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SHIFTING GEARS



MEXICO FIGHTS FOR POSITION IN GLOBAL RACE

By Harold D. Hunt

The race to global economic integration picks up speed daily. For the last few years, however, Mexico has found itself in the economic slow lane while other developing countries like China and India roar ahead at autobahn speeds. A number of reasons are cited for Mexico's underperformance, not the least of which has been America's own sputtering economic engine.

The U.S. economy has begun to improve, putting Mexico at a critical juncture in the competition for economic success. Will it merge into the fast lane or be forced into the pit?

Texans are more than just observers at the race. Mexico's future position in the global economy will have important consequences for Texas real estate markets.

Mexico Versus China

The speed and frequency of jobs being shuffled around the globe has become mind-numbing. Few countries, and even fewer jobs (if the press is to be believed) are immune from the onslaught of outsourcing. A survey of 180 U.S. companies conducted in March 2004 revealed that 86 percent expected to



COMPETITION for North American markets is fierce. Mexico has an edge over China if transportation cost is a major factor. But low manufacturing labor costs — about one-fourth those in Mexico — make China the winner in that arena.

send more technology-related jobs overseas within the next year. This compares to only 32 percent two years ago.

The most popular outsourcing destination appears to be China, with its irresistibly cheap labor. Mexico, like the United States and a host of other countries, will continue to lose manufacturing jobs to China. It is inevitable. But after the smoke clears, will the end result be bad for Mexico or Texas? The answer is "it depends."

Mexico's economic fate is largely in the hands of its politicians. The disappearance of the one-party political system that once gave Mexican presidents total control is forcing the current executive branch to work with a fractured legislature to implement reforms necessary for global competitiveness.

Needed reforms are well defined, and the list is long. It includes creation of a more equitable and predictable tax system to increase financial certainty for investors. A government policy needs to be implemented to help all businesses, not just a select few, become globally competitive. The energy and electricity sectors need to be privatized to increase their efficiency through competition. And there needs to be a genuine commitment to crafting a 21st century workforce through better education.

Passing the needed reforms will not be easy. Experts are divided on whether the politicians will take any action.

They know that any reform of the system will threaten entrenched vested interests. Some argue that the legislature, dominated by the PRI party, will delay the reform process until 2006 to deny the president's party, the PAN, any political victory before the next election. Others argue that rapid globalization has made both the PRI and the PAN realize that reforms must be carried out now.



Other factors affecting Mexico's economic future, such as the wage differential, are largely out of its control. The average hourly compensation for Mexican manufacturing labor is about one-eighth that of workers in the United States. However, the average hourly compensation for Chinese manufacturing labor is about one-fourth that of Mexico's.

If it were simply a matter of cheaper wages, all manufacturing would have left for China long ago. Logistical considerations, managerial talent, productivity per worker and protection of intellectual property rights also affect a company's location decisions. Mexico currently has an advantage over China in all of these areas.

According to Erwan Quintin of the Dallas Federal Reserve Board, "Mexico continues to offer unbeatable access to North American markets and a workforce more qualified than China's. However, there is little doubt that in sectors where transportation costs, skill requirements and added value are low, China's expanding capacity will erode Mexico's market share in North America."

"The transition of jobs from Mexico to China has primarily occurred in textiles, certain electronics and other products

requiring low-tech, high-labor assembly," says John Adams, executive director and CEO of the Laredo Development Foundation. Mexican plant managers, having come to the realization that they cannot compete with China's labor costs, are now attempting to move into more complex manufacturing processes that have historically been reserved for U.S. manufacturing operations.

The electronics and automotive sectors have already begun to implement more skilled labor and advanced technology in their Mexican manufacturing facilities. The electronics industry generally carries out research and development (R&D) activities in the United States while often choosing to manufacture components that need frequent retooling or quick delivery in Mexico.

Materials for the components are generally shipped to Mexico from the United States duty-free under NAFTA. The finished components are then distributed throughout the world or shipped back duty-free to the United States. However, manufacturing of commodities such as VCRs is usually shifted to countries with cheaper labor, such as China.

China and Mexico want to increase the number of foreign-owned R&D facilities located there, but U.S. companies are hesitant to outsource their core R&D functions. Delphi currently employs about 2,200 engineers in its Juarez R&D facility, according to Eduardo Solis, chief of the Office for International Trade and Investment Promotion in Mexico. Solis says this is the largest number of engineers in one location outside the United States.

Facilities like Delphi's are still a rarity in Mexico. China has started to offer incentives to companies willing to bring R&D programs there. However, fear of intellectual property theft is one of the top reasons firms cite for bringing their manufacturing operations back to Mexico from China.

Automotive manufacturing of both parts and finished vehicles continues to expand in Mexico. Connections between U.S. and Mexican automotive operations are strong, and the movement toward manufacturing and assembly in Mexico probably would have been faster if not for U.S. labor union contracts.

One weakness in the past has been lack of local suppliers for auto companies assembling in Mexico. According to Nick Criss, industrial director for Cushman & Wakefield, "In the long run, we'll see more manufacturing and less assembly in Mexico. The number of suppliers will increase during the next five years, and they will start to supply multiple original equipment manufacturers (OEMs) instead of just one."

One OEM, Toyota, has chosen to locate its two newest assembly plants in Tijuana, Mexico, and San Antonio, concluding that it is cheaper to build cars here than to assemble them in Asia and ship the finished vehicles to the United States. According to Atsushi Niimi, president and chief executive of Toyota Motor Manufacturing North America, Inc., "You can't

always be chasing around to areas with cheaper wages. Eventually, China's wages will go up. We are always striving to reduce costs, and the key is to use technology and innovation."

Worst Case Scenario

If none of the necessary reforms are carried out and Mexico does everything wrong, some companies will still find it beneficial to locate in Mexico strictly for its locational advantage and its cheaper wages relative to the United States.

Goods from Mexico can be shipped anywhere in the United States in four days or less, while shipping from China typically takes four to six weeks by ship. If problems or defects are discovered in a product in the supply chain, one to four days worth of defective inventory is much more manageable than four to six weeks worth.

Furthermore, inventory control technology continues to improve. More and more companies are attracted to a "pull" system, in which goods are not manufactured or assembled until the plant indicates they are needed. A short, predictable delivery time is critical for a pull system to work effectively.

Even under the worst-case scenario, the demand for industrial distribution space in Texas is not going to disappear. This is especially true for space along the border. Homeland security considerations have now guaranteed that international border

crossings will be required stopping points for all transported goods well into the foreseeable future. Historically, commerce has developed well around areas where transported goods must stop for whatever reasons.

Nevertheless, any decline in the economic viability of Mexico will have a negative impact on Texas. A preliminary report by Dr. Michael Patrick, director of the Texas Center for Border Economic and Enterprise Development at Texas A&M International University in

Laredo, estimated that nearly four of every ten border workers are employed in trade and commerce-related activities with Mexico. Statewide, the number drops to about one in ten. Patrick's study also estimates that a 1 percent permanent annual decline in Texas exports, about \$417 million, would decrease annual gross state product by \$1.2 billion and Texas employment by 8,300.

If Mexico's standard of living does not improve, Texas service jobs and retail establishments that depend on visiting Mexicans could suffer over the long term as well. Patrick calculates a mere 1 percent permanent decline in cross-border shoppers would cause a \$4.6 million loss in annual state sales tax collections.

Cross-border shoppers from Mexico to the Texas border regions (defined as arriving on foot or in a vehicle) accounted for \$8.8 billion in sales in 2002, the most recent numbers available. The average total sales per cross-border shopper per visit was \$151.

Best Case Scenario

If all of the necessary reforms are implemented and Mexico transitions into more high-value, capital-intensive manufacturing, wages per employee should rise, but the number of

Mexican plant managers, realizing that they cannot compete with China's labor costs, are attempting to move into more complex manufacturing processes.

manufacturing jobs will decline. The United States has faced this situation for years. As technology increases productivity in the workplace, machines begin to replace people who must then retrain for other jobs in the economy or face a lower living standard. This is part of the “creative destruction” required for dynamic economies to adapt and expand over time.

With higher wages, the remaining manufacturing workers should have a higher standard of living, increasing the demand for better homes, better cars and a myriad of services and conveniences. Assuming Mexicans will be allowed to easily enter and exit the United States, many of these services will be purchased in Texas.

Under this scenario, commerce between Texas and Mexico should increase dramatically. As a result, the demand for all types of Texas real estate should continue to increase as well. A more affluent Mexican population will consume more goods and services in both Mexico and Texas.

Whether Mexico can compete with China and the rest of the world in the race for a significant share of global outsourcing has yet to be decided. A strong finish by Mexico, however, would likely prove an excellent outcome for Texas real estate markets as well. ♣

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