Americas Policy Program Policy Brief

Taking Away the Ladder: China and the Competitiveness of Mexican Exports

By Kevin P. Gallagher and Roberto Porzecanski | September 4, 2008

Cambridge University economist Ha Joon Chang has pointed out that developed countries are "kicking away the ladder" of development policies traditionally used by developed and developing countries alike to raise the standards of living of their people. According to Chang, rich countries do this by forcing poorer countries to sign on to constraining trade treaties such as NAFTA. However, China, a large country that has been able to avoid such treaties, is "taking away the ladder" by deploying policies that are outlawed in NAFTA-like treaties to outperform Mexico and virtually every other developing nation in world manufacturing markets.

After decades of an inward-looking economic strategy, Mexico opened its doors to the global economy in the late 1980s to follow a strategy based on trade and investment liberalization. A key goal in this strategy has been to gain ever-increasing access to the largest market in the world—Mexico's northern neighbor the United States. Liberalization began in the 1980s and culminated in the North American Free Trade Agreement (NAFTA), launched in 1994. The hope was that by transforming into an export-oriented economy with preferential access to the United States, Mexico would attract foreign and domestic investment to support long-term economic growth.

A recent study we did with Juan Carlos Moreno-Brid, published in the journal *World Development* shows how the rise of China undermines Mexico's bid to become a major export-oriented economy. We find that over half of all Mexico's exports to the United States are under "threat" from China, meaning that Mexico is rapidly losing ground in the U.S. market, while China gains. This is particularly concerning given that over 85% of all Mexican exports are destined for the United States and that Mexico has preferential access to the U.S. market.

The study labels categories in which China's market share in the U.S. economy is increasing and the Mexican share is decreasing, as those of "direct competitive threat." Categories in which both Mexico's and China's market share are increasing but China's share is increasing faster are listed as facing a "partial threat."

By this measure, a growing number of Mexico's exports to the U.S. market have become threatened. During the period 1988 to 1991, 22.5% of Mexican exports were under threat. By 2005 the figure had increased to 53%. In other words, over half of all Mexico's exports are under "threat" from China.

The vast majority of exports classified as under "direct threat" entered that category after 1997. The percentage threatened stood at 14.6% during the 1988 to 1991 period, dropped as low as 6.5% during the period 1994 to 1997, then climbed to 43.7% in 2005.

For example, in computers, Mexico gained 1.9 percentage points of the U.S. market but China gained 42.6. China's success in these industries is remarkable given that computers take 18 hours to travel to the United States from Mexico, versus almost 18 days by ship from China, and that China faces a tariff of six and Mexico's is zero. In response to this pressure, high technology firms in Mexico have shifted to contract employment to keep wages, costs, and protests to a minimum. They have also shifted the product mix and upgraded the level of technology in their firms. These draconian measures have still not resulted in a return to competitiveness in the U.S. market.

Our analysis comparing penetration of U.S. markets by Mexico and China finds that the only exports where Mexico is gaining U.S. market share faster than China are those related to the automotive and transportation sectors. Mexico is still holding onto its competitiveness in motor

Percentage of Mexican Exports Under Threat from China, 1988 to 2005

	1988-1991	1991-1994	1994-1997	1997-2000	2000-2005
Direct Threat	14.6%	15.2%	6.5%	22.1%	43.7%
Partial Threat	7.9%	32.9%	22.1%	19.7%	9.3%
Total	22.5%	48.1%	28.6%	41.8%	53.0%

vehicles, trucks, and piston engines because these goods are heavier and more costly to ship across the Pacific Ocean, and because of NAFTA's rules of origin that state that over 60% of all cars sold in North America must be made in North America (thus effectively acting as performance requirements).

Mexico's decline in competitiveness vis-à-vis China is largely due to four factors:

1) **Low levels of domestic investment:** The performance of investment in Mexico over the last two decades has been lackluster. Since the 1980s, gross fixed capital formation has never reached more than 22% of gross domestic product (GDP). This is below the 25% benchmark identified by the United Nations Conference on Trade and Development (UNCTAD) as the minimum investment ratio required to sustain the long-term annual rate of economic expansion of 5% that Mexico needs to absorb its increasing labor force. Poor investment performance has in part been caused by foreign firms wiping out Mexican firms under NAFTA. In contrast, China's gross fixed capital formation as a percent of GDP has been over 40% over the same period and increasing.

2) **China's low wages, rising productivity:** Average real wages are higher in Mexico than in China. This gap tends to more than compensate the differences in their average levels of productivity, which still favor Mexico but where China's productivity growth rate far exceeds Mexico. Low wages are no longer a comparative advantage of the Mexican economy and, with scant investment, competing in high-tech or more value-added industries is unlikely.

3) **Poor exchange rate policy:** Another element that has tended to undermine Mexico's international competitiveness relative to China's is the evolution of the real exchange rates of the Mexican peso and of the Chinese currency against the U.S. dollar. Mexico's obsession with tight macroeconomic policies, which include relatively high interest rates, has led to a persistently overvalued currency. In the nearly two decades that have elapsed from the mid 1980s—when Mexico began its drastic trade liberalization process—up until 2006, the exchange rate of the peso vis-à-vis the U.S. dollar (calculated in terms of their relative consumer price indices) has appreciated 21% in real terms. In stark contrast, the Chinese currency has depreciated by almost 80% during the same period. Part of China's strategic industrialization plan has been to hold its currency down. This acts as a subsidy to its exporters as they angle to capture world markets.

4) **The dismantling of Mexican industrial policy:** Lastly is the shift in the orientation of industrial policies in Mexico. Since 1984 Mexico has had a "maquila mindset" that has privatized and liberalized the manufacturing sector with hopes that foreign firms and trade would pour into the country. It was further believed that such new trade and investment would automatically create linkages with the broader Mexican economy to spur growth and poverty alleviation. Mexico has learned the hard way that such linkages do not happen automatically and Mexico's highly productive export sector is an enclave divorced from the larger economy. In contrast, China selectively targets key industries with subsidies, export support, and mandates of linkages with foreign firms. China had the "policy space" to conduct such policies before it joined the World Trade Organization (WTO) and still maintains the ability to deploy some of them under the WTO. Mexico has relatively little policy space for industrial development under NAFTA.

With high oil prices, attention in Mexico has partly shifted away from the economy. Yet, with Mexico's proven reserves dwindling at a rapid rate the economy will again need to turn to the manufacturing sector for growth and development. If Mexico doesn't rethink its industrial and macroeconomic policies, China may take away the ladder to economic development that Mexico seeks to climb.

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