Benefiting from NAFTA: New Opportunities in North America

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A rather experienced Mexican president, Porfirio Diaz – he was in office 36 years – portrayed his nation's basic attributes in the following way:

„Pobre México, tan lejos de Dios, tan cerca de los Estados Unidos."

(„Poor Mexico, so far from God, so near the United States.")

It's this basic fact of life, of course, that led to NAFTA – the North American Free Trade Agreement. In this article, I will provide an overview of the trends that are behind NAFTA. I will also address the challenges and opportunities that this newborn free trade area creates for US. and Canadian firms. In particular, I will focus on:

- How the new trade area can be a springboard to the rest of Latin America
- How newcomers can determine whether they should be focusing on NAFTA and Mexico
- What multinationals should be thinking about
- Four proven strategies for companies eager to capitalize on new opportunities

The Road to NAFTA

Though NAFTA seemed to emerge suddenly as a public issue in the United States in 1993, the forces that gave rise to NAFTA have been gathering speed over the last several years. Ratification of NAFTA by the U.S. Congress this past November merely recognized the business logic and mutual benefit of the trade that has been burgeoning across North America.

Let me begin by describing the ultimate North American product – a relatively new brand of bottled water called Clearly Canadian. The bottles are made in Mexico, then filled with water from Canada and sold in the United States. The product comes from Vitro, the Monterrey-based Mexican conglomerate that, in 1989, in the first-ever major Mexican takeover of a U.S. company, bought the troubled US. glassmaker, Anchor Glass.

A decade ago, the story of Clearly Canadian water and the Vitro/Anchor operation would have seemed like a fairy tale. But now, everything has changed because of two powerful forces: the competitive pressures on the U.S. and the reform of the Mexican economy.

In the late 1980s, Mexico began a vast overhaul of its economy. Before 1986, when Mexico joined the General Agreement on Tariffs and Trade, tariffs on industrial imports averaged 150 percent. Now they are in the 10 to 15 percent range.

Also during the 80s, in the United States and Canada, domestic markets were being penetrated by Asian competitors. U.S. and Canadian companies were regularly battered because, in my view, the playing field was – and is – uneven. Asian companies can export to the United States and Canada far more easily than U.S. and Canadian firms can export to Asia.

In addition, many of the goods coming into North America were cheaper than local goods because of the rise of Asian production-sharing networks. By production sharing I mean disaggregating the production chain and locating the labor-intensive and highly variable parts in a developing country and the higher technology/capital-intensive part in the developed country. (For a detailed discussion of production-sharing networks, see *Prism*, fourth quarter 1991, pages 21-31.) Production-sharing strategies lead to lower total costs. The U.S. International Trade Commission estimates that no fewer than 3 5 percent of Japanese exporters of manufactured goods have production-sharing arrangements in developing countries. The U.S. equivalent is fewer than 4 percent. This ratio gives Asian companies a large edge over their North American competitors (and over many European competitors as well).

The need in the United States and Canada to regain and maintain competitiveness, coupled with the reform of the Mexican economy, created a new continental environment. In 1989, these two powerful drivers led to the signature of a Free Trade Agreement between Canada and the United States. In 1992, they gave birth to the trinational NAFTA and later to three-sided agreements governing labor policy, environmental issues, and enforcement.

Meanwhile, intracontinental trade has been thriving. U.S./Mexico trade has more than doubled since 1987, when it was at $34.85 billion, and it has continued to rise in the midst of global recession. In 1986, U.S. exports to Mexico were $10 billion; in 1993 they were $40 billion. In fact, U.S. trade with Mexico has gone from a $5 billion deficit to a $6 billion surplus. Canada has experienced a similarly dramatic increase – since 1985, Canadian trade with Mexico has more than doubled. The point is that for the United States and Canada, trade with Mexico, unlike that with some other nations, has a synergistic effect. The more the United States and

Canada trade with Mexico, the more Mexico trades with the United States and Canada.

The Benefits – and the Opportunities

In my mind, there is no doubt that NAFTA is a historic milestone for business. Beyond facilitating trade and investment for both goods and services, it will:

• Establish a comprehensive framework for doing business, incorporating innovative approaches to enforcement, labor standards, and environmental concerns

• Add a youthful, sizable growth market to the more mature horizons of U.S. and Canadian companies

• Improve environmental protection in Mexico, the United States, and Canada – particularly along the border regions

• Provide momentum for free trade in the entire hemisphere

• Enhance the competitiveness of U.S., Canadian, and Mexican companies

Indeed, Latin America already has some free trade areas (FTAs) and more are to come. MERCOSUL now links Brazil, Argentina, and Uruguay. Chile and Mexico have a successful FTA. The Group of Three – Venezuela, Colombia, and Mexico – is negotiating an FTA as well. So an all-Americas FTA is clearly in the cards, perhaps within the decade.

With the Japanese continuing to protect their market and the European Community tightening its trading network, the United States, Canada, and Mexico will find in NAFTA their own trading bloc. It will mean a powerful tool for negotiation with the rest of the world because it will enable us to negotiate as a continent rather than as individual nations.

Because of the sheer weight of these powerful forces behind NAFTA, we at Arthur D. Little firmly believe that this is a critical time for U.S., Canadian, and Mexican companies to reconsider their positions relative to the North American trading bloc. Those European and Asian firms in whose strategies North American markets and competitors represent important elements should also reevaluate their perspectives on NAFTA at this time.

Implications for Participants

NAFTA will mean different things to different countries and companies. For Mexico, NAFTA means increased foreign investment as the country's overall attractiveness rises considerably for U.S., Canadian, and other foreign firms. For Mexican firms, NAFTA means enlarged markets for exporters, greater opportunities for supplying foreign firms that manufacture in Mexico for export to the NAFTA area, and many new import-driven businesses and entrepreneurs. And in general, Mexican firms will have greater value as strategic allies for foreign firms.

However, NAFTA also means enormous pressure on Mexican firms to lower costs, meet international pricing levels in the Mexican market, and modernize – in terms of technology and productivity – by the deadline, 15 years hence, when tariffs come down to zero. Some Mexican firms will be able to meet this challenge, many will not, and new firms will emerge.

For major South American firms, NAFTA means that eventually the rest of the major American markets will come to be their markets, and all major competitors will come to have freer access to their domestic markets. Such firms should plan on the extension of NAFTA to the new FTA arrangements evolving in South America. It is likely that NAFTA will eventually merge with evolving Group of 3 arrangements (Venezuela-Colombia-Mexico), with MERCOSUL (Brazil-Argentina-Uruguay), and with the Mexico-Chile FTA.

For European and Asian firms, NAFTA does not present large short-term threats or opportunities. However, those who export significant volumes to North America should consider that their NAFTA competitors will come to have a smaller tariff and eventually no tariff, whereas the Asian and European firms are likely to face some tariff. The Rules of Origin of NAFTA would over time press European and Asian competitors to set up total or partial manufacturing capacity in North America. In addition, NAFTA will tend to close the cost gaps, unfavorable now to NAFTA firms. Therefore, European and Asian firms so affected should expect enhanced North American competitors in the next decade.

The implications of NAFTA for multinationals that are already well-established throughout North America differ from those for companies that are new to the area. With NAFTA, a newcomer has the opportunity to conceive its regional business from scratch, in the context of freer trade. A company may focus on NAFTA and Mexico particularly if:

• It faces intense competition and has not yet leveraged its production through production-sharing.

• Its U.S./Canadian distribution network can be extended to Mexico.

• It can develop synergies between the Mexican and the Hispanic markets of the United States and Canada.

• Its product or service finds a growth niche in Mexico's pent-up demand.

• It is logical to use Mexico as a jumping-off place to the rest of Latin America.

On the other hand, for some multinationals already in Latin America, the movement toward a free trade area might represent a threat. Typically, multinationals have operated small-scale subsidiaries to supply isolated, protected national markets. In the emerging environment, they may well discover that they are operating overlapping, small-scale plants with too many workers producing too many products at too many sites in Latin America, with too much pollution. Such multinationals may want to consider a much longer-term strategy that goes beyond Mexico and builds on the prospect of an all-Americas free trade area.

However, these companies will first have to put their organizations on a renewal course. The leading Mexican and Latin American firms and the multinationals operating in the region spent the 1980s struggling with depressed markets, price controls, and excessive regulation of international trade. They paid little attention to keeping up with world trends, including the total quality revolution, environmental protection, high performance approaches to organization, and lean manufacturing practices.

Most multinationals and Latin American firms have traditionally experienced extensive government protection. However, for the most part, they have not suffered under this protection. To the contrary, they have adapted and profited. So to succeed in the new environment, they must now relearn the way they do business, revise their strategies, and recast their firms' internal processes accordingly.

Strategies for NAFTA Participation

Now, I'd like to turn to some practical considerations and discuss how U.S. and Canadian companies can leverage themselves in the expanding North American marketplace.

Our research at Arthur D. Little points to four proven strategies:

• Expanding existing North American marketing and distribution to include Mexico

• Restructuring operations to establish a production-sharing network with Mexico

• Striking strategic alliances to gain a position in the Mexican market

• Redesigning the entire North American/Latin American organization (particularly applicable to large existing firms)

Expanding Marketing and Distribution to Mexico.

This first strategy takes into account two important features of the Mexican market. First, the Mexican market is not only growing but exceptionally young; more than 90 percent of the population is under 40. Furthermore, per capita income is rising. This is why from 1987 to 1991 total imports in Mexico grew by almost 300 percent, making it one of the fastest-growing markets in the world.

Second, Mexicans prefer U.S. and Canadian goods and services to all others. Of how many other markets can that be said?

Furthermore, geography works in favor of U.S. and Canadian companies. In large measure, companies can use their existing home-market distribution and marketing bases to operate in Mexico. Proximity means they can get into the market first with new goods and services – creating lasting brand loyalty – without necessarily having to establish a separate management structure in Mexico. For example, Dell Computer of Austin, Texas, has forged an alliance with a Mexico City-based distributor. The new combined operation will be supported directly from Austin in every major aspect of management and marketing. This approach contrasts sharply with Dell's distribution strategy for the rest of Latin America, where Dell has engineered an alliance with Xerox, which has a broad distribution network.

Another example is Symbol Technologies of Bohemia, New York, a medium-sized manufacturer of bar code scanners and portable terminals, for whom going to Mexico with a product new to that market paid off. In the United States, Symbol had stiff competition. In Mexico, the field was wide open. Sales have been tripling every year. Learning from its Mexican experience, Symbol is now gearing up to export to the rest of Latin America – from its base in the United States.

Establishing a Production-Sharing Network.

The second strategy, production sharing, is advisable for companies whose labor costs represent more than a third of their total manufacturing cost and who face strong international competitors that have production-sharing agreements with developing countries. Simply put, production sharing in North America calls for disaggregating the production chain, locating labor-intensive manufacturing and supply elements in Mexico, and

focusing U.S. or Canadian production on high-value-added processes. Lower total costs are achieved through binational, complementary plants operating as one network, allowing companies to set more competitive prices and increase sales.

A Canadian company, Northern Telecom, is about to embark on just such a production-sharing arrangement in Mexico, synchronizing operations between its California plant and a new operation in Monterrey. Similar strategies have produced dramatic results for U.S. companies. One of them is NIBCO of Indiana, a valve and fittings manufacturer. Because it was under intense pressure from competing Taiwanese and Japanese companies, NIBCO turned to production sharing. Within three years, this strategy led to a solid turnaround, saving old jobs and creating new ones in the United States.

A much larger, global firm, Emerson Electric in Missouri, was losing share in one of its businesses, UPS (which stands for „uninterruptible power systems“ for computers and medical electronic equipment). Production sharing gave Emerson a sufficient cost advantage to increase its share of the world market significantly. In the process, several hundreds of new jobs were created in the United States, at Emerson and at its suppliers.

This point merits more than passing mention in the face of the „jobs controversy“ surrounding NAFTA. Findings based on actual research – rather than on unfounded warnings about „giant sucking sounds“ of jobs moving south – indicate that production-sharing networks create more jobs in the United States, for both the company and its suppliers, than in Mexico. Specifically, gains in US. employment outnumber losses by more than 2 to 1. We have demonstrated this gain through extensive study of the actual experiences of 15 U.S. firms with production-sharing plants in Mexico. In addition, our study revealed that all 15 Mexican plants were meeting the environmental standards of the Environmental Protection Agency.

One major consequence of NAFTA is that, increasingly, US. firms that were sourcing in Asia for lower costs have moved work to the U.S.-Mexico region. In contrast to the results of production sharing in Mexico, outsourcing in Asia has probably contributed to the so-called „hollowing out“ of U.S. manufacturing, since North American firms sourcing in Asia seldom use goods from U.S. suppliers.

Lastly, other companies are now discovering what firms like Emerson Electric, NIBCO, Ford, and GM have learned through their production-sharing networks: the young, ambitious Mexican work force can be a gateway to lean manufacturing and high-quality cultures, while at the same time helping the company increase output and jobs in the United States.

Strategic Alliances. The third strategy – forging partnerships in the NAFTA climate – is timely because there now exists a first generation of Mexican companies that are fast becoming multinationals.

Often, the driving force in these alliances is the need to exploit existing Mexican distribution networks, which are complex and quite different from those north of the border. Such alliances can also help in overcoming cultural and linguistic differences.

For example, Wal-Mart certainly has the muscle to penetrate the Mexican market on its own. But to shorten the time required to master the market, Wal-Mart sought a partnership with CIFRA, one of Mexico’s largest retailers.

Nielsen, the Canadian candymaker, has set a goal of becoming the largest seller of chocolate bars in Mexico. It has just signed a multimillion-dollar deal with Sabritas, a subsidiary of Pepsico, to distribute its chocolate bars south of the border.

Among the first generation of fast-developing Mexican multinationals, candidates for new continental alliances are:

• Bimbo, which virtually created the Mexican market for sliced bread and packaged pastries. Bimbo is now moving into South and Central America, as well as into North America by means of new joint ventures in the United States.

• Posadas, the leading Mexican hotel chain, which already operates in the United States and is about to start up in Venezuela with its Fiesta Americana hotels.

• FEMSA, the dynamic consumer products conglomerate that is Coca Cola’s partner in Mexico and a key player in Coke’s struggle with Pepsi for the Mexican soft drink market, the fourth-largest in the world. FEMSA is also developing new alliances in its beer and packaging businesses.

• And finally, of course, PEMEX, the Mexican oil parastate company, which is now clearly moving in the direction of new alliances and joint ventures in areas such as petrochemicals.

Redesigning the Business. The fourth strategy involves redesigning the business. Accelerated by NAFTA, the advancing pattern of unobstructed trade and investment opens the way to creating high performance businesses designed on the best possible options in terms of:

• What should be manufactured or subcontracted – and where?

• What should be imported?

• What should be exported, into what subregional trading bloc and market?

In Latin America, these kinds of options were previously closed by regulations and protectionism. Today, a few far-sighted firms – such as du Pont, CEMEX, and Nissan – have already redesigned their operations. For example, du Pont has consolidated its large South American operations into a single entity headquartered in Sao Paulo. Du Pont Mexico was organized separately, taking a long-range view of possible synergies arising out of NAFTA, and looking to serve Mexico as a platform for certain exports to South America.[1]

Another example is CEMEX, the Mexican cement leader. Though hindered by protectionist antidumping litigation in the United States, CEMEX is gearing up for the implementation of a first-class management and distribution system in North America. It is also expanding in Spain and the Caribbean. Its basic philosophy is to become a high performance organization that will lead, not merely react, in the new environment of international competitiveness.

Finally, Nissan has redefined its previously small Mexican operation, incorporating it in its global network. It will ship Mexican-made utility vans and engines to its U.S. plants, replacing Asian-made products. The vans will be exported to Asia.

Because of its excellent reputation for quality in the Mexican marketplace, Canada is extremely well-positioned to do business in Mexico and indeed in Latin America. There are clear opportunities in many sectors, including energy, machinery, machine tools, paper, telecommunications, shipping, engineering, and construction (in particular, in quality control and environmental services).

In summary, for Canadian, U.S., and Mexican firms, the new business realities and the changing marketplace call for an expanded scope of marketing and distribution, restructuring into production-sharing networks, strategic alliances with Latin American firms, and riding the driving forces of free trade to implement higher-performance organizations on our continent.

The challenges now are great. The opportunities are much greater, for companies across North America. This is not to say that there are no risks. Mexico has some way to go before fully joining the „first world." Deep pockets of poverty and significant social problems remain in Mexico, as in much of Latin America and indeed in the United States and Europe as well. However, Mexico is steadily developing and is meeting the challenge of structural poverty.

So, at the risk of sounding like an unreconstructed Mexican nationalist, which I am, let me say that Porfirio Diaz was right for his time about „poor Mexico," and maybe even about „so near the United States," but not for today. Given half a chance, NAFTA will turn North America into the biggest and must successful alliance between developed and developing countries that our world has ever seen.

[1] *Seizing Free Trade Opportunities in the Americas,* Business International*, 1992.*

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