KfW Research
Emerging Markets Spotlight

»» Mexico – implementing economic reforms in a difficult external environment

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Economic situation Real growth (neutral) Private consumption (yoy) (neutral) Inflation rate (poor)	**Economic uncertainty** Uncertainty surrounding the economic relations with the USA weighed on consumer sentiment and the business climate while the real economy presented itself in a robust state in the first half of the year. Fast-rising inflation prompted the central bank to intervene; key interest rates were raised by a cumulative 400 basis points since November 2015, which explains the expected drop in inflation from the second half of the year. The OECD early indicator means the next half year is worth paying close attention to.
Growth financing Budget balance to GDP (good) Current account balance / GDP (poor) Private sector lending to GDP (good)	**Government finances under pressure** A further reduction of the budget deficit requires public spending cuts, so a clearly negative fiscal stimulus can be expected up to the year 2018. The real depreciation of the peso facilitates a lower current account deficit but increases the value of external debt. The latter is mostly long-term, but two thirds of it is in foreign currency. The country's currency reserves are adequate, however. While the relatively strong growth in private sector debt needs attention, the banks are deemed robust.
Growth resources Investment ratio (neutral) Share of manufacturing (good) Real effective exchange rate (very good)	**A very open two-speed economy** The investment-to-GDP ratio is hovering around the 23 per cent mark, placing Mexico in midfield among the major emerging economies. But gross fixed capital formation has stagnated since the end of 2015. Among other things, low commodity prices are leaving their imprint. A strong manufacturing industry has benefited from the country's opening and the expansion of value chains, but a high informal share makes it hard to transfer these successes to the overall economy.
Economic relations with Germany Germany's share of exports (very poor) Germany's share of imports (poor) FDI inflows from Germany (good)	**Economic relations with Germany are based on direct investment** The trade relations are modest, especially Germany's importance as an export market for Mexico. The geographic proximity and cross-border value chains with the USA dominate Mexico's external trade. Nevertheless, Mexico has steadily grown in importance as a recipient of German direct investment. The automotive sector is of particular interest for German direct investment in Mexico.

Legend (see p. 5 for detailed explanation of methodology) — very good | good | neutral | poor | very poor

Investment climate – assessment by our local experts

The economy was in the spotlight last year, primarily because US President Trump called into question the economic relations with Mexico during his campaign and at the beginning of his tenure. Since then a certain degree of calm has been restored on that front; NAFTA will not be dissolved but renegotiated. In return, the focus is on the coming presidential elections in 2018, which also provide the timeframe for renegotiating NAFTA. Without a stability-oriented economic policy the uncertainty would likely be even more noticeable.

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Focal theme: Radical restructuring of the energy sector

The structural reforms initiated in the years 2012/2013 and their implementation are being closely monitored, especially in the energy industry. The latter comprise both the oil and natural gas sector and the electricity sector. The rounds of bidding for exploration which were decided before the oil price drop are taking place in an unfavourable low-price environment. Other questions surrounding implementation, such as strengthening the regulatory institutions or restructuring the two state monopolists (PEMEX for oil and CFE for electricity) into productive state-owned enterprises that will now have to compete in the market, arise independently from the oil price level. The implementation of the reform has also progressed to an extent and created domestic and foreign stakeholders, so it appears unlikely to be wound back even under a new government from 2018.

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Investment climate – assessment by our local experts

Mexico's proximity to the USA and its openness to trade make it an attractive location. At the moment, it has 12 free-trade agreements with 46 countries and is seeking to expand its trading networks. Negotiations are thus underway on updating the trade section of the EU-Mexico global agreement with a focus on non-tariff trade barriers, rules of origin, public procurement and the protection of intellectual property. Economic relations with China are to be deepened as well, however. Fears that a renegotiation of NAFTA may lead to severe disadvantages have now largely subsided. The large and growing domestic market – 128 million inhabitants in a country sitting in the upper-middle-income group – should also be of interest to consumer goods producers. Foreign investment benefits from local business conditions that are good in a Latin American comparison, particularly the macroeconomic environment and relatively well trained workers and reasonable labour costs.

The public's low confidence in government policy, the bureaucracy and corruption, as well as the inadequate security situation are negatives, although regional differences are significant. Thus, exporters and direct investors tend to settle in regions where institutions are of higher quality. The implementation of the reforms initiated in the areas of law and corruption prevention leaves something to be desired. In addition to these structural weaknesses, the investment climate is currently suffering from uncertainty. While uncertainty over the economic relations with the USA has diminished, the Mexican presidential election of 2018 is already casting its shadow. Andrés Manuel López Obrador, with his newly founded party MORENA and left-wing populist programme, sees a good chance of emerging victorious.

The automotive and aerospace industries are running well, and approved and ongoing projects of foreign businesses have secured investment activity for the years ahead. The weak peso is another asset in this situation. However, potential investors have been unsettled by the comments made by US President Trump. Retailers are benefiting from private consumption which is relatively solid even if inflation is weighing on real incomes. But consumer confidence has recovered from its decline at the start of the year. The energy sector and the telecommunications industry are benefiting from the reforms, which are breaking up the respective monopolies and have opened up the market for (foreign) investors. Mobile telephony costs, for example, have fallen noticeably already. Even if it has taken longer to implement the reforms than initially assumed, especially in the energy sector, the processes are now gaining a certain momentum of their own in these areas which should lead to structural changes in combination with substantial investments in the long term.

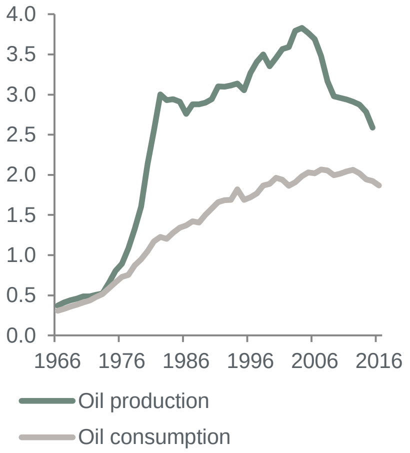
Based on an interview conducted with Dr Stefan Blum (DEG Mexico Office Director) on 27 June 2017. ■

Focal theme: Radical restructuring of the energy sector

In the early 1920s, Mexico was the world's second largest oil producer. The country is currently implementing a radical reform of its energy sector, from oil and natural gas production to electricity generation to the promotion of renewable energy. All previous attempts at reform had failed, most recently in 2008. This is explainable from the historic context because the state-owned oil company PEMEX is a symbol of Mexico's independence. The broad political coalition that set the energy reform in motion as part of the Pact for Mexico in 2013 is therefore all the more remarkable.

Figure 1: Oil

In million barrels per day

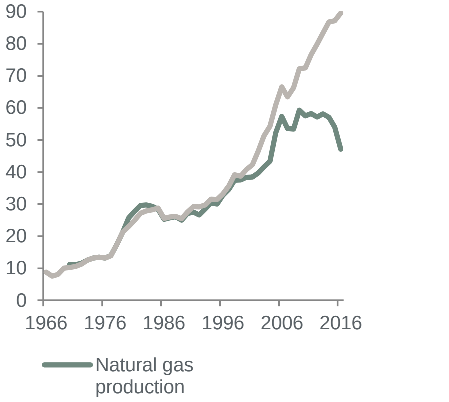


Source: BP Statistical Review of World Energy 2017.

A glance at the oil and natural gas production and energy prices clearly illustrates that a reform of the energy sector was necessary. In 2016 some 1.4 million barrels less oil was produced per day than in the peak year 2004. Consumption, on the other hand, tended to stagnate, leaving less scope for exports. Lack of consumption momentum is partly due to limited refining capacity. Accordingly, Mexico imports petroleum products in a proportion of around 1.6 % of GDP on a net basis. In addition to capacity bottlenecks, some technical requirements are lacking as well, for example to process heavy oil. Consumption of natural gas has risen strongly, but here, too, despite substantial reserves Mexico relies on imports, primarily from the USA. The Energy Information Administration (eia) estimates that the country has the world's sixth largest shale gas reserves. The low-cost imports from the USA, however, take away the necessary incentive for expanding own production. Besides, demand for electricity has grown so quickly that state-owned capacities increasingly had to be supplemented by independent and captive power producers. Nevertheless, depending on the segment, electricity prices in 2014 were as much as 149 % higher than in the USA.

Figure 2: Natural gas

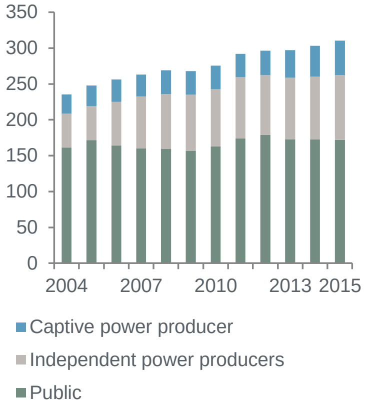
In billions of m^3



Source: BP Statistical Review of World Energy 2017.

Figure 3: Electricity generation

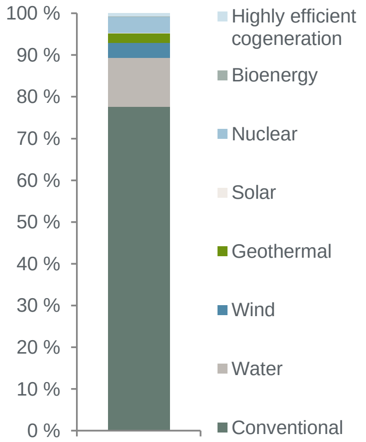
In TWh



Source: SENER.

Figure 4: Renewable energy

Share of electricity generation in percent, 2016



CHP – combined heat and power

Source: SENER.

A search for the causes of the poor performance of the oil sector quickly reveals the role of the state monopoly of PEMEX. From 1958 up to the reform, it held the monopoly in the oil sector across all stages of the value chain, and cooperation with private investors was rare even before that time. The high financial burden and low degree of autonomy caused it to neglect capital expenditure, both on infrastructure and on exploratory drilling for new reserves. Without private and foreign investors, PEMEX missed technological advances, e.g. in the area of shale oil and natural gas, and in the development of deepwater fields. As a monopolist it also lacked incentives for efficiency improvements and innovations, so PEMEX focused on the exploitation of existing fields that are relatively easy to exploit. The deposits now waiting for development, however, require precisely the expertise it is lacking.

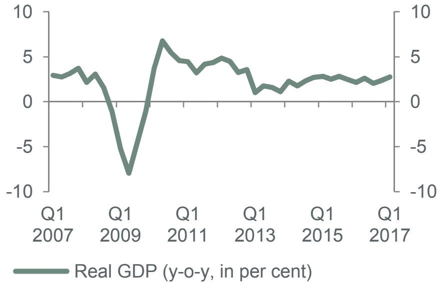
The energy reform has opened up the oil and natural gas sector for private foreign investors. The licensing of private competitors also requires PEMEX to be more flexible, so the company was given more decision-making autonomy. At the same time, PEMEX remains a dominant market player that has secured a substantial portion of the reserves for itself. Private investors can make bids for the remaining deposits. The process is currently in licensing round two. The fiscal treatment of the oil sector has also been modified. In addition to a corporate tax of 30 %, three further levies are charged whose levels depend on the oil price. The reduced state revenue from oil and natural gas is being offset by the general tax reform. Revenues (royalties) are being allocated to the newly created oil fund. This fund is designed to feed long-term investment, especially in education, infrastructure, research and development and not – as was the case with the previous funds – to be used merely for budgetary purposes.

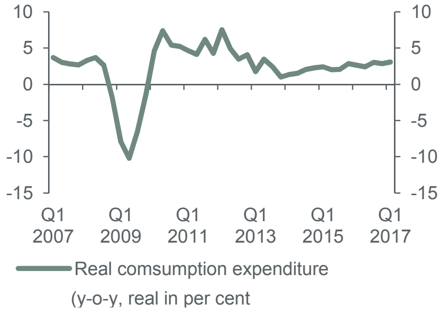
The energy reform has the energy turnaround built right into it. By the year 2050, half the electricity is to be generated by clean energy (including nuclear energy, among others). From 2018, energy utilities and large consumers will have to prove through corresponding certificates that 5 % of their supply originates from clean energy. At the same time, electricity generation and supply have been opened to competition and electricity retail trade will follow. The sophisticated auction system for long-term supply contracts for clean energy was launched in March 2016 (focus on solar and wind energy), and in autumn of 2017 it will enter the third round and will also include certificates by 2018.

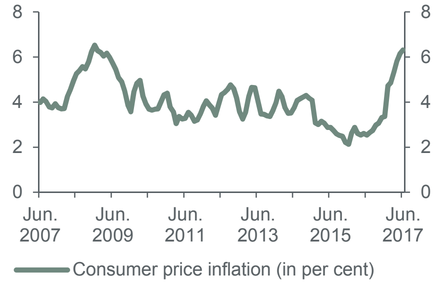
The energy reform is fraught with great expectations. Large volumes of oil and natural gas that can be reached only with additional capital expenditure and imports of technical expertise are expected to lead to competitive prices and rising government revenues. The competition in the electricity market is forcing the development of capacities, and electricity costs are falling. Ultimately this is expected to provide positive impetus to growth and employment. According to estimates by the International Energy Agency, winding back the reform would cost Mexico some 4 % of GDP by 2040. Its success will depend not just on successful licensing rounds for oil and in the electricity sector, but also on continued implementation efforts and sound sector regulation. It will also have to be supported by the next president and his government after the 2018 election. ■

Charts

Economic situation

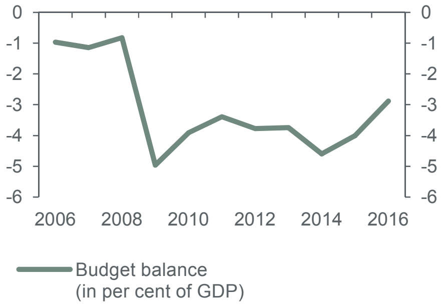


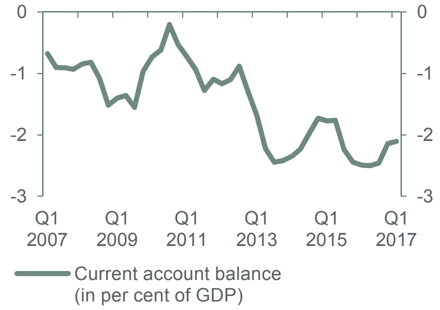




Source: Thomson Reuters Datastream; IBGE, IMF, own calculations.

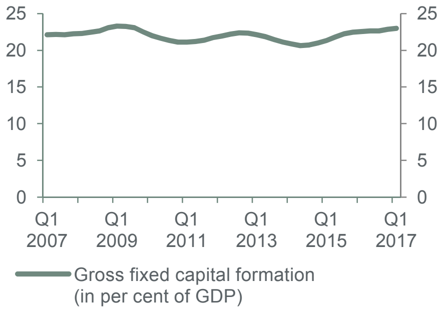
Growth financing

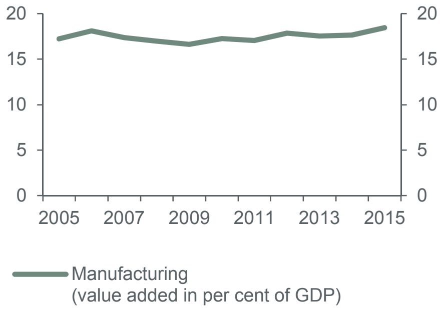




Current account balance in per cent of GDP as a moving average over four quarters.
Sources: Thomson Reuters Datastream, IMF, Banco de México, IBGE, Bank for International Settlements, own calculations.

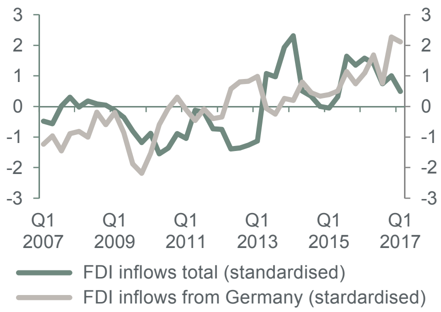
Growth resources





Gross fixed capital formation in per cent of GDP as a moving average over four quarters.
Sources: Thomson Reuters Datastream; IBGE, World Bank, Bank for International Settlements, own calculations.

Economic relations with Germany



Moving average over four quarters.
Sources: Deutsche Bundesbank; Thomson Reuters Datastream; IMF; European Central Bank, own calculations.

Methodology

In the Emerging Markets Spotlight, a selected country is analysed based on various macroeconomic indicators. These indicators are grouped into four categories: economic situation, growth financing, growth resources and economic relations with Germany.

Quintile 1
Quintile 2
Quintile 3
Quintile 4
Quintile 5

The indicators are used to compare the country's situation with its peers. The group comprises Brazil, China, India, Indonesia, Mexico, Russia, South Africa and Turkey. The comparison is based on a quintile ranking in five categories, which are labelled in different colours (see chart):

The country is assigned to a quintile of the country group for each indicator analysed. The best quintile may be different for each indicator. For example, higher growth rates are better, so here the upper quintile is coloured dark green, but higher debt rates are a negative factor, so here the upper quintile is coloured dark red.

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