

A Renaissance for Mexican Manufacturing?

Dr. Chris Kuehl, Economic Analyst



The dominant story from Mexico today is one of violence and corruption. The drug wars are a very real part of Mexico these days and nobody would underestimate the challenges that lie ahead for the government.

However, there is another story, not in the headlines yet and perhaps far more important to the future of the country. In June, CNBC reported that Mexico's economy is expected to grow by 4.5 percent this year. Contrast that number with the 1 percent growth expected in the U.S. and the 0.5 percent pace in Europe. The Mexican economy is outpacing some of the faster growing regions in the world—such as Russia—and it is estimated that Mexico will be the eighth largest economy in the world by 2050. In March of this year, the Wall Street Journal reported that unemployment fell to 4.6 percent and is at the lowest level since December of 2008. Contrast this rate to the 9 percent plus rate in the United States.

Mexico is not far from breaking out as one of the key trading nations in the world. It now has signed 13 free trade agreements that involve 44 nations, and is clearly less dependent on the performance of the U.S. economy than in the past. This should not be misconstrued that the U.S. is not an important trading partner, as imports from Mexico rose by over 30 percent in 2010 and are on pace to exceed that in 2011.

Part of the reason for that surge in trade activity is that since 2005, the cost of manufactured goods from China has risen by 40 percent. Wages in China have risen rapidly over the past five to six years and now they are almost the same as the wage rates in Mexico. Wages have increased by 218 percent in China compared to 25 percent in Mexico. It is projected that wages in Mexico will continue to rise in the next 10 years, but only one-third as fast as those in China.

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In addition, one of the most significant advantages that Mexico has had in its competition with China and other Asian nations is transportation costs. It is 80 percent cheaper to bring goods over the border to the U.S. than it is to bring them from Asia, and that will increase in the years ahead as energy prices drift back up. This benefit grows when one looks at issues of speed, reliability, insurance and security.

In terms of cross-border trade statistics, trade has returned to the level that existed prior to the recession—a recovery faster than that with any of the other U.S. trading partners. It is almost twice as fast as the recovery that took place between the U.S. and Europe.

Another factor: The population of Mexico is rapidly becoming one of the most competitive in the world. The average age in Mexico is 29, which means it is one of the youngest nations on the planet. Every year 90,000 engineers graduate from Mexican universities—three times the number that graduate from U.S. schools.

Today the nation has the ninth largest pool of IT professionals in the world—behind only the U.S. in this hemisphere. Since the start of the NAFTA trade agreement, foreign direct investment (FDI) in Mexico has tripled and that investment has been divided between more than a dozen industrial states from Europe, Asia, and North America. In 2010 that FDI number reached \$18.6 billion and there are 75 additional FDI projects in development between now and 2015.

In short, this is a very different story from the one that dominates the media and it is the story that has the most significance for Mexico in the years ahead. This is not to say that Mexico doesn't have issues to address. For example, there are problems with corruption at various levels of business that can make getting paid awkward and complex at times. These are the kinds of inhibitions to growth that must be dealt with sooner rather than later.

How Can Mexican Manufacturers Increase Their Competitive Edge?

There are many variables involved in creating a competitive edge. It must be recognized that many of those are wholly out of the control of the manufacturer. Taxes and regulations imposed by government will influence how well a company does, and there are issues of tariffs and trade that impact business. The government needs to provide a safe environment within which to do business and there has to be a reasonable system for payment. All of this is crucial to the success of a given business.

The key to competitiveness lies in the decisions that an individual company can make for itself and these fall into three broad categories. The first is to continue down the path of diversification in evidence for the last few years. The recession in the U.S. was a severe blow to the Mexican manufacturer, but it also may have been a blessing in disguise as many Mexican operations found opportunities to do business with other nations.

Those trade agreements allowed expansion into other markets, but so has the

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increase in foreign direct investment. The advantages that Mexico has will become ever more appealing to operations in other parts of the world as production in Mexico has the added benefit of being close to the U.S. market. Shipments can be delivered at a transportation cost that is far less than from other parts of the world—and dropping.

As part of this first step toward diversification, Mexico is in a position to be at the forefront of the development taking place in other parts of the Americas. The economies in Brazil, Colombia, and Chile are developing fast and opportunities exist for the Mexican manufacturer to become fully engaged in these countries as well as in the U.S.

The second major advantage is the skill base developing in Mexico. The country has been emphasizing education for a long time and there have been many graduates in the last 10 years. This will either become a huge problem or an advantage—depending on the reaction of the private sector.

If this young, educated population finds few opportunities to use their skills, they will become frustrated and angry and Mexico could well experience the same challenges affecting governments in the Middle East. If the economy expands and the business community takes advantage of that talented young population, the country stands to grow quickly.

The U.S. is rapidly coming to a crisis from the other direction as its labor pool decreases and needed skills start to vanish. The average age of a fully qualified welder in the U.S. is now 63; this points to an emerging problem. It will be next to impossible for the U.S. to address that issue in any way except through mass immigration and that is simply not politically feasible in the foreseeable future. That puts greater emphasis on production outside the U.S., and Mexico becomes the most logical candidate if there is attention to the needs of a growing industrial sector.

The third major advantage stems from proximity and the costs of providing the inputs needed for modern manufacturing. In addition to labor costs, a more important consideration may be the ongoing cost of transportation.

Trade with Asia is getting more expensive and all projections hold that this will be a greater concern in the years ahead. Currently the cost of fuel has fallen a bit, but this is a temporary situation that will reverse as the global economy begins to recover. It will become far too expensive to ship certain goods from a great distance when there is a nearby alternative.

Mexican operations will become increasingly connected to those in other nations as companies in Asia seek to reduce the costs of feeding the U.S. market. This is an opportunity for Mexican companies to tie themselves to the plans of American transportation providers.

Given the resistance to expanded truck traffic between Mexico and the U.S., the most likely area of cooperation is in the rail sector with those U.S. companies that

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have invested in developing their networks in Mexico. As Mexican manufacturers become more comfortable with the northern opportunities, they can start to choose expansion locations that take full advantage of new ports and new rail lines.

Obviously barriers exist to these expansion plans, as they often do. There will be competitive pressures from the nations that do not wish to lose their advantage. Government decisions by both the U.S. and Mexican regimes will compromise expansion plans. A number of the social issues can't be ignored and, most of all, there is the battle over perception. Too many people in the U.S. and in Mexico are convinced the nation is in a death spiral, but the actions of the business community can challenge that assessment.

The U.S. manufacturing community is in an ideal position to link with those Mexican counterparts as both nations start to see the predicted shift in production. As the Boston Consulting Group and others have pointed for the past couple of years, China is losing its edge and there is an opportunity for others to grow at its expense. It is not that China is doomed to decline, but the trends of the last couple of years will only accelerate. Higher wages, higher production costs, and higher transportation costs will make China less competitive in the years to come and give Mexico a distinct advantage.

Dr. Chris Kuehl is an economic analyst for the Fabricators & Manufacturers Association, International (FMA), and managing partner of Armada Corporate Intelligence. Dr. Kuehl is the author of Fabrinomics, a biweekly economic analysis e-newsletter for members of the FMA. For more information, go to fmanet.org/fabrinomics [1].

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