

# Mexico wins back manufacturing business

After being temporarily snubbed by investors eager to tap into China, Mexico is re-emerging as a major manufacturing hub for the North and South American region. *Jax Jacobsen* reports.

**M**exico has been building up its manufacturing sector for the past four decades. It first attracted the interest of multinational firms in the 1970s with the launch of the maquila programme, which allowed the duty-free import of equipment to develop products for export. Success was mixed, though Juarez and Tijuana emerged as major hubs for electronics production.

Foreign interest in export-focused manufacturing in Mexico soared after the 1994 signing of the North American Free Trade Agreement (NAFTA), which catapulted the importance of trade to the Mexican economy. Trade's participation in the country's GDP jumped from just 39% in 1990 to 58% by 1995, according to McKinsey's *Tale of Two Mexicos* report (March 2014).

But in the late 1990s and early 2000s, multinational companies started to pull away from Mexico, lured by the cheaper labour costs found in China and Southeast Asia, with General Electric and Caterpillar withdrawing their Mexican operations to resettle them in China.

While wage competition in Southeast Asia cost Mexico a fair share of textile and shoe-producing business, other types of manufacturing have by and large returned. In fact, the country recorded its highest-ever foreign direct investment (FDI) in 2013 at US\$35.2bn.

"The last four years have been our strongest years since we've been in business," says Scott Stanley, senior vice-president at North American Production Sharing, which specialises in relocating and establishing manufacturing enterprises in central Mexico.

According to Doug Donahue, vice-president of business development at Entrada Group – a company helping US firms set up manufacturing operations in Mexico – what brought international investors back to the country was a mix of rising labour wages in China and a realisation that bottom-level wages were not the most important factor in producing for a global economy.

“Companies started to focus on other things, and it was no longer just about the cost of labour,” he says. “China also had a very strong supply chain. But there was a manufacturing trend, where Europe started manufacturing for Europe, North America for North America, and Asia for Asia. Almost all industries realised it was better to produce in the region where they were going to sell products.”

Having manufacturing centres based half a world away also made it difficult for companies to control quality, and generated significant delays in receiving product orders: it takes four days to truck goods from

Mexico City to Pittsburgh, Pennsylvania, McKinsey found, but an average of 30 days to ship goods from Beijing to Atlanta, Georgia.

The Mexican manufacturing sector has also matured, graduating from the production of low-quality, low-skill goods such as t-shirts, jeans and shoes to electronics, appliances, and automobiles, deputy director Christopher Wilson of the Wilson Centre’s Mexico Institute says.

“What’s happened is that the manufacturing sector has figured out its niche, and how to exploit the advantage of proximity to the US in the most effective way,” he adds.

While Mexico has stayed away from large-scale production of complex products like pharmaceuticals and scientific equipment, it has flourished in the production of goods such as flat-screen televisions, home appliances and factory machinery. Deloitte estimates that over 400 manufacturers of electronics products are based in Guadalajara alone, employing nearly 50,000 workers.

### Automobile boom

Though Mexican manufacturing churns out a vast array of products, no industry has seen the runaway success that the automobile industry has. The country was the world’s seventh-largest automobile producer in 2015, and is on track to become the fifth-largest producer by 2020.

Almost every major carmaker has operations, or is planning to establish a factory, in Mexico. In December 2014, General Motors said it would invest US\$1.5bn to double its Mexican production capacity, while Nissan and Daimler are jointly investing US\$1.5bn to produce 300,000 Infiniti and Mercedes Benz vehicles from 2017.

In 1994, Mexico’s 10 largest automobile factories produced 1.1 million vehicles. In 2012, they produced nearly 2.9 million – an increase of 5.5% a year.

A factory operated by Honda and Mazda in Guanajuato is set to produce 400,000 vehicles a year, while Audi AG is establishing a plant in Puebla – already home to Volkswagen’s second-largest plant – to produce 150,000 luxury SUVs annually.

Auto production accounts for 30% of Mexico’s economic output, with 70% of all completed cars shipped for export. Of those, 90% are destined for American drivers.

Part of the secret to Mexico’s stratospheric growth in automobile production has to do with the terms in the many free trade agreements signed over the years, Donahue says.

“The ‘Detroit Three’ [GM, Ford, and Chrysler] wanted an advantage over all the other global car manufacturers,” he says. “So they insisted that, in order to qualify for the NAFTA benefit, ‘x’ amount of the value added of the car needed to be produced in North America.”

Mexico, having much lower wages than the US, got the bulk of the manufacturing. And in its 44 other trade deals, Mexico was also savvy enough to recognise the importance of securing manufacturing contracts.

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Christopher Wilson, Wilson Centre Mexico Institute

“The only common thing in all those 44 agreements is that you have to produce in Mexico,” Donahue adds. “This was of particular interest, not to North American manufacturers, but to European and Asian manufacturers, because here was a way to get into the North American market, get to South America, ship the product back to Europe and Asia, and still get the benefits [of the agreement].”

## “GROWTH IMPLIES THAT THERE IS QUALITY COMING OUT OF THE MEXICAN AUTOMOTIVE SECTOR.”

Scott Andes, Brookings Institute

### Quality-based growth

But according to the Brookings Institute’s Scott Andes, it isn’t just low wages and shipping costs that are attracting foreign firms.

“If the quality and the speed is not at its highest level, then low wages will not be enough to keep manufacturing in Mexico,” he says. “Growth implies that there is quality coming out of the Mexican automotive sector.”

Mexico is unlikely to lose its perch to regional competitors anytime soon, analysts concur.

“No country has the same combination of factors that Mexico has,” the Mexico Institute’s Wilson says, referring to low wages and Mexico’s fortuitous geography. “There are only two countries in the world that share a border with the US, and Mexico will, for decades to come, have lower wages than Canada and a much larger population. It will eventually have a larger economy.”

Though Central and South American countries have found success in specific industries, such as Costa Rica’s growing production of medical devices, none of the regional economies have the supply bases and cross-industry expertise that Mexico has.

### Productivity issues

Still, Mexico’s continued growth in manufacturing, and particularly in car production, is far from guaranteed.

“Mexico’s biggest competitor and challenge is itself,” Wilson says, pointing to a slew of issues that are holding the sector back, including low productivity rates, higher-than-optimal electricity costs, and the need for more educated workers.

Mexico’s low productivity rates are an ongoing challenge for the government and the industries served by factories. The country now has the lowest productivity growth rate among OECD members, Deloitte has found – its productivity is just 24% of that of the US.

These low productivity rates are largely due to the

enormous informal sector in the Mexican economy: the largest Mexican plants have an average productivity rate of 80% of that of the US, with some plants even exceeding the US average. However, 80% of Mexican parts suppliers are small, informal businesses which have fewer than 10 employees, and an average productivity rate of 10% of that of the larger firms.

Productivity could be improved by investing and upgrading plants and improving manufacturing systems, but this requires capital investment, which small and medium-sized Mexican enterprises have little opportunity to secure.

Uneven collection of taxes is also putting a dampener on manufacturers’ enthusiasm for Mexico.

“The Mexican government has done a poor job in the collection of taxes throughout history,” Donahue says. “This has two effects: there isn’t enough money to pay for education, and they could build better infrastructure, but have a lack of funds for that.”

According to him, the Mexican government’s reliance on collecting taxes from the corporate sector might also backfire in the long run.

“The Mexican government is hoping that there’s been so much momentum built up in the manufacturing sector that if they increase taxes on it, it won’t slow that momentum, and it will create more income,” he adds.

Even with these challenges, the Inter-American Development Bank’s lead economist Paolo Giordano foresees several avenues that will allow Mexican manufacturing to continue to boom.

### High-value goods

Top among these is the ongoing talks about the Trans-Pacific Partnership, which is seeking to open trade between 12 Pacific-bordering states including Mexico, the US, Canada, Japan, and several Asian and South American economies. An agreement is expected by November this year.

“Even with the reduced protection, Mexico still has a comparative advantage,” Giordano says. “If they work hard on trade facilitation, and remove the red tape, they can still leverage their positional advantage of being close to the US border.”

In terms of manufacturing production, though other economists maintain that Mexico will not be moving into higher value-added goods like scientific equipment anytime soon, Giordano emphasises that traditional products – such as those in agriculture – can still be labelled ‘high-value’. He believes that exporting raspberries, for example, could be considered high-value if there’s a demand from expensive restaurants that pay a huge premium because of the speed of delivery.

“A lot of high value can be added in more traditional industrial segments,” he points out. “We tend to focus a lot on finished products, such as planes and nuclear reactors. In fact, Mexico is already supplying the US market with very sophisticated intermediate parts. In order to be able to participate in value chains, they really need to be consistent with the timing of delivery, the quality of delivery, and that’s something that’s a part of being high-tech.” **GTR**