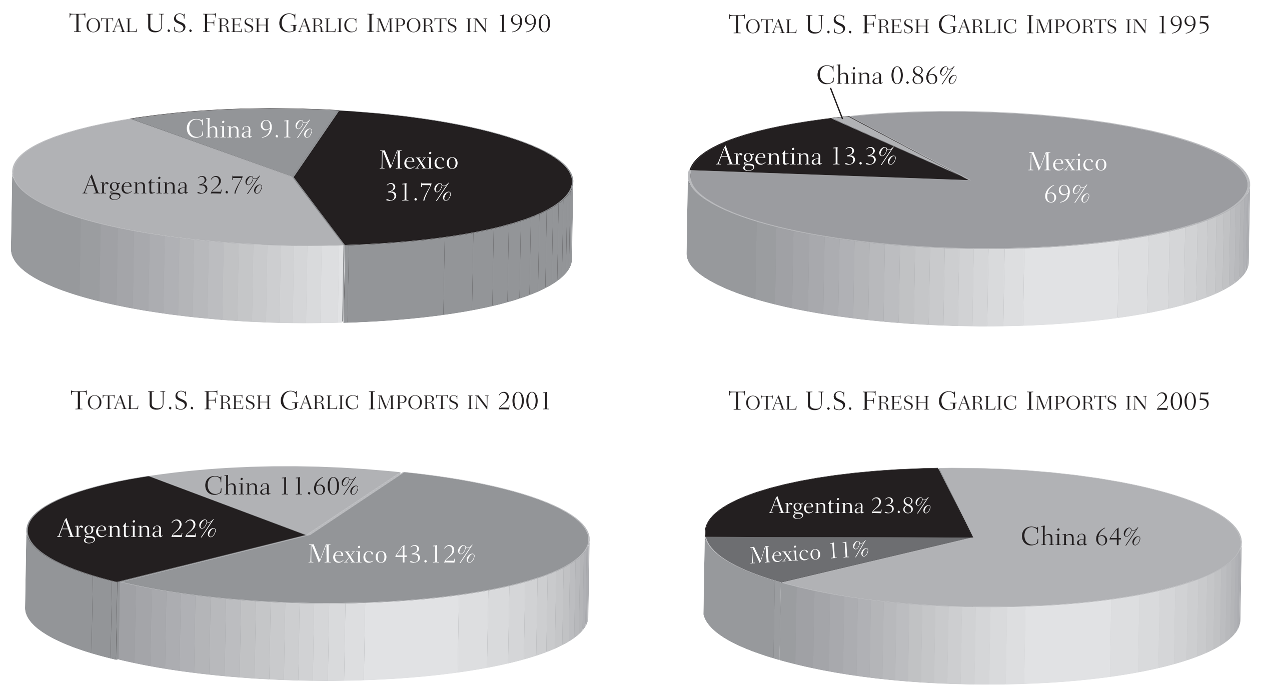
After downloading, the raw data was converted into an Excel file. The data was arranged according to the items 1-99 that comprise the data set. From that point each country was grouped together according to item. For example, China imports of item 1, Canada imports of item 1, and Mexico imports of item 1 one row after another and then on to item 2. Each item is linked to a category of merchandise and an HS code, for example: Item 03-Fish; Crustaceans & Aquatic Invertebrates. This allowed us to turn the data into graphical representations. The graphs enable visual appraisal of the fluctuations in the imports to the U.S. from each of the three countries.

The 99 graphs were then filtered to find those items showing increases in one country and decreases in another in any given year. For example, a decrease in imports from Mexico in 2001 for item 3 and an increase in imports from China in the same year for item 3. From here, the goal is to try to infer informal causal relationships between world events and these fluctuations found in the graphs.

## RESULTS

In order to contextualize our results we shall stress that even though China surpasses Mexico as a trading partner of the United States, Mexico's largest trading partner remains the United States. In 2004, the total exports from Mexico to the U.S. were U.S.$165.1 billion, which accounts for 87.8 percent of its

GRAPH 1
MEXICO'S GARLIC EXPERIENCE




**Note:** The pies represent only Argentina, Mexico and China's garlic exports to the U.S. and therefore do not add up to 100 percent.

total exports. Among Latin American countries, Mexico is the country that has most suffered the impact of China's success.

In agriculture, for example, China's exports almost doubled in four years and Mexico's grew at an average of 7 percent since 2000. We will illustrate the salience of the "China factor" by a short case study of the garlic sector, a precursor to the main research reported on in this paper, with respect to China's emergence in the U.S. market and its commensurate impact on Mexico's market share.

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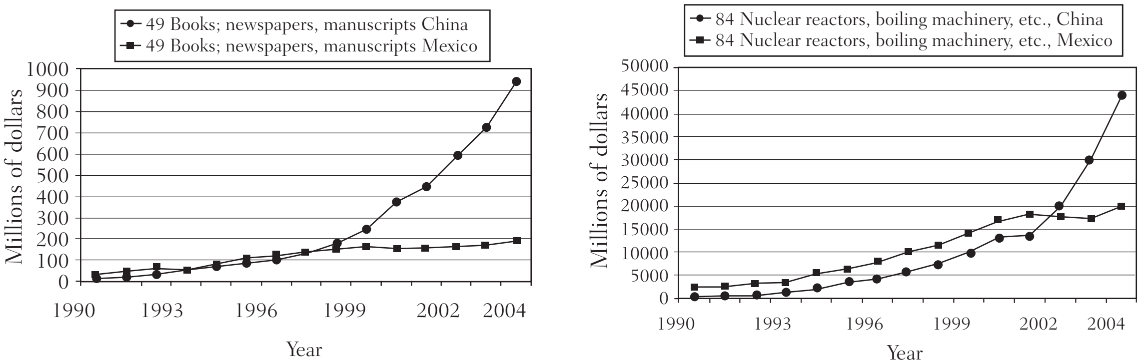
## GARLIC CASE

Since 1990 the three major exporters of fresh garlic to the U.S. are Mexico, China and Argentina, accounting for between 73 and 98 percent of the market of this produce. In 1990, Mexico accounted for 31.4 percent, Argentina, 32.7 percent, and China with 9.1 percent of the garlic market. By 1995 Mexico had gained 69 percent of the total market share, leaving China with only 0.86 percent and Argentina with 13.3 percent.[29] During the period 1995-1997 the currency crises in Asia and Latin America caused negative impacts in all three countries. However, these impacts were much stronger in China and Argentina than in Mexico. From 1996 until the year 2000 the market share pattern did not change significantly, and during this period Mexico retained the largest market share.

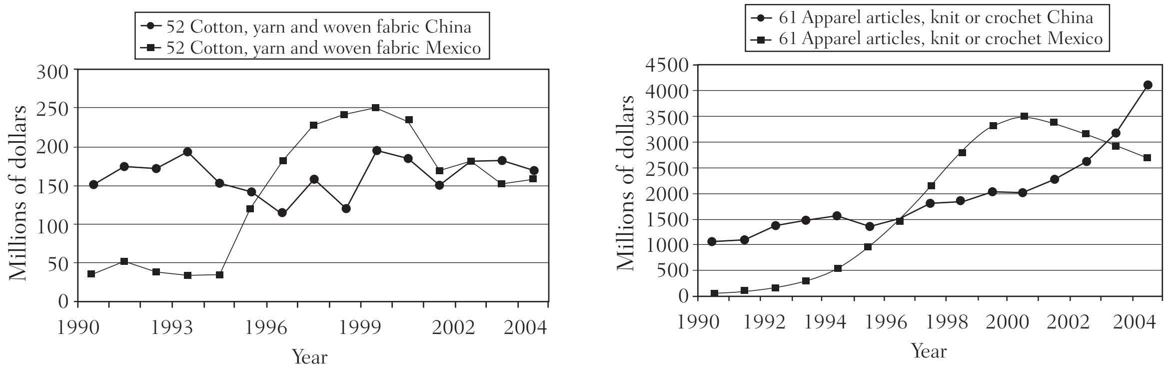
In 2001 China experienced a spurt equivalent to 4,620 percent, taking it to an 11 percent market share. During the following four years, Jimenez maintains, China's exports soared, delivering a 67 percent market share by the end of 2004, with Mexico and Argentina holding 17.84 and 9.4 percent respectively. From January to May of 2005, China exported 63.6 percent of all the fresh garlic that the U.S. imports, while

GRAPH 2
MEXICO AND CHINESE EXPORTS TO UNITED STATES

MEXICO RUNS FIRST BUT IS OVERTAKEN BY CHINA




JOCKEYING FOR POSITION: CHINA ENDS UP AHEAD




Mexico only exported 10.9 percent and Argentina 23.7 percent.[30]

Argentina's garlic exports have been gradually recovering since 2002, but Mexico has been squeezed out of the market. Graph 1 provides a visual description of the further changes of fresh garlic in the U.S. and the impact China has had on Mexico and Argentina. The effect is dramatic (see graph 1).

If the garlic case is part of a generalized phenomenon, the loss of competitiveness experienced by Mexico since the beginning of the decade must be profound. Further, the following analysis shows that despite its NAFTA advantages in the mid-1990s, many fields have become dominated by China with apparent ease, especially since that country's accession to the WTO. Assessment of the growth in exports to the U.S. from Mexico and China reveals the magnitude of the impacts entailed in this Chinese expansion.

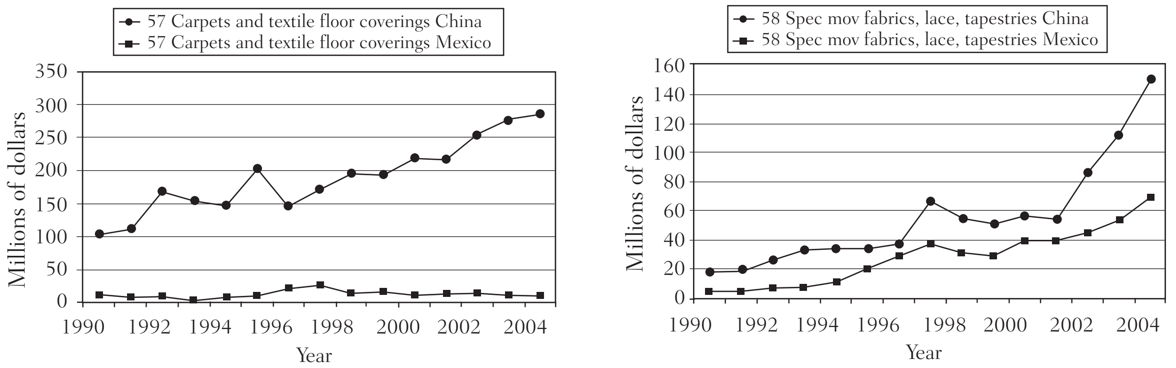
## HS2 ANALYSIS

HS2 stands for harmonized system or harmonized commodity description and coding system. HS2 is a broad aggregation of imports and exports; 177 countries use this system for international trade data.

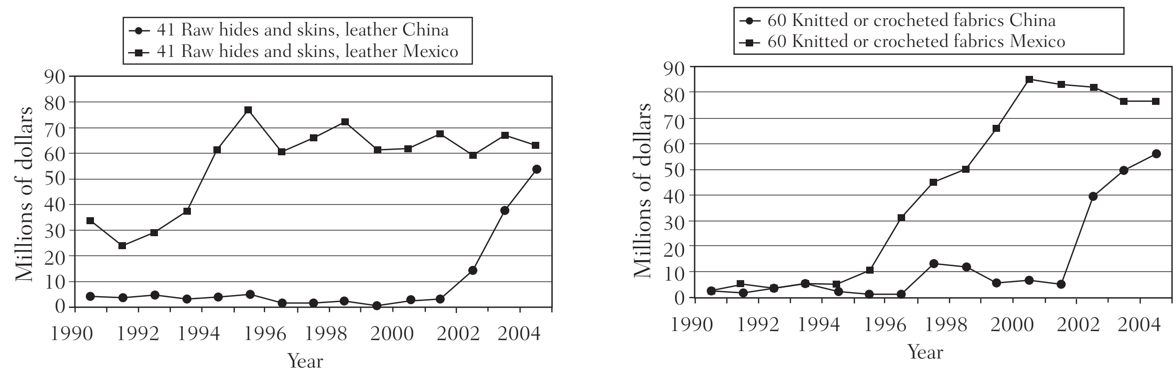
In some categories, as graph 2 shows, Mexico started in 1990, with a lead into the U.S. market, however slight. The record shows that in each of these cate-

GRAPH 2
MEXICO AND CHINESE EXPORTS TO UNITED STATES
(CONTINUED)

CHINA BETTER IN ALL




MEXICO BETTER THROUGHOUT




gories China has overtaken Mexico. For example, exports of newspapers, manuscripts and printed books from China have quadrupled since 1998; whereas Mexico's corresponding growth is around 10 percent in the same period. The increase in technological innovation coupled with low cost of labor in China combined with the poor performance of technology development in Mexico has bolstered this trend. Some 24 charts were generated from our data analysis. These illustrate the pervasiveness, across product categories, of the decrease in Mexico's relative competitiveness with respect to China. For the sake of brevity, a convenience sample of eight of these charts is included in Graph 2.

China has become the world's leading exporter in natural pearls, precious metals and stones since the beginning of the decade. The pattern is clear: its accession to the WTO also boosted its rapid growth after 2001.

Graph 2 is informative: U.S demand for Chinese nuclear reactors and boiling machinery (this is a spurious description and refers to more general engineered products) tripled since 2001. Mexico experienced a steady growth after NAFTA came into effect, but after 2001, its exports to the U.S. have grown by an average of only 10 percent. Until 2004, Mexico was the leading exporter of "electric machinery, TV and sound equipment" (not depicted in graph 2);

China and Mexico had shown similar growth trends until the beginning of the decade, when China's growth climbed beyond Mexico's.

Our analysis also shows how China has continued to dominate many categories regardless of NAFTA and in most cases has progressively widened its lead over Mexico. China overshadows the global industry in lac, gums, resins, explosives and pyrotechnics. Mexico has never been a main exporter of those products; it is evident that the growth patterns after China's accession to the WTO has not only left Mexico lagging behind, but it has also rendered insignificant the slight benefits gained after NAFTA. For instance, in the category of fur skins, vegetable fibers, nesoi, tin, base metals, miscellaneous metal articles, musical instruments, works of art, collector pieces and antiques, China's exports have also soared after the WTO accession. This is similarly true of carpets and special fabrics, shown in graph 2. Mexico remains very uncompetitive for all these products.

Graph 2 also shows a pattern where China and Mexico reverse positions as their relative competitiveness shifts to and fro, over time, due to market and other forces. The exports of fish and crustaceans, as well as corks and derived articles have also shown the same trend after NAFTA and China's accession to the WTO. In the case of the cork industry, China has become the second largest exporter to the U.S.

Although in contrast to China the Mexican economy has not grown profoundly, it has performed better in some products such as sugar and confectionery products, vinegar and beverages. This is mainly due to the fact these Chinese products are globally uncompetitive, with unstable prices or low quality. This is not indicative of an inherent comparative advantage on Mexico's part. However, there are products in which Mexico has been performing better, but China has been catching up rapidly. This is the case of knitted or crocheted fabrics, raw hides and fur skins (graph 2). Mexican industry should not misjudge this trend; China has shown its growth potential in many other areas and the trend could continue to expand.

We shall now review the results of our analysis against the three previously established propositions:

*Proposition 1:* After the formation of NAFTA, Mexico's exports into the United States will accelerate across many sectors.

This proposition is demonstrated. We have seen China's exports to the U.S. accelerate across a wide band of product categories, and these are visually obvious as the sample from the wider group from which they were drawn indicates (graph 2). For example, graph 2 exhibits a Mexican progressive upward trend in some categories. But while Mexico had an initial advantage over China, the latter quickly displaced the former. While the graph shows a spurt in the relative standard of Chinese export performance in some sectors, it also demonstrates a class of categories where China performed better overall at the beginning and thereafter. Graph 2 also reveals some switching of positions but even then China ends up ahead. It further shows two examples from four categories in which Mexico performs better overall, but the gap appears to be closing in China's favor.

*Proposition 2:* China will intrude into the NAFTA arrangement by demonstrating a competitive advantage over Mexico, despite Mexico's tariff and apparent proximity advantages. These will show clearly in the U.S. import trend lines. Visual examination reveals a dramatic acceleration of China imports into the U.S. across a wide range of categories.

*Proposition 3:* Analysis of these trade patterns may suggest some areas of focus whereby Mexico may develop a competitive advantage.

The arenas in which Mexico surpasses China appear to be based rather more on China's lack of advantage as opposed to distinctive strengths for Mexico. It seems possible that China could easily intrude into these sectors; indeed it is closing the gap in the latter two arenas of raw hides and knitted or crocheted fabrics. Overall this amplifies the concern regarding Mexico's strategic position given that its a secure retreat of defendad position appears so precarious.

## STRATEGIC IMPLICATIONS AND CONCLUSION

This study and our analysis of the data have illustrated, without a doubt, the impact that China has inflicted on Mexico's trading performance. This illustration should serve to encourage Mexico to respond and to do so quickly before it is too late.

Mexico, it seems, is failing to take the necessary steps to remain globally competitive. Yet, China's expansion will likely continue and extant trade agreements will be insufficient to bolster Mexico's competitiveness. As it is, the world is dividing into three major commercial blocks; North and Central America, the European Union and a China-dominated Asia, including ASEAN (which groups the major South East

The Chinese government has supported and made strong investments in higher education and research and development to counterbalance its relative disadvantage in capital intensive goods.

Asian countries of Indonesia, Malaysia, Singapore, Vietnam, the Philippines and Thailand). Even though the largest in terms of GDP will for a long time continue to be North America, those countries that do not have access to the major trading blocks will remain marginalized. Relying mainly on regional blocks will be insufficient to face the global competition as it has been seen from the NAFTA experience that such benefits apply only temporarily.

China's growth trends and the impacts it has had in the past few years, have clearly demonstrated its growth potential to all. Indeed, time is running against Latin America;[31] Mexico and other emerging economies should expand their trade horizons and strategize and invest effectively to remain competitive in global markets. China's strategy was to invest in hard infrastructure, higher education, development and innovation of technologies. The combination of these factors has made possible lower manufacturing costs that will continue to have significant worldwide impacts. As evidenced by the garlic experience, the potential inroads that China may make on the inherent industries in Mexico is great. Mexico must therefore address the reality of globalization now before it is too late. As the Chinese say, "Dig the well before you are thirsty," and, "What you cannot avoid, welcome."

If research could come close to yielding an exhaustive list of world events —i.e. 9/11, China's entering the WTO, formation of NAFTA, etc.— the HS system could be used to pursue the goal to match up companies in the respective countries that could have possibly contributed to the fluctuations. It should therefore be theoretically possible to glean how these companies were able to be successful in one country exporting to the U.S. when a supposed equal counterpart in another country was unsuccessful. We could determine best business practices that enabled companies to endure fluctuations in world economic events and then relay these best practices to those companies that were unsuccessful during those same events and thus enable preparation for similar future occurrences. This is rather an ideological outcome, but if the results of the study even came close, the impact could be great. VM

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