Importing Inequality? The China Shock and Wage Disparities in Mexico*

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Abstract

TEXT

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1 Introduction

The rapid rise of China in the global market, termed the "China Shock," was an unprecedented disruption to international trade dynamics. This surge in export dominance was largely unforeseen by the Western world given China's turbulent 20th century experience: marred by colonialism, civil wars, and extreme isolationism under Mao, all within a few decades. However, the extensive economic reforms under Deng Xiaoping's tenure played a major role in this transformation (e.g. enabling foreign direct investment, creating special economic zones for foreign firms to produce manufactures in, relaxing internal migration restrictions, and enabling China to receive the Most-Favored Nation status from the United States since 1980). In effect, China was well-equipped to become the dominant manufacturing exporter due to its comparative advantage in producing manufacturing goods relative to the rest of the world.[1] To illustrate, China's share of global manufacturing exports soared from 3% in 1995 to 10% in 2006 and 20% in 2020 (Baldwin, 2024).

How did this shock impact labor markets across the world? Did inequality improve or worsen? The China Shock enables the re-assessment of the costs of trade on local labor market outcomes, even in a developing context. Less developed countries whose vulnerability to trade shocks grows increasingly important considering their growing presence in global commerce as their share of world merchandise trade increased from 22% in 1964 to 44% by 2023 (UNCTAD, 2024). Even more uncertain are the interactions of such trade shocks with distortions commonly found in developing countries like weaker institutions, larger informal economies, and greater information frictions that characterize developing economies (Atkin and Khandelwal, 2020; Artuc et al., 2015).

These interactions drive the motivation for our paper: What are the short-, medium-, and long-term impacts of a trade shock on inequality in the local labor markets of developing countries? More specifically, does such a shock worsen wage inequality and regional wage

[1]For a more detailed discussion of China's specialization in exporting manufactures, see Autor et al. (2018).

disparities? Do these effects spill over into neighboring labor markets? To answer these questions, this paper examines how Mexican labor markets responded to China's rapid rise in export dominance from 1990 to 2020 (pre-COVID-19).

Conventional trade theory suggests that sustained global trade benefits all parties (in an aggregate sense) by raising incomes, improving welfare, and optimizing production. These manifest themselves through heightened competition, technological diffusion, and greater factor mobility through the Ricardian and Heckscher-Ohlin frameworks which served the foundation of the literature's conventional wisdom (Ricardo, 2014; Heckscher, 1919; Ohlin, 1933; Samuelson, 1948). The Stolper-Samuelson theorem, derived from this framework, argues that trade-induced increases in a good's price should raise the real return to the factor used intensively in its production (Feenstra, 2004). In theory, as developing countries engage in trade, demand for their goods should rise, driving up prices. Since these countries specialize in industries reliant on less-educated labor, wages for low-skilled workers should increase, thereby reducing inequality. Losses should be minimal since workers would relocate from industries/regions that face import competition to those that are export-oriented. Throughout the late 1990s and 2000s, the trade literature gradually reached a consensus that trade was not the primary driver of the decline of the manufacturing sector in the developed world and domestic wage inequality (Wood, 2018).[2] But the empirics have shown otherwise. Only a fraction of displaced workers relocate (between areas or sectors) and many struggle to transition into new employment in both developed and developing contexts.[3] Figure 1 offers a striking example from Mexico: while Chinese import penetration rose steadily from the early 2000s, wage inequality (as captured by the log income gap between the 7th and 3rd deciles) declined. However, this aggregate pattern may mask important heterogeneity, especially if certain regions, sectors, or demographic groups experienced concentrated losses despite overall gains.

[2]For a comprehensive review of the trade-versus-technology debate on inequality, see Helpman (2018).

[3]On developed countries, see Dorn and Levell (2024) for an overview of the literature. Goldberg and Goldberg and Pavcnik (2007) cover the late 20th-century experience in developing countries, while Pavcnik (2017) reviews more recent contributions.

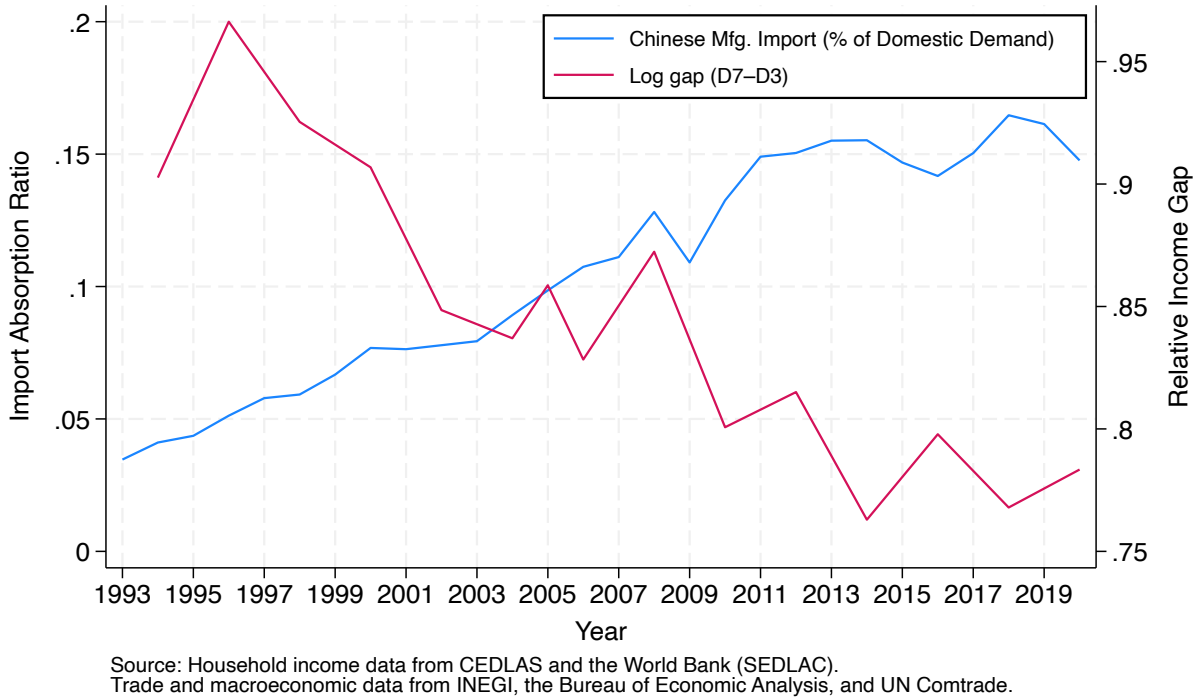

Figure 1: Chinese Import Penetration (Left) and Wage Inequality in Mexico (Right), 1993–2020

We study this phenomena in the context of Mexico using a dataset (which we refer to as the SIDIE dataset hereafter) produced by Banco de México's EconLab (Aldeco et al., 2024), which divides Mexico into 777 local labor markets (LLM) using the methodology proposed by Fowler and Jensen (2020), building upon the approach by Tolbert and Sizer (1996) for defining U.S. Commuting Zones. This dataset harmonizes Population and Housing Census data from 1990, 2000, 2010, and 2020, along with the 2015 Intercensal Survey, all collected by Mexico's National Institute of Statistics and Geography (INEGI). The harmonization process facilitates consistent analysis of Mexican local labor markets over the period 1990–2020. They are able to standardize variables on the LLM's demographic composition, employment, labor income measures, social and economic vulnerability, and informality. For data on countries' manufacturing imports, we access the United Nations' Commodity Trade (UN Comtrade) database on import values of manufacturing goods for Mexico but also similarly developed countries for the construction of our instrument. These imports are classified

by the Harmonized Description and Coding System (HS) which which we connect with the censuses' industry classification through the crosswalk of Faber (2020).

Using this synthetic panel of LLMs, we adopt the empirical strategy of Autor et al. (2013), as applied in subsequent work by Autor et al. (2014), Acemoglu et al. (2016), Autor et al. (2021), and Autor et al. (2025). We exploit variation in LLM exposure to the China Shock, instrumented using Chinese exports to countries with similar levels of development. Given the long intervals between observations, we estimate long differences using a difference-in-differences approach, controlling for both LLM and time fixed effects. This identification strategy allows us to examine how the China Shock affects wage dispersion across LLMs in the short-, medium-, and long-term.

This paper contributes to the growing literature that re-assesses the consequences of trade and globalization on local labor market outcomes (such as wage inequality and employment levels) in developing contexts. We embed ourselves within a subset of this literature which follows the "local labor market approach" of Topalova (2007, 2010) which uses inter-regional variation to estimate the effects of trade shocks on variables of interest. While many of these studies employ trade liberalization as the trade shock of choice (e.g. Dix-Carneiro, 2014; McCaig, 2011; Pierce and Schott, 2016), we instead focus on the sharp rise in Chinese import competition (particularly in manufacturing) as our trade shock of interest. We thus adopt the empirical framework developed by Autor, Dorn, and Hanson and their co-authors (Autor et al., 2013, 2014; Acemoglu et al., 2016; Autor et al., 2021, 2025). However, the existing China Shock literature largely centers on the impacts of trade on average wage and employment levels, often decomposing these effects by worker or firm characteristics and exploring underlying frictions—such as mobility costs (Kovak, 2013; Dix-Carneiro, 2014; Dix-Carneiro and Kovak, 2017) and firm dynamics (Coşar et al., 2016; Ruggieri, 2022; Felix, 2022). We distinguish our approach by repurposing the methods of this literature to examine trade's role in shaping inequality, specifically by estimating the effect of the China Shock on wage dispersion rather than on average wage outcomes. Through their model of heterogeneous

firms, Helpman et al. (2017) argue that within-sector inequality plays a more significant role in overall inequality, calibrating their model with Brazilian data. We distinguish our approach by examining different dimensions of inequality in the context of Mexico while simultaneously exploring a wider breadth of wage inequality. Moreover, we extend this analysis to capture inequality dynamics over the short-, medium-, and long-run angle explored in the context of trade liberalization (Dix-Carneiro and Kovak, 2017), but not yet applied using the China Shock.

We also contribute to the studies analyzing trade's impact on Mexican LLMs. Studies typically use Mexico's waves of trade liberalization as their source of exogenous variation in trade. Specifically, Mexico's 1985 unilateral tariff reductions (Hanson and Harrison, 1999; Bouillon, 2000; Sánchez-Reaza and Rodríguez-Pose, 2002) and the implementation of the North American Free Trade Agreement in 1995 (Chiquiar, 2005, 2008; Esquivel and Rodríguez-López, 2003; Hakobyan and McLaren, 2016). Such studies typically exploits geographic and sectoral variation in pre-shock exposure to trade. Common identification strategies include difference-in-differences, regional tariff instruments, and shift-share designs based on local industry composition. Although studies do highlight heterogeneous impacts across areas, sectors, and worker demographics, the findings on wage inequality remain contradictory. A parallel and expanding line of work examines the impact of the China Shock from the 2000s, adapting the empirical strategy of Autor et al. (2013). In the Mexican context, these studies use variation in regional exposure to Chinese import penetration (instrumented by China's exports to neighboring Latin American markets) to estimate its effects on employment, formality, and wage levels (Mendez, 2015; Chiquiar et al., 2017; Majlesi and Narciso, 2018; Blyde et al., 2020, 2023; Heckl, 2024). While these papers document significant labor market disruptions (especially among lower-skilled workers), most focus on the average outcomes rather than the shock's distributional effects. Our study extends this literature by adapting the established identification strategies to estimate how the China Shock has influenced wage dispersion across regions, sectors, industries, and demographics

in the short-, medium-, and long-run.

The remainder of the paper is organized as follows. Section 2 outlines the background of the China Shock and situates it within Mexico's economic context. Section 3 introduces the data and describes the empirical specification. Section 4 estimates the short-, medium-, and long-term effects of the China Shock on wage inequality. Section 5 conducts a similar analysis for the levels of wages and employment, while Section 6 investigates whether trade-exposed LLMs remain persistently depressed. Section 7 concludes.

2 Background

The China Shock was the culmination of several socioeconomic and geopolitical forces that reshaped China's role in the global economy. This transformation was driven by a series of major reforms initiated by Deng Xiaoping as China's paramount leader whose tenure stood in sharp contrast to that of his predecessor, Mao Zedong. Their key difference was that Deng leveraged market forces to reform the Chinese economy and emphasized regional comparative advantages, whereas Mao pursued a more autarkic model of development (Naughton, 2007). Most discussions on the China Shock attribute its origins from key reforms which enabled greater factor mobility, capital investment in manufacturing, and reducing the role of the state in trade. Specifically, this came in the form of the establishment of export-oriented special economic zones (SEZ), market-oriented policies, and China's accession to the World Trade Organization (WTO), all of which fueled its rapid export growth and global manufacturing dominance (Autor et al., 2018).

China's SEZs were first established in 1980 along the southeastern coastal regions of China to take advantage of their better infrastructure, human capital, and trade links. These SEZs allowed foreign multinational firms to invest and operate there, constructing infrastructure and plants dedicated towards exporting final goods from imported intermediate inputs. These SEZs were able to enjoy special privileges regarding labor regulations, export controls,

and investment restrictions that allowed them to prosper (Alder et al., 2016). These SEZs also stood out since these areas saw greater investment in human capital (Lu et al., 2023), foreign direct investment, and wages (Wang, 2013). Such success prompted the creation of even more SEZs, even in the less developed regions of the country. To put this into perspective, the number of SEZs jumped from the initial 4 in 1980 to over 1,600 SEZs by 2010 (Lu et al., 2023).

From this came the second wave of economic reforms that followed Deng's famous southern tour in 1992, some of which were implemented to adhere to WTO provisions for accession (lifting restrictions on foreign direct investment and trade). The most notable of which included uplifting the system that required firms to export goods through state-owned intermediaries and the public subsidies towards state-owned manufacturing firms. Consequently, with smaller, less efficient state-owned enterprises (SOE) being replaced by private manufacturing firms, productivity, output, and competition all grew, allowing the manufacturing sector to mature and develop rapidly. China greatly accelerated its drive to restructure and downsize state-owned and collective enterprises. Over roughly a decade, close to 50 million urban public-sector workers (including those in state-owned and collective firms) lost their jobs—a reduction of about 40% of the public industrial workforce (Naughton, 2007).

Also significant was the partial relaxation of migration restrictions under the hukou system, which originally tied every individual and their legal residence to a specific location. This system bounded people since it determined their access to education, work, and social welfare (Chan and Zhang, 1999). If workers were to try to migrate in spite of this, they would essentially have significantly reduced rights and benefits, outweighing the potential gains of migration. Reforms introduced temporary residence permits, "blue-stamp hukous" (which grants legal urban residence for individuals who purchase property or invest locally), and various municipality-specific policies. Consequently, rural workers then had greater freedom to leave their agricultural homes towards the more lucrative and secure job opportunities in manufacturing-intensive regions. Notably, the number of workers who migrated to urban

areas have grown from 25 million in 1985 to 159 million in 2011 (Li et al., 2012).

China was granted the Most-Favored Nation status in the U.S. in 1980 but subject to annual reauthorization by Congress under the Trade Act of 1974. The act actually prohibited trade with nonmarket economies but under the Jackson-Vanik amendment may be waived by the president on an annual basis if it may promote freer emigration from said country. If renewal was not granted, the tariff rate would be as high as 37% in 1999 compared to the preferential 4%. This uncertainty disincentivized Chinese firms from making export-oriented investments that were typically U.S.-bound (Pierce and Schott, 2016). China's accession into the WTO was able to quell such uncertainty. This benefit supplemented the more immediate advantages of WTO membership such as reduced tariffs on imported intermediate inputs along with special agreements among members. Examples include the Multi-Fiber Agreement which eliminated export quotas for textiles and apparel (Khandelwal et al., 2013) or the Information Technology Agreement which removed tariffs on a wide range of information technology goods (Borrus and Cohen, 1998).

All of these reforms shaped the Chinese manufacturing sector to the exporting giant it has been in the 21st century. Both developed and developing countries alike have been affected. Though the associated costs manifest through different channels, reflecting the distinct structural distortions present at various stages of development, including Mexico.

Mexico, although classified as an upper-middle-income country, exhibits structural distortions common in developing economies which drives inequality differently than their developed counterparts. Particularly, these distortions manifest themselves in their large informal economy, relatively weak institutions, and lower total factor productivity (TFP) which may be indicative of frictions to factor mobility.

Informal firms tend to be more inefficient and are ridden with more distortions that drive down workers' marginal product. In doing so, the wages paid out are, on average, lower relative to the formal sector. The formal-informal wage disparity is an apparent driver which further drives wage inequality (La Porta and Shleifer, 2014). Figure 2 plots the kernel

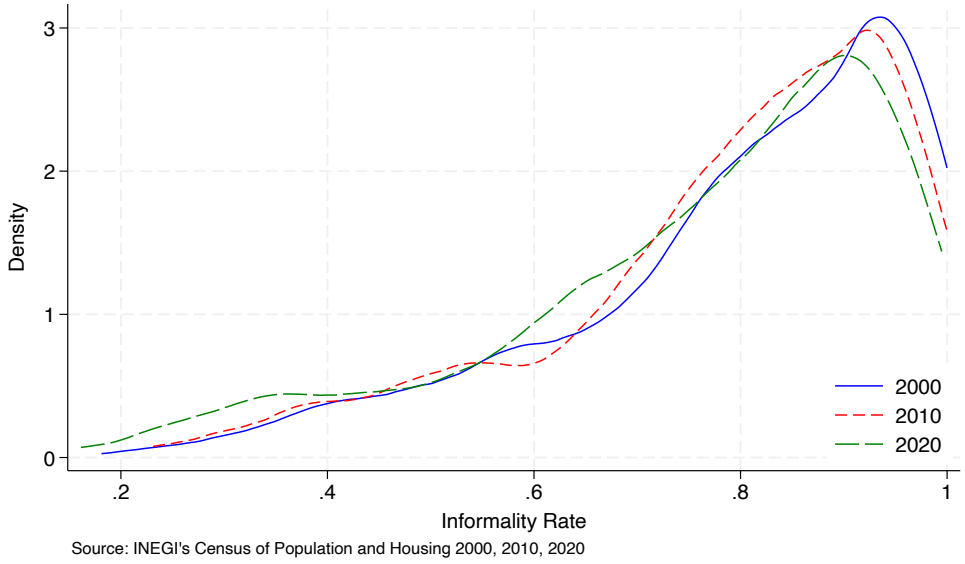

Figure 2: K-Density of Informality Rates among Mexican Local Labor Markets

density plots of informality rates across Mexican LLMs from the population censuses. A notable pattern emerges as a significant number of LLMs have informality rates higher than 80% illustrating the pervasiveness and persistence of their dual economy.

Institutions also matter in this context since weak institutional frameworks often reinforce existing inequalities– limiting economic opportunities for the poor while enabling the rich to capture more wealth and influence (Chong and Gradstein, 2007). Strong institutions also ensure that labor regulations support firm productivity and allow workers to reallocate efficiently, enabling the labor market to adjust and clear in response to shocks. While there are many measures on the quality of a country's institutions, we highlight the World Bank's Worldwide Governance Indicators to position Mexico relative to the rest of the world. Figure 3 shows that on almost every indicator, Mexico is at best middle of the pack, and at worst close to the bottom when it comes to governance quality. Mexico's rankings have since plateaued or trended downwards, implying limited progress in this respect.

An economy with low TFP may reflect deeper differences in the economy's productive capacities that are characteristic of the developing experience. It may indicate limited access to quality human capital investment or that there exists credit constraints for firms to make

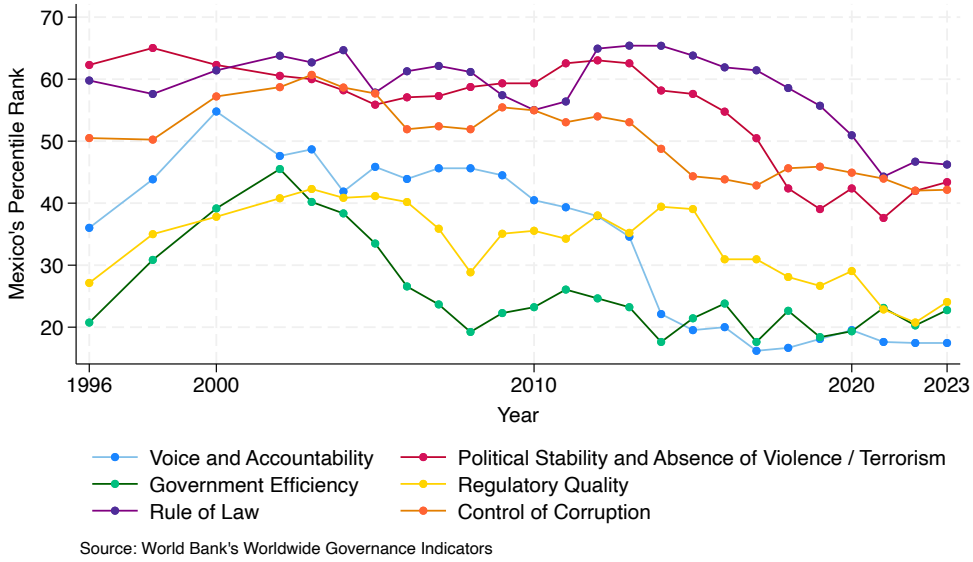

Figure 3: Mexico's Worldwide Governance Indicators from 1996-2023

optimal investments. These are apparent as, according to the World Bank, Mexico's female labor force participation rate was as low as 47% in 2023, implying potential structural or cultural barriers preventing potentially productive workers into the labor market. Fajnzylber et al. (2009) highlight the significance of credit access to firms and the currently existing constraints present for Mexican firms. Granted that, trade shocks may disproportionately harm smaller, less productive firms and thus drive them out of the market, causing greater within-sector inequality. Figure 4 highlights the prolonged and steady decline of Mexico's TFP since the 1980s.

Together, these structural features are just some of the many frictions salient in Mexico's labor markets and illustrates its segmented and constrained nature. Unlike in frictionless labor markets, where workers can freely reallocate across firms or regions in response to shocks, the Mexican labor market is shaped by barriers to mobility, uneven enforcement of regulations, and large gaps in firm productivity. These distortions not only drive baseline inequality but also mediate how external shocks, such as rising import competition, propagate across regions and workers. For instance, areas with more flexible institutions or lower informality may be better positioned to absorb displaced workers and adapt to shifting

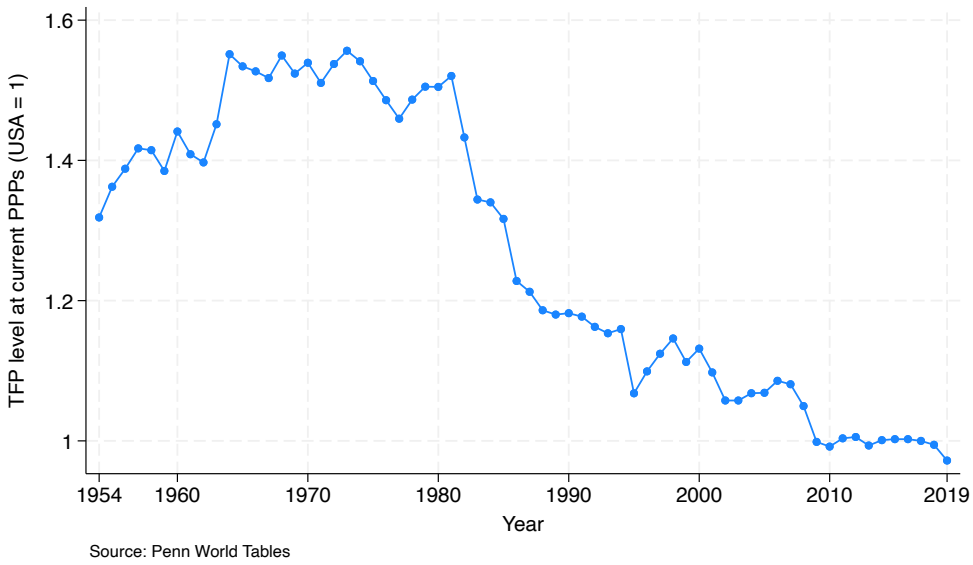

Figure 4: Total Factor Productivity in Mexico (at constant 2017 prices), 1954–2019

comparative advantages, while others may experience more persistent labor market disruptions. In this context, analyzing the China Shock requires going beyond average effects and instead investigating how its impact varies across local labor markets with different structural characteristics. This motivates our local labor market approach and our focus on the distributional consequences of trade exposure.

3 Empirical Strategy & Data

3.1 Empirical Strategy

To estimate the impact of the China Shock on wage inequality, we adopt an instrumental variables differences-in-differences framework controlling for industry, LLM, and year fixed effects. Specifically, for LLM i, sector j, at time t, this relationship is expressed in equation 1:

$$\Delta y_{ijt} = \alpha_i + \beta\, \Delta\text{Import Exposure}_{ijt} + \mathbf{X}_{ijt}\boldsymbol{\zeta} + \gamma_j + \theta_t + \eta_{ijt} \tag{1}$$
$$t \in \{2000,\ 2010,\ 2015,\ 2020\}$$

where y_{ijt} is a measure of wage inequality, defined as the standard deviation, inter-quartile range, or the Theil index of wages (i.e. $\sqrt{Var(w_{ijt})}$, $IQR(w_{ijt})$, $T(w_{ijt})$ respectively). We calculate long differences between each time period. Meanwhile, α_i, γ_j, and θ_t control for the LLM, sector, and time fixed effects respectively. $\mathbf{X_{ijt}}$ represents the matrix of controls. We opt to look at residual wage inequality to isolate the impact on wages not confounded by the roles of experience and ability (proxied by age and education).

We then instrument Chinese import exposure using a Bartik-style instrument as in Autor et al. (2013).

We follow the China Shock literature in using a ... as out measure of LLM exposure to Chinese import competition.

$$\Delta IPW_{ijt} = \sum_j \frac{L_{ijt}}{L_{ujt-1}} \frac{\Delta M_{ocjt}}{L_{it-1}} \tag{2}$$

3.2 Data Sources

We make use of the SIDIE dataset that merges and harmonizes INEGI's Housing and Population Censuses for the years 1990, 2000, 2010, 2015, and 2020. Combining this with the

We merge several datasets from Statistics Denmark on firms and workers for 2001–2015. Below we summarize the key pieces of information from these datasets. Appendix A.1 provides additional details including the construction of the sample and the definition of key variables.

4 Inequality

5 Replication

6 Depressed Regions

7 Conclusion

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