







# Emerging Markets Spotlight

## Mexico – An economy with potential

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### Economic situation

Real growth	 
Inflation	 
Private consumer spending	 

### Current economic weakness with prospects for recovery

Mexico's economy is gathering momentum. A dynamic development is also expected for the second half of the year. In this situation, the economy is reliant upon external stimuli, in particular from the USA. The current development of private consumption gives no indication of a recovery in domestic demand. The central bank is supporting the economy with low interest rates since it does not anticipate persistent inflationary pressure.







### Growth financing

Credit to private sector / GDP	 
General government debt /	 
International reserves / short-term external debt	 

### Financial system is resilient

The share of private credit in gross domestic product is comparatively low. This means that the long-term upwards trend does not present a problem. At about 47 % of GDP in 2013, general government gross debt is sustainable. It is meant to be reduced only in the medium term so that the current situation is not additionally impaired by fiscal contraction. Currency reserves are stable relative to short-term external debt.







### Growth resources

Investment ratio	 
Energy use / production	 
Labour force participation rate	 

### Extensive structural reforms for more growth

The structural reforms most recently decided on are intended to promote investment activity. The impact will become clear only over the medium term. Since mid-2012, the investment ratio has been declining albeit at a decreasing pace. Reforms in the energy sector should improve again the relation between energy use and production. Strengthening of formal employment through labour market and education reforms will further support the rising labour force participation rate.











### Economic relations with Germany

Share of DEU in goods exports	 
Share of DEU in goods imports	 
FDI inflows from Germany	 

### Trade links with Germany capable of expansion

Traditionally, Mexico's external trade is focused to a large extent on the USA. Germany's share in its exports and imports of goods is correspondingly small, and even the current increase in exports to Germany leaves this picture unchangend. Germany's direct investments in Mexico are relatively stable but also limited.

Legend (for detailed explanation of methodology see p. 4)

 very good	 good	 neutral	 weak	 very weak
 much improved	 improved	 stable	 worse	 much worse

### Investment climate: assessment of our local experts

With its good macroeconomic conditions, its position as a NAFTA production location and thanks to its generally open economy, Mexico offers good conditions for investors and exporters. Extensive structural reforms have now been initiated with the Pacto por México. These should provide support for the positive conditions in the medium term. Expectations of a rapid impact should, however, not be too high since the concrete implementation of the reforms in secondary law and regulations requires time.

Continued on p. 2

### Focus topic: More productivity needed

Mexico has been a member of the OECD since 1994. Its nominal GDP per capita was about 37 % of the OECD average in 1995. It has increased from then on, almost reaching 45 % in 2012. Nonetheless, this is currently the lowest level after Chile and Turkey. One of the reasons for the comparatively slow convergence are the country's low productivity gains. These vary considerably depending on the sector. But expanding innovation capacity can only benefit Mexico, with its currently heavy emphasis on vehicle construction.

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## Investment climate: assessment of our local experts

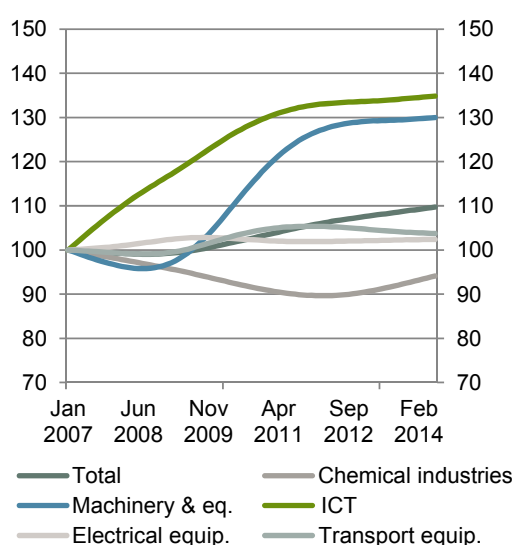
**Mexico is often underrated as a place to invest.** One key advantage is its openness. Mexico has signed free trade agreements with more than 40 countries, e. g. within the framework of NAFTA, EFTA, with Japan and various Latin-American countries. It has established itself as a production location for NAFTA, making good use of its geographical proximity to the USA. Accordingly, the production processes are highly integrated with the USA. With support from a good fiscal and monetary policy framework, the economy has recovered very quickly from the financial and economic crisis. Mexico offers potential, especially for investors.

**Like Germany, the country concentrates on exporting high-quality industrial goods.** Emphasis is placed on developing the industry, primarily manufacturing of transport equipment (automotive and aviation). This is supported by many well-trained engineers. But there is still a need to catch up as far as schooling is concerned and Mexico suffers from a shortage of skilled labour. That is why the country is showing interest in the German model of the dual training system. At the same time, Mexico has rich oil and gas deposits that should be extracted more efficiently and in greater volume as a result of the reforms launched in the energy sector. Openness for exports is also being furthered. For example, negotiations with South Korea regarding a free trade agreement have been ongoing since 2007. Meanwhile, the effects of the free trade agreement now being negotiated between the EU and USA remain to be seen.

**The initiated reforms are necessary, but we should not expect too much too quickly.** The ease with which a direct investor can gain a foothold in the Mexican economy depends very much on the sector. This is relatively simple for a component supplier in the vehicle construction industry as it is integrated in the supply chains of customers and there is location competition in this sector. In others, the confrontation with bureaucracy, a lack of competition and the informal economy can be marked obstacles. It is therefore all the more important for foreign companies to utilise existing networks and inform themselves in detail about the applicable and changing regulations, e. g. in tax law. The structural reforms currently being implemented address two key sectors: energy and telecommunications. However, the reform agenda has so far been judged more positively abroad than within the country itself. Because uncertainties regarding its implementation in secondary law and in regulations, together with its application in case law, weighing on growth. Only when certainty has been created here can investors assess the opportunities presented. But they are ready to exploit them.

Based on an interview with Dr Stefan Blum (Head of the DEG representative office in Mexico) on 3<sup>rd</sup> September 2014. ■

**Figure 1: Labour productivity in the manufacturing industry**  
[Index Jan. 2007 = 100]



Note: HP filter (smoothing parameter 14,400)

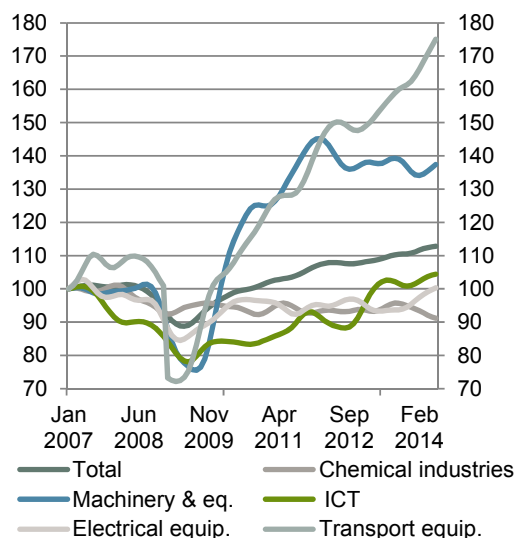
Source: INEGI, author's calculations.

## Focus topic: More productivity needed

Economic conditions in Mexico are undergoing radical changes. The structural reforms (Pacto por México) agreed on in late 2012 aim to promote economic growth, employment and competitiveness. This is to be achieved through changes in the financial, energy and telecommunications sectors, in education and the labour market as well as through new fiscal regulations and tax laws. The energy reform even necessitated constitutional amendments.

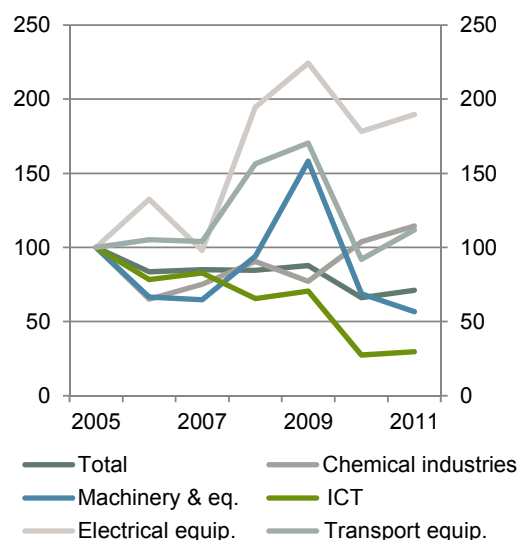
**Productivity gains are urgently needed.** Since the 1994/95 Tequila crisis, the economy has on average grown in real terms by 3.1% per year. This has to be seen in the context of population and employment growth of approx. 1.3% and about 2.4% per year respectively. There was correspondingly weak growth in overall labour productivity, which along with the expansion of labour input, is a main factor in the increase of per capita income. According to the OECD, increasing labour participation, the expansion of capital intensity and human capital endowment were responsible between 2000 and 2011 for the growth experienced, but it did not result from higher productivity through technical progress.

**Figure 2: Output in the manufacturing industry**  
[Trend, Index Jan. 2007 = 100]



Source: INEGI, author's calculations.

**Figure 3: R&D expenditure in the manufacturing industry**  
[real, Index 2005 = 100]



Source: OECD, author's calculations.

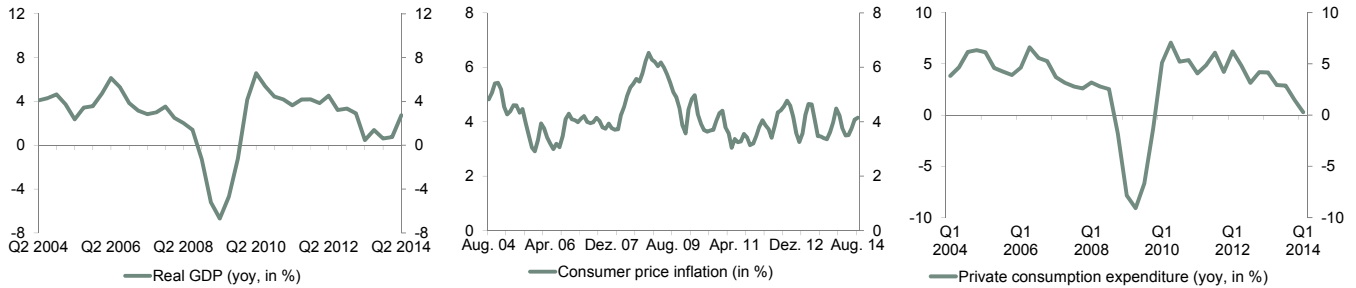
**Labour productivity develops very differently from sector to sector.** Since 2007, labour productivity has increased chiefly in manufacturing of machinery and equipment and the ICT sector (manufacturing of computer, electronic and optical products), less so in manufacturing of transport equipment. In contrast, manufacturing of transport equipment ranks first in terms of output growth, followed by manufacturing of machinery and equipment, while the ICT sector has just managed to regain the position it held prior to the slump it suffered in 2009. Transport equipment manufacturing and, above all, machinery and equipment manufacturing also managed to more than make up for the job losses that arose during the crisis. Conversely, in the ICT industry employment has remained at the lower crisis level and since then productivity has been practically constant. Because real R&D expenditure in the ICT sector is low compared to other industries and, furthermore, decreasing, barely any impulses for productivity can be expected from this side. But there is undeniably market potential for this sector since e. g. there is large pent-up demand in the area of Internet use (2013: only about 43% of the population; OECD 75%). The chemical industries and electrical equipment manufacture are developing rather disappointingly.

**The high-tech industries can only grow, however, if a knowledge base and qualified manpower are available.** The employment of more highly qualified personnel has risen disproportionately (since 2005: by approx. 55%; total employment: 22%). Tertiary graduation rates have also improved markedly by an average of 4% per annum since 1998. But R&D expenditure would have to keep pace, as this consists to a large extent of staff expenditure. The real R&D spending of companies in the manufacturing industry reached its highest level in 2005 after years of increase, and then decreased until 2011 by close to 30% (OECD; last available figure). Overall, the ratio of business R&D expenditure to gross value added in the manufacturing industries is very low at 0.6%. The same holds true when we examine total domestic R&D spending (as a proportion of GDP) (Mexico: 0.4%; OECD: 2.3%). So there is a need to make up lost ground if Mexico is to further establish itself as a production location for the high-tech industry.

**More competition and higher investment activity should increase the growth potential of the Mexican economy.** Stronger competition would compel the companies to improve their efficiency and stimulate innovation. The reforms are intended to e. g. strengthen the position of the competition commission (CFC) when it decides to break up monopolies and to reduce entry barriers in the telecommunications industry. Productivity increases in those sectors where the OECD locates the high-tech sectors would also support high-technology exports. The share of high-tech products in manufactured exports is about 16% (as in the case of Germany). But with strong overall export growth, high-end exports were unable to keep pace. In 2000 their share was still 22%. The ongoing reforms should in any case contribute to expanding the innovation capacity of Mexico's economy. ■

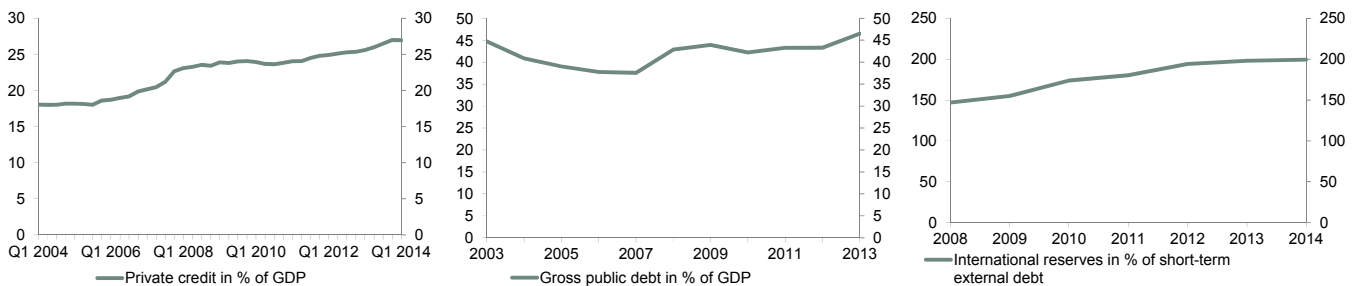
## Overview of figures

### Economic situation



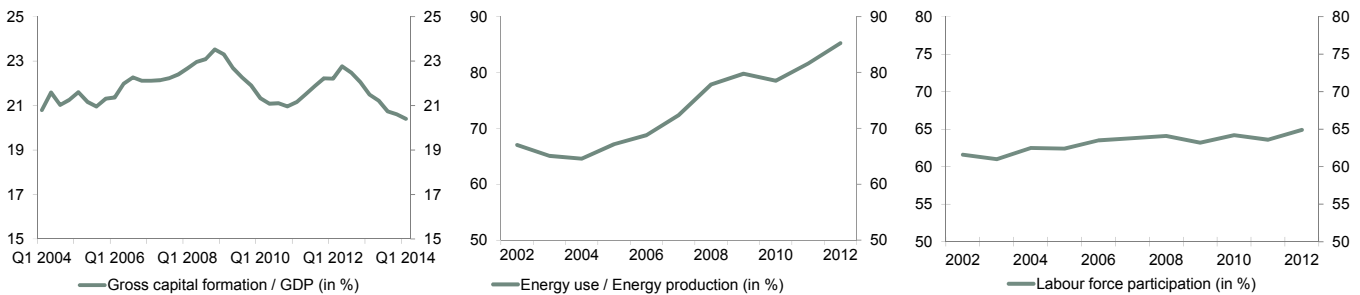
Source: Datastream; OECD, Instituto Nacional de Estadística, Geografía e Informática; author's calculations.

### Growth financing



Source: Datastream; IWF, BIS; author's calculations.

### Growth resources



Source: Datastream; OECD, World Bank; author's calculations.

### Economic relations with DEU








Source: Deutsche Bundesbank; Datastream; IMF, OECD; author's 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.

Firstly, the development of the indicators over time is examined for the country itself. As a rule, the analysis is based on the last ten years. The direction of arrow is determined by the current change in comparison to the previous period. An improvement in the indicator is shown with an arrow pointing upwards, while a deterioration is shown with an arrow pointing downwards. A horizontal arrow indicates that the variable is practically unchanged. For example, a higher inflation rate compared to the previous period signals a deterioration, and – depending on the extent of the change – is labelled with an arrow pointing diagonally or straight downwards. The magnitude of the absolute change compared to the average historical absolute change determines the extent of the change and therefore the direction of the arrow.

-  Strong improvement in the given indicator: > 3/3 of the historical absolute change
-  Improvement in the given indicator: 1/3 – 3/3 of the historical absolute change
-  Slight change in the given indicator: <1/3 of the historical absolute change
-  Deterioration in the given indicator: 1/3 – 3/3 of the historical absolute change
-  Significant deterioration in the given indicator: > 3/3 of the historical absolute change

Secondly, 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:

Quintile 1	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.
Quintile 2	
Quintile 3	
Quintile 4	
Quintile 5	

## Disclaimer

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