FEDERAL RESERVE BANK of ATLANTA

Podcasts

Related Links

- Play (MP3 16:37)
- Bordering on a Boom: Mexico Manufacturing Builds a Future
- EconSouth Now
- Podcasts

The Mexican Manufacturing Renaissance

March 2013

Steve Kay: *I'm Steve Kay, senior economist and coordinator of the Atlanta Fed's America Center, and I'm talking to Ed Skelton, a business economist at the Federal Reserve Bank of Dallas. We're going to discuss the resurgence of manufacturing in Mexico, which is a development that Ed has watched closely. Ed, thanks for joining us today.*

Ed Skelton: Thank you, Steve. It's a pleasure to be with you this morning.

Kay: *In the current issue of* Econ South*, we have a story on the expansion of Mexico's manufacturing sector, and we note that forecasters now expect Mexico's manufacturing exports to the United States to grow and even displace some of China's exports to the United States. Do you agree with these forecasts? And if so, what accounts for this Mexican boom in manufacturing?*

Photo of Ed Skelton

Skelton: Well, first off, manufacturing is very important to Mexico. Manufacturing is directly responsible for about 17 percent of the country's GDP, or gross domestic product. And there are two things that have been driving manufacturing's recent growth. The first is rapid productivity growth, and the second is foreign investment is paying off. Where manufacturing is really booming in Mexico is auto manufacturing for exports to the U.S. It's roughly tied with oil for Mexico's biggest export. The other thing is, it's not just vehicle parts. A lot of times people think that Mexico produces the vehicle parts. But increasingly, Mexico is producing the cars themselves within Mexico.

Other big sources of the manufacturing growth are different types of machinery. Electrical machinery, industrial machinery, things like that—those are also big exports from Mexico to the U.S. Mexico is the third-largest trading partner with the U.S., behind only Canada and China. It's actually gaining on Canada.

The bottom line behind Mexican manufacturing is that it's moving up the value added chain. The stereotype of cheap, labor-intensive goods produced in Mexico is dead. One example of Mexico moving up this value-added chain is that Mexico is beginning to export services. Increasingly, the border factories, the maquiladoras, are increasingly using domestic sources for services and then exporting the finished product. Before, the services side of production would come from the U.S. side of the border. So this is an important development because these services based jobs pay higher wages than traditional manufacturing jobs.

In looking at Mexico versus China, there's a misconception that the rise of Chinese manufacturing has hurt Mexico. This was true, this used to be true, so it's based in history. When China first ascended to the World Trade Organization in 2001, Mexico lost market share as the U.S. began importing some goods, particularly these labor-intensive goods that I mentioned—and also goods that are cheap to ship—from China rather than Mexico. So what happened is Mexico suffered a fairly painful adjustment period, which is really similar to any other incident of opening up trade. You know there's winners and there's losers, and at least in the short run there's this disruption and there's somewhat painful adjustment. But Mexico has two big advantages over China. The first is transportation costs, right? They have geography on their side. Obviously you don't have to go across the Pacific Ocean to get from China to the U.S., whereas Mexico shares a border, obviously. The second advantage is the productivity side. Wages in Mexico's manufacturing sector are more than three times higher than Chinese manufacturing wages. In Mexico, the hourly wage for someone working in manufacturing is $6.20, whereas in China it's $1.70. But what's happened is productivity has more than kept pace with rising manufacturing wages. So it delivers a better value and it keeps Mexico competitive internationally.

Kay: *Following up on the first question, just a few short years ago we were comparing Mexico's economic prospects unfavorably with those of Brazil and other commodity-exporting countries. Mexico was stuck trading with the slower-growing U.S. economy while Brazil was selling commodities to rapidly expanding emerging markets like China. These days Mexico's prospects are looking much brighter. What accounts for this?*

Skelton: Yeah, and it's one of those things. Mexico had relied on commodities to fuel growth. This began to change in the '80s. And when it really accelerated was with the signing of the North America Free Trade Agreement in 1994. And another thing that's happen within Mexico, one of the things that's helped Mexico, is the boring policy discipline. Their federal budgets have been balanced or near-balanced for years. They have low national debt, prices are stable, inflation is stable. In a lot of ways, Mexico has gone from a crisis-prone, kind of a rollercoaster of an economy to a fairly boring economy. And I say that as a compliment, right? To me, boring is good.

Kay: *Mexico's new president, Enrique Peña Nieto, has an ambitious reform agenda. What has he accomplished so far and what is your view of the prospects for reform over these next few years?*

Skelton: Well, the reforms actually started happening before Peña Nieto even took over the presidency. The departing president, Felipe Calderon, gave him a nice present, which was labor market reform, the first labor market reform in about 40 years. The labor reform creates a more flexible labor market and makes it easier to hire and fire workers. One of the paradoxes of unemployment and labor law is that in countries where it's easier to fire workers they have lower unemployment rates and also more efficient economies.

The second thing that happened—and this happened right after Peña Nieto took office—was an education reform. And there are a couple of interesting things about the education reform. First is to get the reform passed, it required a majority of state legislatures to approve the reform. So after taking office in December, by January Peña Nieto was able to get 18 of the 31 state legislatures to approve the reform. The actual details of the reform still have yet to be ironed out, but the essence of the reform is that it shifts the oversight of teacher hiring, evaluation, and competency exams from the teachers' union to the federal government.

A second development is right after the reform was passed, Elba Esther Gordillo —who's nicknamed "La Maestra," or the teacher—she's the longtime head of the teachers' union, and she's also someone who had long been considered untouchable. Gordillo was arrested and she was charged with embezzling $200 million. She's also charged with money laundering. So looking at the prospects for additional reform, the prospects seem really good. I'm cautiously but extremely optimistic. And the first thing, it started when Peña Nieto took office. He developed a pact with Mexico, and so one of the things he did is he wrote this pact and he wrote it with the other political parties and had them sign off on this pact as well. And what this pact with Mexico did was it laid out the things that were necessary for Mexico's economic development. And essentially it's a framework for structural reform. It addresses everything from education, to the judicial system, to property rights, to developing a more competitive economy, to improving infrastructure, to opening up the energy sector. It's extremely wide ranging. The genius was in writing this pact with all the parties present at the table.

In the U.S., we like to talk about bipartisanship. The politicians talk about it, but it's tough to deliver. What Mexico seems to have delivered with three main political parties, is actually an example of tripartisanship, if that's a word. It's already bearing fruit. We've seen it in the education reform. Right now there's a telecommunications reform in front of the Mexican congress. A judicial reform has been proposed. The details are still being drafted. There's an outline of an energy reform and foundation for a tax reform.

One other thing that happened was within Peña Nieto's own party—the PRI, the ruling party. What they did is, at their most recent national assembly meeting, they changed the parties official platform, they agreed that private investment could have a bigger role in the country' energy industry, and also that a value-added tax could be extended to include food and medicine. And the reason this was important is it cleared some procedural impediments. Historically, PRI members couldn't support these types of reforms because the plank of the party said, "No, we don't agree with this." So what happened was it cleared the way for the ruling party and the ruling-party politicians to support these reforms.

Kay: *Most economists agree that monopolies have had a negative impact on economic growth in Mexico. Do you think that this government will be able to weaken the telecommunications monopoly? You mentioned there already has been a telecommunications reform. How far do you think that reform is going to go?*

Skelton: Well the reform is still in front of Congress. So it's been announced, it's in front of Congress, and one of the things that makes me extremely optimistic is when the reform was announced and the president announced the reform, he was flanked by the leaders of the country's three main political parties. So in my opinion there has never been a better time to reform telecommunications. But what happens is the telecommunications reform in Mexico, it doesn't just take on special interests, it takes on maybe the most special of all of Mexico's special interests. You have a combination of the world's richest man, Carlos Slim, who dominates the country's fixed and mobile phone industry, and there's also a pair of billionaires that they're taking on in the television industry. To pass the reform, the three parties will need to maintain a near-solidarity in the face of these most special of all interests. Looking at the reform itself, one thing it does is it overhauls the regulation of telecommunications. It sets up a brand-new regulator called the Instituto Federal de Telecomunicaciones. And it also sets up a specialized court system. Before, under the old regulatory regime, any competitive or regulatory disputes were kicked to the country's judicial system. So the deep pockets of these dominant telecommunications firms could keep these disputes mired in the courts with appeals and what they call *amparos*, or stays, for years and years and years. This new system would expedite these disputes and at least, as designed in the law, would resolve them in a more timely manner. One of the more important things about the new regulator is that it would be granted the power to force companies with market shares over 50 percent to sell assets. To put into perspective exactly how uncompetitive the industry is, Carlos Slim owned America Movil, had a 75 percent market share in fixed line phone service, a 70 percent market share in broadband Internet, and a 70 percent market share in mobile phones, while Televisa controls 60 percent of the free-to-air broadcasting market. Potentially to help with these asset sales, the reform also allows increased foreign ownership of media and phone companies. I would argue this is essential if they want to reduce the dominant firms' market shares below 50 percent.

Kay: *Mexican state and local debt has been rising rapidly in recent years. Is this something we should be concerned about?*

Skelton: Being an economist, I'm going to give you a straight answer, and the answer is yes and no. It's small as a percent of GDP. So on a national scale, the size isn't a big deal. One good thing is it did lead to a reform of how state and local governments support their finances, and it's made their finances more transparent. So it's one of those things that even though the federal government could fairly easily bail out the state and local governments, there is also the need to enforce discipline because what's happened is there's been a few of these state and local governments that have been undisciplined borrowers, that have willingly borrowed a lot of money. So at the end of the day, bailouts reward bad behavior, and rewarding bad behavior is bad policy. The government is facing this balance between making sure investors feel their money is safe in the country, and also that they are willing to invest in the country while also preserving policy discipline and maintaining the proper incentives for the state and local governments.

Kay: *For my last question, I'd like to ask: In thinking about Mexico's economy in the next five to ten years, what are the things we should be most concerned about?*

Skelton: Well in the shorter run, one thing is the reversal of capital flows. Mexico has been not just a darling of emerging markets, but it's also been seen as a safe haven for investors, so it's seen a large amount of portfolio inflows. Capital inflows have been good for the country in terms of lower interest rates and providing additional sources of funding. The catch is the international financial market is anything but sustainable right now. And we would expect to see a reversal of capital flows at some point. So the question is: Is this reversal or normalization of capital flows going to be somewhat orderly in the fact that investors let their existing dead instruments expire and simply not roll them over? Or is it going to be less orderly, where we see a sudden reversal of capital flows? If we see a sudden reversal, than that would be somewhat disruptive to the economy and the exchange rate. So these capital inflows, it's the good and bad news of policy discipline, because there could a reversal at some point in their future.

Another risk is that Mexico is still tied to the economic performance of the U.S., particularly U.S. industrial production. If you get up one morning and you want to know how Mexico is doing, the fastest way to do that is to look at U.S. industrial production numbers, and that explains a lot of what is happening in Mexico. Mexico has diversified its trade. Twelve to fifteen years ago over 90 percent of Mexican exports went to the U.S. Now that number is only—only, right?—78 percent. Mexico, to diversify, it's become arguably the most open country in the world. Twelve free trade agreements with 44 countries, you know being next to the U.S. is a double-edged sword. You've got the world's largest economy at your doorstep, so it's smart to do that. But by the same token some diversification is needed.

But the bottom line is, with the U.S. just to the north, the ability to diversify internationally is limited. The key is to sufficiently develop internal markets to allow domestic demand to play a bigger role in economic growth and development. So in that regard, countries such as Germany or maybe Korea are good models to follow. They're export oriented, but their domestic economies are strong enough that they can support growth too. Which gets to our next point, that it's also necessary to develop the economy. So another risk is, in spite of my optimism, what if the country is unable to pass structural reform? Or if the structural reforms that are ultimately approved are watered down and don't address the weaknesses within the country? Number one is the education system has to be improved. Mexico is either next to last or last among all OECD [Organisation of Economic Co-operation and Development] countries. Mexico is virtually last in every measure of educational achievement. And so to continue up the value-added chain, Mexico has to close this gap with other countries. It's absolutely vital for Mexico's continued development and also to continue the gains the country has made in manufacturing.

The next risk is, I guess it's sort of the elephant in the room, it's the thing I hate talking about the most, and that's drug violence. According to Mexico's Secretary of the Interior, more than 70,000 people died in drug related violence in Mexico between 2006 and 2011. The formal president, Felipe Calderon, had focused on fighting narco-trafficking. Peña Nieto has changed the strategy to reducing homicides, kidnapping, extortion, to strengthening the rule of law in the country.

Kay: *Ed, I'd like to thank you for being with us today.*

Skelton: Thank you, Steve. It's been a pleasure.

Kay: *Again, we've been speaking today with Ed Skelton, a business economist at the Federal Reserve Bank of Dallas. This concludes our* EconSouth Now *podcast on manufacturing in Mexico. For more information, please see the first quarter 2013 edition of* EconSouth *magazine, where you'll find our article on this topic. On our website, www.frbatlanta.org, you can read the full article about this topic or subscribe to* EconSouth *in print. Thanks for listening and please return for more podcasts. If you have comments please e-mail us at podcast@frdatlanta.org.*

Federal Reserve Bank of Atlanta, 1000 Peachtree Street NE, Atlanta, GA 30309-4470 Tel. (404) 498-8500