A U.S.-Mexico Economic Alliance: Policy Options for a Competitive Region

By Christopher E. Wilson

Key Recommendations

- Negotiate future trade agreements as a North American bloc and cooperate on global trade issues, recognizing that exports from the Mexico and Canada contain high levels of U.S. parts, materials, and value. The current Trans-Pacific Partnership negotiations represent a great opportunity for a collaborative approach.
- Facilitate regional commerce by cutting the time it takes to cross the U.S.-Mexico border.
- Liberalize services trade within the North America. Great cost savings could be found in the healthcare and transportation industries. An Open Skies agreement and moving the cross-border trucking program beyond its pilot phase would be positive first steps.
- Fully implement customs single windows and move toward a common North American external tariff, even if that means beginning industry by industry or product by product.
- Harmonize regulations on the books in North America and coordinate the development of new regulations so manufacturers do not need separate production lines for the Mexican, U.S. and Canadian markets.
- Facilitate greater U.S.-Mexico private sector and civil society dialogue regarding enhanced economic cooperation.

At a time when Mexico is poised to experience robust economic growth, a manufacturing renaissance is underway in North America and bilateral trade is booming, the United States and Mexico have an important choice to make: sit back and reap the moderate and perhaps temporal benefits coming naturally from the evolving global context, or implement a robust agenda to improve the competitiveness of North America for the long term. Given that job creation and economic growth in both the United States and Mexico are at stake, the choice should be simple, but a limited understanding about the magnitude, nature and depth of the U.S.-Mexico economic relationship among the public and many policymakers has made serious action to support regional exporters more politically divisive than it ought to be.

The Value of U.S.-Mexico Trade

- Bilateral goods and services trade reached a record breaking $500 Billion dollars in 2011
- Mexico is the United States' second largest export market (after Canada)
- The U.S. exports more to Mexico than all of the BRICs (Brazil, Russia, India, China) combined
- Imports from Mexico contain, on average, 40% U.S. content
- Trade with Mexico is growing faster than trade with China

The United States and Mexico have become profoundly integrated, and the two countries are now partners, rather than competitors, in the global economy. The North American Free Trade Agreement, geographic proximity, and the complementary nature of the two economies have fostered an integrated manufacturing platform. The United States and Mexico do not only trade finished products; they build them together. Indeed, roughly 40 percent of all content in Mexican exports to the United States originates in the United States, much more than the comparable figures with China, Brazil, and India, at four, three, and two percent respectively. Only Canada, at 25 percent, is similar. As a result, improvements in productivity in either country, as well as advances that lower the costs of moving goods across the border (i.e.: long wait times, inefficient customs procedures), strengthen the competitiveness of manufacturers throughout the whole region.

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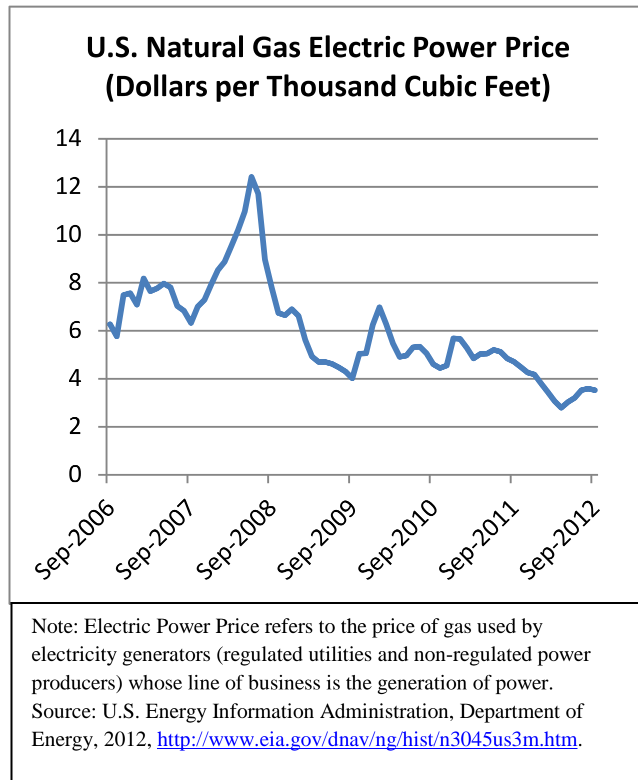
An Evolving Context

The Advent of Advanced Manufacturing and the Return of North American Competitiveness

Driven by a series of global developments and technological advances, a manufacturing renaissance is taking hold in the United States and Mexico that is increasing the competitiveness of regional industry and the volume of U.S.-Mexico trade. After many companies moved their factories to Asia in search of cheap wages over the past two decades, new trends are pulling production facilities back to North America.

While manufacturing wages in China were four times less than Mexico in 2000, they are now nearly equal and are expected to be 25 percent higher than Mexican labor costs by 2015.[1] The simple math of wage differentials drove the past decade's movement of factories from the U.S. and Mexico to China, but companies are taking an increasingly holistic approach in deciding where to locate factories, considering transportation costs and shipping times; exchange rate and political risks; language, culture, and time zone differences; contract and intellectual property law enforcement; security; production flexibility; the supply and cost of materials and energy; and the availability of skilled and educated workers. In most of these categories, Mexico is gaining ground or maintains a distinct advantage over other regions of the world, particularly in terms of serving markets throughout the Americas.



Note: Electric Power Price refers to the price of gas used by electricity generators (regulated utilities and non-regulated power producers) whose line of business is the generation of power. Source: U.S. Energy Information Administration, Department of Energy, 2012, http://www.eia.gov/dnav/ng/hist/n3045us3m.htm.

For example, between 2007 and December 2012, the value of the Mexican Peso fell by 17 percent compared to the U.S. Dollar and by a full 33 percent compared to the Chinese Yuan, improving the competitiveness of regional exports vis-à-vis Chinese goods.[2] Crude oil prices rose 231 percent between 2002 and 2012, thus raising shipping costs and incentivizing the use of shorter, regional rather than longer, transcontinental supply chains.[3]

New drilling techniques, however, are changing the outlook for oil and especially natural gas, opening access to new reserves, increasing production, and therefore lowering some energy costs. While this may eventually lower long-range shipping costs, the more immediate effect is proving to be a major decline in natural gas prices, which has already lowered electricity costs in some parts of the United States and has the potential to do so throughout both the region. Such a decline in prices provides a major boost to energy intensive industries, such as steel, and petrochemical producers. The United States is on the forefront of the technological advances in the energy industry and stands to gain the most from them, but Mexico could reap the benefits as well should it either reform its energy industry to take advantage of its significant shale gas reserves or develop the pipeline infrastructure to support increased gas imports from the United States.

Technological advances and improvements in the manufacturing process and logistics are revolutionizing industrial production in ways that significantly change cost structures, further incentivizing those that had

[1] Harold L. Sirkin, Michael Zinser, and Douglas Hohner, "Made in America, Again: Why Manufacturing Will Return to the U.S.," Boston Consulting Group, August 2011, http://www.bcg.com/documents/file84471.pdf.
[2] Author's calculations, with data from International Monetary Fund, Exchange Rate Archives, 2012 (http://www.imf.org/external/np/fin/data/param_rms_mth.aspx).
[3] Author's calculations based on data and price projections for 2012 from: U.S. Energy Information Administration, 2012 (http://www.eia.gov/forecasts/steo/realprices/).

offshored to China to consider nearshoring in Mexico or reshoring their production back to the United Sates. Robots and the high-tech sensors that allow them to function with precision are allowing many of the simple, repetitive jobs that traditionally made up factory work obsolete. The need for large numbers of relatively unskilled laborers is on the decline, and the need for high skilled technicians who can program and maintain the complex machines and robots of today's factories is on the rise. As a result, labor costs are a shrinking portion of total production costs, as evidenced by a recent study that found only 5.3% of the price of an iPhone goes to offshore manufacturing wages.[4] This shift opens an opportunity for advanced economies like the U.S. to recoup some of their share of global manufacturing, especially if the complementary nature of high-tech design and production in the U.S. is complemented with lower cost manufacturing in Mexico for the portions of production that still require a higher degree of manual labor.

The widespread implementation of *lean manufacturing* principles has improved the efficiency and agility of factories around the world. One important area in which fat has been cut from the manufacturing process is in warehousing. *Just-in-time* supply chain management has minimized the costly storage of parts and products, thus fueling the trend of regionalization in manufacturing by increasing the importance of a robust network of nearby suppliers. It is also greatly increasing the need for short and predictable wait times at the U.S. land borders since an unexpected delay has the potential to shut down production until the needed parts arrive at their destination.

Mexico on the Move

For years, Mexico oriented its economy toward the U.S. in hopes of harnessing the growth of the world's largest market. Now, at a time when Mexico is growing around four percent a year – faster than the United States – Mexico can return the favor and provide a boost to the U.S. economy. Measures of the

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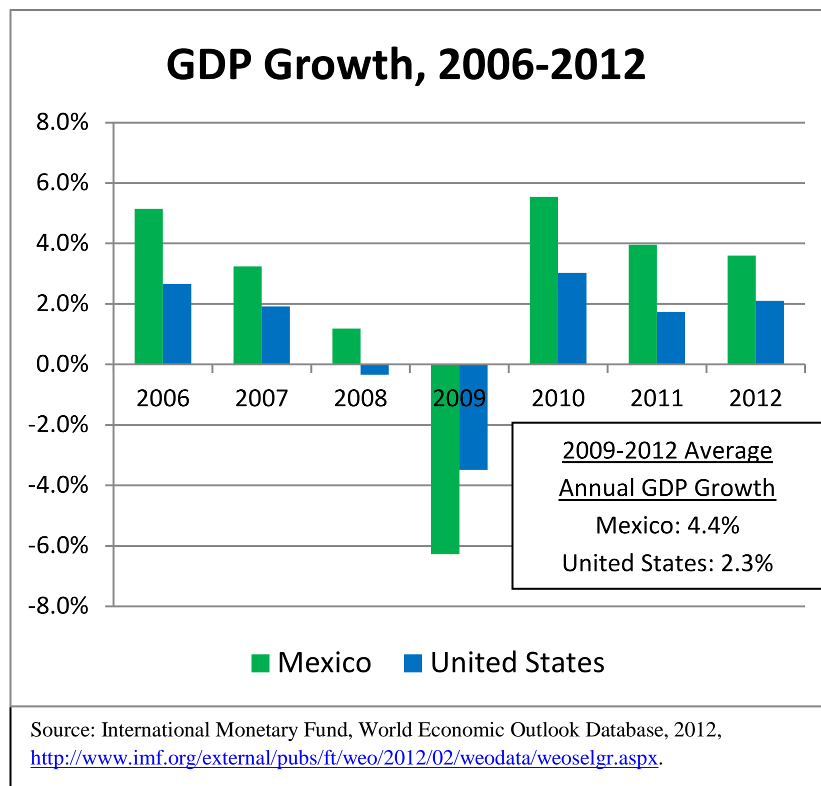
country's manufacturing sector are showing record-high growth, a clear sign of strengthening competitiveness, and the country is building ever more complex products like cars while leaving behind simpler industries like textiles and shoemaking. Mexico's large and growing middle class has become an increasingly important market for U.S. products and a force for many of the economic and political reforms needed to unleash Mexico's full economic potential.[5]

[4] *The Economist*, "A third industrial revolution," April 21, 2012, (http://www.economist.com/node/21552901); and Kenneth L. Kraemer, Greg Linden, and Jason Dedrick, "Capturing Value in Global Networks: Apple's iPad and iPhone," July 2011,(http://pcic.merage.uci.edu/papers/2011/Value_iPad_iPhone.pdf).

[5] Both the Mexican government and HSBC versions of the purchasing managers index for manufacturing (PMI) recorded record growth in late 2012: Adam Thompson, "Mexico manufacturing: chugging along," Financial Times, January 2, 2013, http://blogs.ft.com/beyond-brics/2013/01/02/mexico-manufacturing-chugging-along/#axzz2GvjxFYDs; and Patrick Fearon, November PMI at Record High, MexECON Blog, Terra Nova Ventures, December 12, 2012, http://www.tnvmanagement.com/mexecon-blog/2012/12/4/november-pmi-at-a-record-high.aspx.



Source: International Monetary Fund, World Economic Outlook Database, 2012, http://www.imf.org/external/pubs/ft/weo/2012/02/weodata/weoselgr.aspx.

Altogether, Mexico's new government inherited a very solid economic outlook despite the complex global environment, and the recent passage of important labor and education reforms suggest that the political gridlock that blocked the passage of several key economic reforms in congress for years may have finally, if perhaps only temporarily, become unstuck. Recent optimism regarding the Mexican economy has attracted significant foreign investments, and the United Nations expects FDI in Mexico in 2013 to reach a record $38 billion dollars.[6] The Peña Nieto administration currently looks poised to manage a period of robust growth, and while global developments or a failure to measure up to high expectations could create downward pressures on Mexico's growth, if Congress passes key energy, fiscal and accountability reforms, the outlook could become even brighter.

A Boom in Bilateral Trade

After years of slow growth (4.5 percent average annual growth from 2000-2008) and then a 17 percent drop between 2008 and 2009 during the Great Recession, U.S.-Mexico trade is now booming as never before. It is growing faster than U.S. trade with China and faster than during any period during the post NAFTA spurt in the 1990s.[7] In the uncertain context of a global economy in search of a new equilibrium—Europe struggling, China's decelerating, a fiscal reckoning in the United States— the

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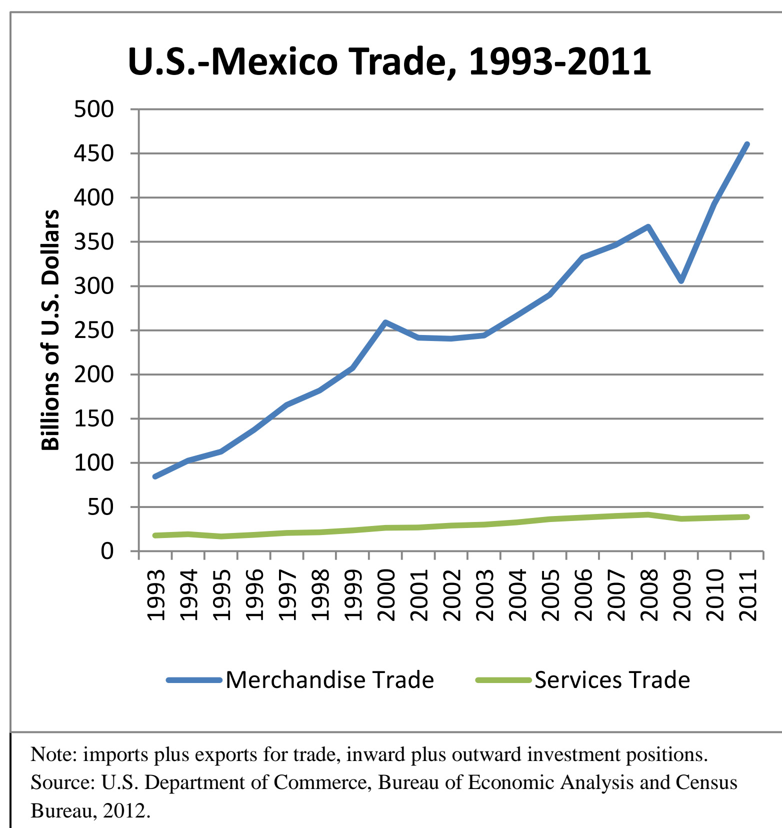
[6] Ulises Diaz, "Favorece IED de 2013 a Peña Nieto," *Reforma*, January 3, 2013, A1.
[7] U.S.-Mexico merchandise trade (exports plus imports) grew at an average annual growth rate of 24 percent from 2009-2011, while U.S.-China trade had 17 percent AAG. Author's calculations with data from U.S. Department of Commerce, Census Bureau, 2012.

bilateral economic relationship stands out as a pillar of strength and perhaps a signpost on the path to a stronger economic region.



Note: imports plus exports for trade, inward plus outward investment positions.
Source: U.S. Department of Commerce, Bureau of Economic Analysis and Census Bureau, 2012.

U.S.-Mexico trade already supports more than six million U.S. jobs, and the return of manufacturing competitiveness to the region, as well as the robust growth of the Mexican economy, presents an opportunity to significantly increase export supported employment should steps be taken to support further advances in North American competitiveness.[8] The amazing thing is that this recent boom in bilateral trade has occurred without a strategy. Imagine what could be achieved if the governments of the United States and Mexico—ideally in conjunction with Canada—designed and implemented a comprehensive plan to improve the competitiveness of our region in the global marketplace.

A Regional Competitiveness Agenda

To cash in on the trends bringing competitiveness back to North America in a way that significantly boosts economic growth and job creation, significant policy action is needed by both the United States and Mexico. At the domestic level, each country must work through its own complex political landscape to press through key reforms, including but not limited to education and fiscal reform in both nations; competition, rule of law and energy in Mexico; and a revamp of the U.S. immigration system so that it attracts and retains the world's top talent. The opportunities for U.S.-Mexico collaboration outlined below go hand in hand with these domestic efforts, supporting regional manufacturers and service providers so they can successfully compete in domestic and international markets. Taken together, they have the potential to truly revitalize the regional economy.

[8] Christopher Wilson, *Working Together: Economic Ties Between the United States and Mexico*, Washington, DC: Woodrow Wilson International Center for Scholars, November 2011.

Strengthening Competitiveness through Integration

The first step to improving regional competitiveness is freeing up the flow of trade within the region. As the central architecture of North American economic relations, NAFTA has spurred huge growth in regional trade and investment. Unfortunately, even as bilateral trade skyrocketed, the United States and Mexico did not make the infrastructure investments or policy advances needed to efficiently move what now amounts to more than a billion dollars' worth of goods back and forth across the U.S. Mexico border each day.

Since the U.S. and Mexico build products together, materials and parts that are used as inputs for production often zig-zag back and forth across the border several times as a product is being made. This means that the bottom line of regional manufacturers is negatively impacted in a magnified way by any inefficiency in moving goods between the two countries. The section of this report on border management describes the challenges and solutions in greater detail, but, in short, the advances in border security made after the terrorist attacks of 9/11 came at a price. Long and unpredictable wait times now chip away at the competitiveness of the region. Thankfully, an innovative set of border management concepts, endorsed by the presidents of the United States and Mexico in the **21st Century Border** initiative in 2010, has the potential to simultaneously strengthen security and efficiency. Some important advances on the implementation of those concepts have been achieved, but the lines at the border remain long and there is much work to do.

In addition to physical security at the border, other important issues also create friction add extra costs to regional manufacturers as they trade within the NAFTA region. Importers and exporters must meet onerous **customs** paperwork obligations to access the preferential tariff rates of NAFTA, but thankfully there are at least two main strategies available to mitigate the burden. First are **single-window** systems, which provide a single electronic platform where importers and exporters can input all of the needed information and documentation regarding a shipment. This streamlines the process by avoiding often redundant interactions between the shipper and the many government agencies involved in clearing a shipment, and the electronic platforms in place in Mexico and the United States should be fully developed for both imports and exports.[9] The second strategy is the implementation of a **common external tariff**, in this case a common tariff charged to any non-NAFTA country as the goods enter North America, which would eliminate the need for rules of origin and the related paperwork. There are more political and technical challenges to this proposal, but the benefits could be significant. Perhaps a product-by-product approach would be the most feasible, creating common tariffs first on goods in which the most-favored-nation tariff among the NAFTA countries is already very close.[10]

To further facilitate the efficiency of regional manufacturers, efforts should be made to **harmonize U.S., Mexican and Canadian regulations** and safety standards. Right now, companies often need to maintain separate product lines for each of their North American markets, adding to manufacturing costs. The

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[9] In the United States, the single-window system is known as the Automated Commercial Environment (ACE) and has slowly added functionality since its debut in 2003. For more information see: http://www.cbp.gov/linkhandler/cgov/trade/automated/modernization/ace/ace_timeline.ctt/ace_timeline.pdf. In Mexico, the Ventanilla Unica de Comercio Exterior Mexicana (VUCEM) began operation in 2012. For more information see: http://www.naftamexico.net/wp-content/uploads/2012/08/jul12.pdf.

[10] Gary Hufbauer and Jeffrey Schott, NAFTA Revisited: Achievements and Challenges, 2005, Washington, DC: Institute for International Economics, October 2005, 473-476.

U.S.-Mexico High Level Regulatory Cooperation Council and the U.S.-Canada Regulatory Cooperation Council are working on some of these issues, but the efforts are not very ambitious. Instead of having two nearly identical commissions working on a dual-bilateral basis, they could achieve greater cost reductions by uniting in a NAFTA-wide effort. Additionally, a plan should be devised regarding how to extend or, better yet, institutionalize regulatory cooperation mechanisms beyond their current two-year term. An approach that encourages regulatory bodies in each country to regularly consult with one another as they design future regulations, a preventative rather than reactionary approach, may offer the most long-term benefits.

In addition to facilitating the flow and trade of goods, an effort should be made **to liberalize the exchange of services**, which currently represent only a small share of bilateral trade (eight percent) but make up the lion's share of both the U.S. (79 percent) and Mexican (61 percent) economies.[11] **Transportation** and **healthcare** are areas particularly ripe for advance, and an open skies agreement, which would allow U.S. and Mexican customer airlines and cargo flights greater access to routes including stops in the other country, would be a good place to start. The current pilot program to allow trucks access to deliver goods throughout Mexico and the United States without unloading and reloading at the border should also be expanded and made permanent. Similarly, at a time when the population is aging and healthcare costs are rising in the U.S., it makes sense to open the market to Mexican health service providers, allowing U.S. residents the option to use their Medicare or insurance to seek lower-cost treatment at authorized hospitals and clinics in Mexico.

The United States and Mexico are among the most open economies in the world, having integrated their manufacturing sectors through NAFTA and having negotiated trade agreements granting preferential access to a combined fifty-plus nations and two-thirds of global GDP. This presents a tremendous opportunity for the sale of jointly produced exports and **cooperation on global trade** issues to ensure North American products receive fair treatment around the world. Whether in the **Trans-Pacific Partnership** (TPP), a trade agreement being negotiated by 11 Pacific Rim countries, or other initiatives, the United States, Mexico and Canada could improve their chances of successfully completing mutually beneficial trade deals by negotiating and working to implement them as a bloc, recognizing that each countries shares in the advantages of a competitive North America. Though the TPP is the next step, it should be understood in the context of a broader strategy to drive progress on the global trade agenda. If the current parties successfully negotiate a comprehensive, 21st Century trade agreement linking the world's largest economic region (North America) to its most dynamic (Asia-Pacific), China may decide it has more to gain by joining in than by sitting out, which would in turn create a strong incentive for long-stalled progress at the World Trade Organization, strengthening the competitiveness of regional exports.

Improving policy requires surmounting political opposition. Past advances in U.S.-Mexico economic relations such as the passage of NAFTA were won not only by the political leadership in both countries, but also by the coalition of business groups and other non-government actors. The business communities of the United States and Mexico are natural allies for any effort to implement the type of competitiveness enhancing policies described above, but the networks forged during the passage of NAFTA virtually

[11] Trade figure: author's calculation with data from U.S. Census Bureau, 2012. Services as portion of GDP: World Bank, Data Bank, 2012.

disappeared. Efforts should be made to **strengthen the networks of U.S. and Mexican businesses and civil society groups** working to support a positive and productive U.S.-Mexico partnership.

Looking Forward

In the end it is about vision. Popular opinion on NAFTA and free trade is still mired in the same tired debates of twenty years ago. Modern day refrains of Ross Perot's "giant sucking sound" still echo. Opponents of trade agreements still measure job loss by subtracting imports from exports, while free traders still retort that a bigger trade pie means more to eat for everyone. The debates are the same, but the world is not. Globalization has changed the very nature of trade, and if our perception does not catch up with reality, there is little doubt that we will be caught with a strategy from yesterday in the world of tomorrow, and one of the best opportunities to reinvigorate the region may be squandered. If instead, the United States, Mexico, and Canada see themselves as the partners that they are, and capitalize on the major advances underway in manufacturing and energy by pursuing a robust agenda to cooperatively strengthen the competiveness of the region, then the likelihood is strong that North America will continue to be among the most dynamic and wealthy in the world.