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United States-Mexico Economic Convergence

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UNITED STATES – MEXICO ECONOMIC CONVERGENCE

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This paper will share some reflections on convergence in North America from an economic standpoint. First of all, the term "convergence" is quite open. It is a wide subject, which makes it a difficult topic to present. By using the convergence model that we know best, that of Europe,[1] one can understand convergence in terms of policies that allow economic conditions in countries of the region to move closer together. Similar economic conditions lead to homogeneity of economic institutions, which lead to greater freedom of movement for factors of production across national boundaries. These conditions also create homogeneity in rates of return on capital and levels of risk.

There are three factors that are crucial to a discussion of the current state of Mexican and North American convergence. The first is economic, the second financial and the third is institutional. Trade and investment drive the economic factor. Financial convergence is led mainly by the fact that Mexico's inflation rates are heading down. Inflation is so important that it has to be the number one element to give way to financial convergence. Institutional convergence is a much more difficult concept, because it comprises not only political but legal regimes. There is also a behavioral component to the institutional factor. There is considerable difference between the way Mexican institutions, individuals, politicians and business people understand good or ethical behavior. This is addressed below.

The expansion of Mexican exports has facilitated Mexico's integration with the U.S. In the 1970s, there was an integration of the Mexican automobile industry similar to the one between the Canadian and U.S. auto industry. It was this event

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1. As argued below, the European model is not one for North America to follow, but provides a point of reference for this discussion.

that began the opening up of Mexico's trade sector. International trade went from 10 percent of Mexican GDP in the 1970s to roughly 30 percent today.[2] Mexico, with 30 percent of output represented by trade, is one of the most open economies in the world.[3] Mexico's trade, as a percentage of GDP, is twice as large as that of the U.S., and near that of Canada and the United Kingdom.[4] Mexico is now fully open in terms of trade. Other conditions, such as the linking of trade and investment, required for this opening have also taken place.

There is no investment decision that makes any sense in Mexico unless it is based on good trade fundamentals. Investment in Mexico, with the intent to produce a product, must be done while taking into account trade flows such as the degree of imports and exports required. In addition, it no longer makes sense for any large corporation to invest in Mexico unless it is part of a global trade strategy. Take for example a company like Ford Motor Company. Fifty percent of core production would be for export. Those exports would make sense in terms of a global strategy, a global sourcing program, specialization of what the Mexican affiliates or subsidiaries are going to produce, and specialization of what they would produce for the domestic market and for the external market. Trade and investment now are linked.

Mexico has liberalized its economy and its trade. It has overcome the difficulties of transforming an initially protected regime that limited the capacity of the foreign investors who, in turn, controlled a majority of Mexican firms from the 1970s through the 1990s. This transformation has been very gradual and sometimes frustrating, especially for business. Mexican liberalization is still only halfway through; it is not fully liberalized.

Investment in Mexico is open to anyone, but Mexico still maintains restrictive sectors, such as electricity, gas, petroleum exploration and production, radio and television, publishing, and a long list of other activities. Liberalization is not complete. This means that whoever goes into any of these sectors, cogeneration of electricity, for example, would always have to take special care of the specific conditions they negotiate with the authorities in order to produce or to sell and at what prices and what rates and with what limitations. So the investment regime, unlike the trade regime, is still a few years behind schedule.

The financial liberalization is also halfway through, since although we have seen a major transformation of banking regulations, it is not yet completed. The fact that it is not yet completed means that there will be further changes in Mexican legislation. Among the changes to be made will be an upgrading of criteria with which the authorities treat the banking institutions. Today we have an emerging pension system that is heavily regulated, and it's going to be less regulated over time. But it's not quite up to the level of financial sector deregulation, as you know it in North America.

All in all, on the economic front, it appears that we are roughly halfway. It should require approximately another five years, 2006 or so. In the mean time we

2. *U.S. Department of Commerce International Trade Administration, GDP & U.S. International Trade in Goods and Services, 1970-2000: National Income and Product Accounts Basis,* (last visited March 24, 2002) <http://www.ita.doc.gov/td/ industry/otea/usfth/aggregate/HL00T05.txt>.

3. *Id.*

4. *Id.*

have new challenges to confront. This first challenge is a very difficult adjustment in wage levels. The goal for this economy is to reach 3 percent inflation rates, as in the U.S., by the year 2003. That is the informal or formal target that President Fox has set.[5]

When wages grow faster than productivity, wage inflation occurs. The U.S. economy has been able to grow rapidly and avoid inflationary tendencies, due to an increasing of worker productivity. With Mexico's wages only one-tenth that of the U.S., and with levels of productivity in terms of output per worker at approximately one-fifth to one-sixth that of the U.S., the standards of work that very different.

In Mexico, the challenge is to focus on the re-education of the labor force. The training required in order to raise workers standards to that of the U.S. is quite remarkable. Mexico is experiencing wage inflation. Over the past three years, Mexican manufacturing wages, as measured in U.S. dollars, have exploded by 30 to 50 percent.[6] Wages, in absolute terms are low in Mexico. But, there certainly are cases where one should think twice before increasing a production line in Mexico, under a scenario of present wage levels.

Last summer Volkswagen and its union agreed after a short strike[7] to a 14.7 percent increase in wages and benefits, broken down as 10.2 percent increase in wages and a 4.5 percent increase in benefits. This is the third successive agreement between Volkswagen and its union that has caused a dramatic escalation of labor costs. The effects of this include Volkswagen freezing a $1.5 billion investment program for Mexico because wage costs are already too high in the Mexican auto industry. Some companies have maintained tolerable rates, but there are some industrial sectors where it is not advantageous to continue enlarging production facilities in Mexico.

Goodyear reached the conclusion early in 2000 that their wage costs in Mexico were already higher than in Canada, adjusted for output per worker. They tolerated the situation in 2000 because demand was growing at very high levels, and they were expecting bad periods sometime in 2001. When the bad period materialized in terms of the market coming down, Goodyear took advantage of a strike they faced and decided to close up shop. The production lost from closing in Mexico was offset by increases in their Brazilian facilities. Similarly, Kodak has also closed down the CD production facility in Guadalajara also because of wage costs, and it is being moved to Taiwan.

Wage levels may appear to be low in Mexico, but the dynamics of wage increase in Mexico are not very reassuring. Mexican industrial groups are anxious about the combined shock of a fall in world demand, particularly in the demand that these companies were having in the U.S., and a very strong currency and whether the

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5. *Secretaria de Economia*, (last visited March 24, 2002) <http://www.economia.gob.mx/wb/distribuidor.jsp?seccion=126>.

6. *U.S. Department of Commerce International Trade Administration, GDP & U.S. International Trade in Goods and Services, 1970-2000: National Income and Product Accounts Basis*, (last visited March 24, 2002) <http://www.ita.doc.gov/td/ industry/otea/usfth/aggregate/HL00T05.txt>.

7. *Volkswagen Mexico Strike Enters Fourth Day* (Reuters, August 21, 2001) <http://www.thestandard.com/wire/0,2231,26718,00.html>.

Mexican government has a strategy to deal with it. On top of a strong currency, we have wages increasing 14 to 15 percent annually. Pemex wages just increased 16 percent, which is hard to understand when the company states its intention to become more efficient.

Wages are, and will continue to be, a problem for convergence. Demographic developments in Mexico and supply and demand situation with labor make this situation even more difficult. The so-called abundance of labor in Mexico is a myth. Mexico has a scarcity of skilled labor. The surplus labor that we have is very much structural, surplus labor that cannot be employed because they don't have the education, the training, the supporting social infrastructure. Mexico has a surplus of unemployable labor, unemployable labor that no one is willing to make the investment to train. Mexico's pool of skilled labor is of a very limited size. Significant numbers of the unskilled labor pool migrate to the U.S., creating another factor, the fact that these laborers do not return. However, this may be overstating it some.

In the 1960s, we would see the workers returning to Mexico. Many would go to the U.S., find a job, work for two years or so, and then return to Mexico. They would return with their savings as well as with vocational training. But, they are no longer returning in the same numbers as before. Over the past five years Mexico has been suffering from a permanent outflow of skilled and semiskilled workers. It is difficult to find today people trained in carpentry, construction, mechanics, gardening, electricians and the like. This has affected companies that operate in the engineering sector especially; auto parts, metal mechanics and similar industries.

Convergence has affected some sectors negatively. When sectors suffer in a free-trade market, it is nobody's responsibility. Conversely, if sectors are badly hit in a common market such as the European Union, it is everyone's responsibility. Today, our free-trade agreement does not reach the quality or the depth of the European union, so that the badly hit sectors are, strictly speaking, Mexico's responsibility.

Badly hit sectors in Mexico include first, sugar, where Mexico negotiated a very small quota in the agreement for export to the U.S.[8] The U.S. maintains a global quota in sugar because of long-rooted conditions. However, Mexico's quota is just too small. At the time of the negotiations, sugar did not loom large in the whole value of the negotiations, so a reasonable quota apparently was not a priority. President Salinas, at one point, said that it was attorney business and that he did not want the agreement to be delayed one month because of sugar, so the offer was simply accepted.[9]

In 1990-1991 Mexico re-privatized the cane sugar mills. These mills were highly subsidized, because sugar is a political sector in Mexico. Cane sugar in Mexico has a high input cost. It was not surprising that sugar mills went bankrupt when the quota prevented them from accessing the U.S. market. At the same time corn imports, including corn fructose a very low-cost sweetener, were liberalized, displacing sugar in some of the food industry.

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8. *See*, Dale E. McNiel, *United States' Agricultural Protectionism After the Uruguay Round: What Remains of Measures to Provide Relief From Surges of Agricultural Imports*, 23 N.C. J. Int'l L. & Com. Reg. 281 (1998).

9. *Id.*

The sugar sector continues to be a problem because it is not possible for the Mexican government to subsidize this sector on a permanent basis, we cannot allow them to go and disappear from the face of the earth. It has 300,000 highly unionized, highly politicized workers. The problem represents regional problems that have forced a business-oriented government like President Fox's government to expropriate the sugar mills in order just to keep the social peace, embarking the federal government into a risky adventure to operate a sugar sector that produces heavy losses.

With the expropriation of 27 out of the 53 total mills, the government had to assume $3 billion in debt.[10] This problem is partly related to the trade negotiation. It is deeply rooted in the structure of trade flows, and cannot be resolved satisfactorily until Mexico renegotiates a more decent sugar agreement with the U.S., one that does not invalidate NAFTA. After all, NAFTA is nearly ten years old and certainly merits some re-visitation.

Grain is another sector where there has been very large displacement of Mexican producers. Small producers of corn and wheat and soy have been completely wiped out. Cattle and potatoes are two other similarly hit sectors. What have been created in their place are communities that simply migrate to the Mexican cities and to the northern border. It is not as easy as simply having these producers switch to producing something else. Whole families have been doing the same thing for centuries. It is not easy to transform quickly. Perhaps this is one of the reasons why there are such great distortions in the European Union's farming sector.

But, these problems do not suggest Mexico should not have signed NAFTA. They do not outweigh the benefits of NAFTA. But they suggest that anybody who is realistic enough about deepening trade integration and making trade issues more smooth over time should be looking at these sector seriously, looking for lasting solutions, not for patches. Patches are very expensive, short-term solutions. Mexico has scarce fiscal resources; it cannot afford to be subsidizing industries. But it will begin. It is a risky adventure.

Other sectors have suffered from a lack of fulfillment. One is trucking and the other is telecommunications. As for telecommunications, Mexico must step forward in order to fully guarantee fair competition in telecom.

There are sectors to be completed. One is natural gas, another is electricity and then there is oil (exploration and production). Water should also be considered here. Water is going to be much more important than oil, in the long term.

Efficient and smooth convergence could call for flexible exchange rates in Mexico in order to maintain competitiveness. In other words, if Mexico pegs its currency, as it has in the past, and tries to use a bank and allow the rate to fluctuate with a limited bounce as it did in the early 1990s, it is not going to be good for flexibility, especially in light of the prospects of China becoming a WTO member.[11]

10. Susan Ferriss, *Mexico Sugar's Failure A Symbol Of Corruption, Market Pressures*, (September 7, 2001) (last visited March 24, 2002) <www.coxnews.com/washingtonbureau/staff/ferriss/090701MEXICO-SUGAR.html>.

11. The WTO's Ministerial Conference approved by consensus on 10 November 2001, the text of the agreement for China's entry into the WTO. China became legally a member 30 days after the WTO received notification of the ratification of the agreement by China's Parliament.

In many sectors where Mexico exports to the U.S., China is also a supplier. The difference being that Mexican plants are probably one-tenth the size of the Chinese plants and the costs of production in Mexico are much higher than in China.

As we continue along the path of convergence, Mexico will need the flexible exchange rate. Suggestions about a common currency, or even dollarization with a fixed peg, are today premature, even with Mexico's low rate of inflation.

The financial sector, as discussed, is probably half way toward convergence, taking into account that already the banking system is largely foreign owned. Inflation is heading down, though still higher than the U.S.[12]

Banking regulations in Mexico have been revamped, and interest rates are low for the first time in 30 years. It looks interesting now to consider the lending interest rates by banks. Stock market and pension plan regulations need to be updated. The banks need to convert their debt into long-term good-quality debt. Too many of their assets are government paper, too much to hold on the promise that the government will pay. Banks must be reassured that the government will honor the debt.

The new credit standards will be tested by reality during the new cycle of growth. Mexico experienced a mini credit boom in 2001. As the economy slowed, banks began aggressive credit lending. All this leads to consumption. This is not necessarily favorable, but any judgment may be premature. The new credit standards are going to be put to a test if the slow down is a prolonged one. The peso is overvalued and adjustment may represent a bit in inflation.

As for institutional convergence, we are only a quarter of the way through. Applicable laws are old. As I was working on my paper on corporate governance, I realized that some of these laws are from 1936, with more current amendments. Of course, none of these laws distinguish what a derivative product is or what an option is. Mexican tribunals are inadequate. Judges are not up to date on the economic and financial topics. There are very, very few judges, or even lawyers, that really understand bankruptcy in Mexico. Corporate governance is still in its infancy in Mexico. Transparency is low and opacity is thick.

To summarize, convergence has taken place in trade very successfully to a large extent. Trade is already linked to investment. Mexico should be moving in the right direction, not necessarily at the right pace as we would like, but we are going to be moving in the right direction.

But there should be caveats. It is not useful to consider the European union model as the model for North America. It just does not fit with the cultural values, especially in Anglo Saxon North America. A union of currencies is not feasible right now. It is completely premature to even discuss it. Dollarization will have to be a unilateral move for Mexico, because of how seriously North Americans take their currency.

Although convergence is a nice topic to speak on and to think about, and although it is important for statesmen and politicians to take the long view, it is something

12. U.S. Department of Commerce International Trade Administration, GDP & U.S. International Trade in Goods and Services, 1970-2000: National Income and Product Accounts Basis, (last visited March 24, 2002) <http://www.ita.doc.gov/td/ industry/otea/usfth/aggregate/HL00T05.txt>.

very much in progress, and in many instances it is premature. Convergence in North America has to find its own ways and its own solutions rather than taking up models that do not fit, such as that of Europe.