Mexico: Prospects better than perceptions

Richard N. Sinkin

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As Mexico gears up for the changing of the guards in the presidential palace, the country is focused on who will emerge the winner. But an equally important issue, said Richard Sinkin, is how the economy will fare in this critical year before the election. Specifically, will President Zedillo be able to avoid the "sexenial crisis" that hits the country every six years?

Looking good

Mexican presidents are elected to one six-year term. "Historically, the government does really well during the middle part of the sexenial," said Sinkin. But in the final year, looking to generate another victory at the polls, the government enters into huge amounts of spending. "Typically, the spending is financed by short-term dollar-denominated borrowings which then can't be rolled over after the election."

All this manipulation triggers a crisis. "Mexico is forced to devalue the peso and the country loses all the benefits it's gotten from the four or five years of growth up to the election."

The real test for Zedillo, whom Sinkin said has been a "superb president," will be in how well he stays the course - regardless of how it might impact the PRI (Institutional Revolutionary Party) and the election outcome.

"So far it looks good. There are no signs of Mexico engaging in a massive amount of government spending, and there's no sign of short-term borrowing. In fact Mexico's debt payment has been extended."

Sinken added, "The pattern now looks very positive. Mexico is looking like it's going to have four, maybe five years of sustained growth."

For investors, "the perception of risk is greater than the reality of risk." If a crisis were to occur, Mexico would devalue the peso, interest rates would soar and wages collapse. So, while "disastrous for certain groups in Mexico, these crises are really good for export-oriented manufacturing companies that have large work forces."

As a social issue, however, this cycle of currency devaluations and wage cuts is a destabilizing influence on the country.

Sinkin also pointed out that the economy differs from North to South. "The North is modern, industrial, prosperous and democratic. The South is impoverished and politically marginalized."
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Imports/Exports

What's driving Sinkin's optimism about the future of the Mexican economy is the tremendous increase in exports, which have more than doubled since the implementation of NAFTA in January 1994. Sinkin noted, however, that 85 percent of those exports are targeted for the United States, making Mexico severely vulnerable to economic downturns across the border.

"If your partners in this export orientation don't do well, you're going to do very badly." Barring the extreme, Mexico's growth will continue to be driven by exports, Sinkin said.

Imports are also doing well, thanks to "the growth of the manufacturing sector in Mexico, and also the need to import food because the agricultural sector is a shambles today."

The current account deficit -- the difference between a country's income and current spending -- is also rising, due to the needs of a growing economy. Imports of big-ticket capital equipment are necessitated by the new factories that dot the landscape.

Companies are paying cash for their capital equipment since they cannot get financed in Mexico; nor are U.S. banks apt to make these loans because there is no instrument to collect on a lien in Mexico.

But direct foreign investment, mostly for plants, is strong, "averaging somewhere close to $10 billion a year."
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Where the jobs are

The Mexican economy is stressed to create jobs for 1,200,000 new workers every year. But the reality, said Sinkin, is that "even in very good years, such as 1996 and 1997, the economy only created 800,000 new jobs." As a result, "migratory pressures" mount as people look across the border for work. "Because that's where the jobs are."

Workers who remain in Mexico have to compete for available jobs at wages that reflect that old "supply and demand" economic theory.

Sinkin talked about a factory in Mexico where the 280 machinists and specialists who make engine parts earn $7 an hour -- including benefits. This wage is "25 percent higher than any other plant in the area." In the U.S., a person doing comparable work would earn $21-$25 an hour; in Germany, $35 an hour.

Today, the average hourly wage of a Mexican is 25 to 30 percent lower than his counterpart in South Korea.

For a company setting up operations in Mexico, a low wage scale is not enough to ensure profits. "If you're going to be successful manufacturing in Mexico, you have to have a full-time commitment to training that is both intense and constant."

Mexicans, continued Sinkin, "are terrific workers, but they're not self-starting workers. They expect to be trained and you have to constantly upgrade the skill sets."

New model

The Mexican economy has been in a state of evolution since 1985, when the government lifted trade barriers, removed most restrictions on foreign investment and privatized some 2000 companies.

"All this culminated in NAFTA, with Mexico making a deliberate policy choice to basically meld its economy with those of the United States and Canada - mostly the United States - and open itself up to foreign competition."

There is a downside, however. "NAFTA has created a sharp divide in the Mexican business class." On one side of the divide are the large, wealthy conglomerates that operate on a global scale; on the other side are small family-owned companies that have lost their pre-NAFTA protection and are not competitive in the global marketplace.

"They didn't invest in technology, they didn't upgrade their skills, and they are now faced with huge debt burdens."

NAFTA has also changed the relationship between business and government. The government no longer plays the kind of role in business that it used to, when it owned thousands of companies. Today, it owns two key monopolies: Pemex, the Mexican oil industry, and the CFE, the Federal Electrical Commission which supplies electricity for the nation.

These companies are inefficient and should be privatized, said Sinkin. But they are "sacred cows" in Mexico and privatization is opposed by both the public and the unions.
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The attachment Mexicans have to Pemex dates back to 1938, when President Cardenas expropriated foreign oil companies. For Mexicans, Pemex represents a victory over the "imperialist nations" they felt were exploiting their country. Other industries, such as telephone and railways, have been privatized without opposition.

Oil no longer drives the Mexican economy, having fallen to less than 20 percent of exports from a high of 85 percent in the late '80s and early '90s. Exports of manufactured products are now the driving engines of the economy.

Changes on horizon

Under the old rules, business people supported the PRI in return for being favored with contracts from the state owned enterprises. The new rules, said Sinkin, encourage business people to become directly involved in politics. These people are contributing to the party of their choice or spreading their contributions around to hedge their bets.

Other changes coming:

- There will be a whole new raft of business organizations, particularly as lobbying becomes an important part of the system.
- Nepotism will fade away. Resumes will be more important than relationships as competition motivates companies to become more professional.
- There will be more female executives, but males will still dominate. Fewer than 10 percent of managers are women today.
- By Jan. 1, 2001, the maquiladora program, originally set up as a way to avoid restrictions on foreign investment, will be a thing of the past. The law now permits 100 percent ownership by foreigners. These plants will no longer be allowed to operate as cost centers, immune from taxes. According to the new rules, the maquilas will have to generate profits and be subject to taxes. And the import tariff protection they had also will be gone.

Inherent risks

The future of the Mexican economy, while looking good, has some inherent risks, said Sinkin.

- Political turmoil associated with the 2000 election could drive off foreign investment, which is necessary for Mexico's growth.
- The bank system is insolvent and there's no fix in sight.
- Dependence on the U.S. means that if the U.S. gets a cold, Mexico gets pneumonia.
- Mexico is still lumped with Third-World countries in the minds of investors. A crisis in one of these countries makes investors pull out of all of them.
- Product security is an increasing phenomenon. It's "theft by demand" as bandits hijack trucks and trains of specific goods, from paper products to food to electronics. "This will not be solved except by sustained economic growth and avoidance of the six-year economic crisis," Siskin said, adding that better pay for police is also needed.

Mexico is trying to mitigate or eliminate these risks as it enters the global economy.
For now, the country's "macroeconomics are indeed very strong. They're translating into real growth, job creation, income growth and income on a personal level," Sinkin said, acknowledging that those on the lower rungs of society have yet to benefit.

"From a direct investment perspective, Mexico is an excellent location to put your money. It has a highly skilled work force that can produce world class products, and it's right next door to a powerful consuming market."