The Mexican Comeback

BY DIANA FARRELL AND JAANA REMES

How middle-income economies can compete with China.

China has set the world's economies on edge. The country's entry into the World Trade Organization in 2001, its increasing dominance in a broad range of manufacturing export sectors ranging from textiles to electronics, and its rising prominence in such lucrative export markets as the United States, have other countries scrambling to respond.

No one is more concerned than middle-income countries such as Mexico, Brazil, Poland, Portugal, and South Korea.[1] Rising standards of living there have significantly weakened long-held positions as low-wage producers and exporters. The problem has been particularly acute in Mexico. Since 2000, more than 270,000 Mexicans have lost manufacturing jobs, and hundreds of factories have closed their doors following the post-NAFTA boom in the 1990s, many leaving for lower-cost production locations in Asia—like China.

But Mexican factories are humming once again. The World Bank reports that *maquiladora* factories added more than 81,000 jobs in the first eight months of 2004, a 7.8 percent gain after three straight years of losses.[2] GDP growth was 4.4 percent in the third quarter, the best quarterly performance since the height of the technology boom in 2000.[3] Toyota, DaimlerChrysler, Lexmark International, Deere & Co., Electrolux, and Flextronics are all expanding existing facilities or building new plants to take advantage of Mexico's still relatively low-cost labor and proximity to the United States.[4]

Certainly much of this resurgence in manufacturing is tied to the recovery of the U.S. economy. But something else is going on: Mexico is beginning to adapt to the pressures of globalization.

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CAPITALIZING ON COMPARATIVE ADVANTAGE

Middle-income countries such as Mexico are learning that they must find their position of true comparative advantage in the global economy. Rather than trying to win back low-wage jobs lost to China, these nations must create jobs in higher-value-added activities to continue moving up the development path.

The former Eastern Bloc workforces have highly educated, moderately paid scientists and engineers that offer a natural off-shoring resource for Western European companies. Poland was a particularly bright spot in the 1990s for foreign direct investment, but has lost significant ground to lower-cost labor in the Czech Republic and Slovakia in recent years. Poland's natural advantage—its relatively high number of university graduates and academic centers—should position it, however, to move into higher-level remote services, such as back-office functions and research and development.[5]

The U.S. semiconductor industry offers a lesson for middle-income countries. In the late 1980s, Japan came to dominate the memory chip market, spurring a public outcry in the United States over unfair competition and the loss of high-paying white-collar jobs. But U.S. chip makers reinvented themselves. The big players—Intel, Motorola, and Texas Instruments—abandoned the dynamic-random-access-memory (DRAM) business and invested in microprocessors and logic products, the next wave of growth in semiconductors.[6]

MEXICO FINDS ITS ADVANTAGE

Mexico has a unique advantage: it sits next to the world's largest consumer market. The country is an ideal location for designing and manufacturing products for which proximity to customers matters. Some goods, such as large-screen TVs and refrigerators, have high transportation costs. Time sensitivity is another consideration. Fresh food can spoil, fashionable items can grow out-of-date quickly, and consumer electronics can rapidly depreciate in value after production.[7] Products that require extensive

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	Types of Products	Rationale	Examples
Transport Cost—Time Sensitive	Low value/weight, volume products	Goods that have low value/weight ratio are relatively more expensive to ship from locations further away from the U.S. market.	White goods Medium/large television sets Telephone switches
Transport Cost—Time Sensitive	Auto electronics products	Mexico's large automotive assembly sector benefits from having integrated electronics supply chain nearby to reduce inventories and supply chain risk.	Car CD and tape players
Transport Cost—Time Sensitive	Short obsolescence cycle products	Short-obsolescence–cycle items in the United States lose value quickly, making it infeasible to wait six weeks to ship via sea from China vs. just days for Mexico.	Desktop computers Laptops Cellular phones
Interaction Sensitive	High customization/ early lifecycle products	Early life-cycle goods require frequent interaction with U.S.-based engineering and design teams, making Mexico more attractive than locations in other time zones	Telephone switches Industrial electronics
Interaction Sensitive	High demand volatility products	Because of long lead time from China, high-demand–volatility items will be difficult to manage	Desktop computers Laptops Cellular phones

Source: *New Horizons: Multinational Company Investment in Developing Economies,* McKinsey Global Institute, 2003.

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interaction among different players in the value chain also benefit from proximity.

The McKinsey Global Institute recently studied the Mexican consumer electronics business and identified several sources of comparative advantage, especially in relation to China, that could be exploited by shifting into product segments like peripherals, switches, computers, and refrigerators (see chart).

Lean retailing in the United States also demands shorter delivery times for a wider range of products, since suppliers must replenish their stock more frequently in response to changes in sales and inventory volumes. Many suppliers face an exponential increase in the complexity of their logistics with the growing number of consumer goods that retailers offer.

Consider the Lands' End pinpoint cotton Oxford dress shirt, which is available in the usual choices of neck and sleeve lengths, five different collar types, two cuts, and multiple fabrics, colors, and patterns. Such consumer choices translate into tens of thousands of SKUs (stock-keeping units). The optimal strategy for most apparel makers is to split production between nearby locations and lowest-cost countries. Accordingly, Mexico's share of time-sensitive goods like jeans for teenagers increased during the 1990s, while China's production of commodity items such as knit pullovers has also grown.[8]

DEVELOPMENT: ONE COMPANY AT A TIME

As foreign investors head to lower-cost locations, developing countries should resist the immediate temptation to try to lure them back with tax breaks and other financial incentives. Such initiatives are not likely to materially influence capital inflows, and simply divert resources from the government and society to multinational companies. Instead, governments should use the funds on improvement of the country's competitive advantage—through investments on infrastructure and removing barriers that stifle business operations.

Although government reform is important, development happens one company at a time, as individual plant managers assess the competitive environment and respond. Jabil Circuit, a contract manufacturer of electronics products for companies such as Dell and Nokia, offers an example of a Mexican plant transitioning to more advanced and lucrative goods for the North American market. Few Mexican industries have been hit harder over the past few years than electronics. As orders were lost to Asia, Jabil saw its workforce of 3,500 shrink by half from 2001 to 2002.[9]

Mexico is beginning to adapt to the pressures of globalization.

Mexican factories are humming once again.

Instead of trying to win back lost orders, it learned to make more complex and customized products, such as computer routers and handheld credit-card machines that were traditionally made in the United States. The factory also retooled its inventory system, trained workers to undertake more than one task at a time, and dramatically increased the number of products it could produce. Orders have flooded in, and employment is now 10 percent higher than it was at its peak in 2001. Other companies in Mexico have made similar transitions.

The lesson for middle-income countries is clear. Enable companies to move up the value chain by capitalizing on comparative advantage, or lose out to the world's rock-bottom-cost producers. ◆

NOTES

1. "Middle-income" refers to countries that fall roughly between $6,000 to $20,000 in annual GDP per capita.
2. As part of the Border Industrialization Program, in 1965 the Mexican government authorized the creation of the *maquiladoras* to help boost employment and the overall economy. These foreign-owned assembly plants were allowed to import duty-free machinery and materials temporarily for production or assembly by Mexican labor and then to export the goods, primarily back to the United States. To reduce transport costs, most of the plants were on the Mexico-U.S. border.
3. "Mexico's Economy Strengthens," Marla Dickerson, *Los Angeles Times,* November 17, 2004, and *Global Economic Prospects 2005: Trade, Regionalism and Development,* World Bank, November 16, 2004.
4. "Up the Food Chain: As Jobs Move East, Plants in Mexico Retool to Compete," David Luhnow, *Wall Street Journal,* March 5, 2004.
5. "Poland's investment challenge," Michal Kwiecinski and Thomas Rüdel, *The McKinsey Quarterly,* 2004 No. 3.
6. Employment data from the Semiconductor Industry Association (SIA) and the U.S. Bureau of Labor Statistics.
7. "When offshore manufacturing doesn't make sense," Ronald C. Ritter and Robert A. Sternfels, *The McKinsey Quarterly,* 2004 No. 4.
8. "Globalization in the apparel and textile industries: What is new and what is not?" Frederick H. Abernathy, John T. Dunlop, Janice H. Hammond, and David Weil, in *Locating Global Advantage,* eds. Martin Kenney and Richard Florida (Stanford: Stanford University Press, 2003).
9. Luhnow, op. cit.