Mexico – hoping for economic policy consistency

No. 19, 11 March 2019

Author: Dr Katrin Ullrich, phone +49 69 7431-9791, katrin.ullrich@kfw.de

Economic situation

- Real growth
- Investment (y-o-y)
- Inflation rate

Outlook is stable

With expected growth of 1.9 and 2%, the economic outlook for 2019 and 2020 is below the 2.6% average of the past five years. In 2018 the business cycle was sustained primarily by private consumption. Investment weakness is now less pronounced but has not been overcome. The central bank has responded with determination to inflationary drivers such as the peso devaluation and energy price increases, raising the policy rate by a total of 525 basis points since November 2015.

Growth financing

- Current account balance to GDP
- Government debt to GDP
- External debt to GDP

Sound public finances

Maintaining fiscal discipline will be a major task for the new government. The negative budget balance is combined with a current account deficit. The public debt level of 54% of GDP has been classified as sustainable and external debt is an unremarkable 39% of GDP. Public debt includes a high share of foreign investors, however, and external debt is susceptible to a peso devaluation despite a relatively high share of domestic currency.

Growth resources

- Investment ratio
- Share of manufacturing
- Real effective exchange rate

Investment activity remains weak

In a comparison of large emerging economies, Mexico's share of manufacturing in economic output is a satisfactory 17%. The investment-to-GDP ratio of 23%, however, leaves something to be desired and demand for infrastructure is high. The outlook for more investment is subdued against the background of reduced public investment, continuing uncertainty over the new president's economic policy and the fate of structural reforms.

Economic relations with Germany

- Share of exports to Germany
- Share of imports from Germany
- FDI inflows from Germany

Automotive sector predominates

Germany's share in total export value has grown significantly since 2016 but remains low. The share of vehicles and vehicle parts has grown to around 70% of export value bound for Germany. The upward trend in direct investment from Germany was stopped in the first quarter of 2018 by the first substantially negative value since the global recession of 2009. Political uncertainty is likely to have been a contributing factor.

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

Investment climate – assessment by our local experts

The ratification of the NAFTA successor agreement USMCA will become a focus of attention in the short term. So will the mixed economic-policy signals sent out by the new president López Obrador, which are causing added uncertainty. In general terms, however, the positive macro-economic framework can be expected to continue and remain stable. For the president it will be crucial to fulfil his election promises around security and the fight against corruption. He has the public's support for this.

Continued on p. 2

Focal theme: Continuity in free trade but a migration turnaround

The border between Mexico and the US is the most travelled border in the world. One million people and goods worth USD 1.5 billion cross this border every day. Based on this, and because of the cross-border value chains, the renegotiation of the North American Free Trade Agreement (NAFTA) between the US, Mexico and Canada has been followed closely. In reality, migration has changed radically for quite some time now and return migration to Mexico has greatly increased.

Continued on p. 2

Investment climate – assessment by our local experts

Mexico's advantages as an export location and investment destination are generally intact: its favourable location, particularly its proximity to the US, its young population and stability-oriented fiscal and monetary policy. The outlook for consumption, as well as the health, logistics and transport sector, is therefore positive. In the short term, however, two factors overshadow these positives: delays and uncertainty over the ratification of the USMCA and mixed signals from the new president López Obrador (AMLO) on economic policy (such as halting the construction of Mexico City's new airport, strengthening the financial sector and energy policy). Furthermore, the situation in the problematic areas of rule of law, public safety and corruption has rather deteriorated instead of improving.

The free trade agreement USMCA between Mexico, the US and Canada has been signed but is not yet ratified. The process is being hampered by a range of factors. These include existing import tariffs imposed by the US on steel and aluminium and the possibility that the issue of ratification will be carried into the US election campaign. If, contrary to expectations, the USMCA fails to be ratified, NAFTA will probably remain in force. Foreign investors in Mexico are relatively relaxed about the local value-added shares and minimum hourly wages that are necessary to qualify for free trade. After all, an estimated 40% of exports have already gone to the US under normal tariff rules without claiming any benefits under NAFTA. In addition, detailed arrangements still need to be fleshed out. Even if the agreement fails to bring about any radical general improvements, the protection it provides against further punitive tariffs from the US on vehicles is an important factor for Mexico. In order to qualify for exemption from such tariff increases, however, the initial NAFTA rules must be complied with or vehicle exports to the US could then be capped at 2.6 million units per year (2.4 million new vehicles were shipped to the US in 2017). Another positive effect is greater legal certainty for exporters under the free trade agreements. This is where Mexico otherwise has serious deficits.

Two further initiatives merit attention. Subject to implementation issues, the reduced withholding tax for foreign investors on interest payments from publicly traded debt certificates, which is part of a broader initiative for strengthening the financial sector, should be welcomed. In contrast, energy policy is a cause for concern as the focus is shifting from renewable energy to fossil fuels. The radical restructuring and opening of the energy sector to private foreign investors appears to be halted for now.

Overall sentiment in the country is positive, however, and the majority of the people are behind their president. This gives AMLO the backing he needs to fulfil his campaign promises to improve public safety and fight corruption. There are no specific approaches on this yet but the population holds high expectations.

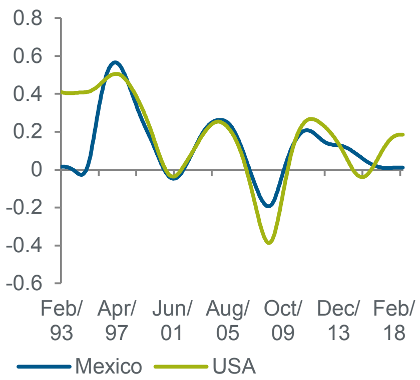
Based on an interview conducted with Johannes Goderbauer (DEG Mexico Office Director) on 6 February 2019. ■

Focal theme: Continuity in free trade but changes in migration

The external environment plays an important role for Mexico's economy and economic policy, especially its close economic ties with the US. Industrial production in both countries moved in parallel since the second half of the 1990s but this close link slackened after the global recession of 2009. The US is not just Mexico's main trading partner but Mexicans' number one migration destination. At the same time, the IMF classifies Mexico as a systemically relevant emerging economy because of its significance for international trade and financial markets and its central position in the relevant networks. The country can rightly be described as an open economy of international significance.

Figure 1: Synchronicity between Mexico's and US industrial output

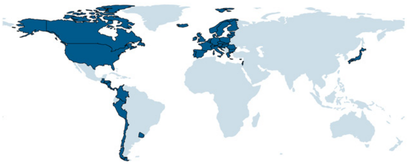
HP-filtered industrial production month-on-month in per cent



Source: Thomson Reuters Datastream, own calculations.

Mexico's economy is very open in the trade of goods. The sum of exports and imports in relation to GDP as a degree of openness is 77%, only 10 percentage points less than in Germany. As recently as in the early 1970s it was a meagre 17%. But the country began to open up to trade in the mid-1980s by abandoning the strategy of import substitution and adopting unilateral trade liberalisation, so before NAFTA came into effect. Today Mexico has the most free trade agreements in the world. The 12 agreements cover a total of 46 countries. The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), which Mexico was the first country to ratify, would add another six countries. It has an investment agreement with China but a trade agreement has not yet been discussed. China is the second most important import market and

Figure 2: Countries that have free trade agreements with Mexico

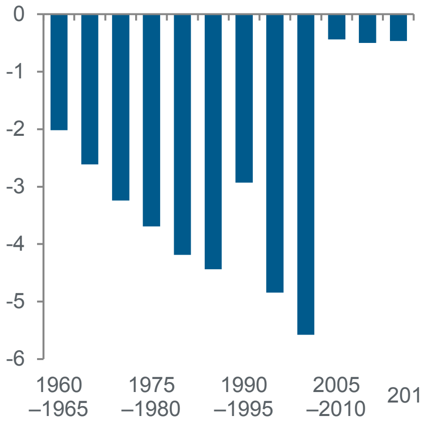


Effectively applied tariffs, 2017	
Simple average	2.97%
Weighted average	1.24%
Maximum rate	75%
Duty free tariff lines share	83%

Sources: Villarreal, M.A. (2017); Mexico's Free Trade Agreements, CRS Report R40784; WITS.

Figure 3: Migration

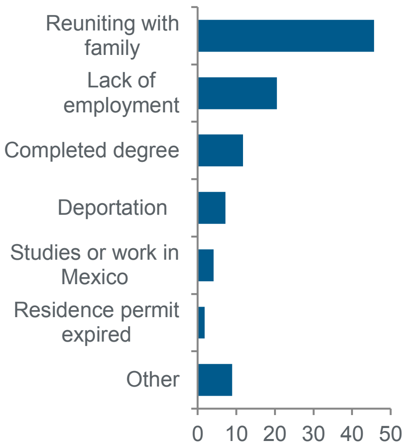
Net migration rate as number of inward less number of outward migrants per 1,000 persons



Source: World Bank (WDI), own calculations.

Figure 4: Reasons for migrants to return to Mexico

Estimated shares in per cent



Source: INEGI, Encuesta Nacional de la Dinámica Demográfica 2014.

fourth most important export market – roughly on a par with Germany. Free trade arrangements with China would presumably become more difficult now under the provisions in the NAFTA successor agreement USMCA on possible agreements with economies not organised in line with market-economy principles.

The impacts of NAFTA are mixed. Only a limited number of sectors are responsible for the positive trade effects: sectors that were heavily protected before NAFTA came into effect, such as the textile industry, sectors with high trade elasticity, such as the oil sector, and sectors with close links to other sectors, such as the automotive and electrical equipment industry. Free trade has primarily benefited large corporations, businesses founded during the time NAFTA was introduced which operate in certain sectors such as transport and workers with more human capital. Enterprises that are situated in the border region with the US and integrated into North American value chains also grow more strongly. In regions with access to international markets and foreign direct investment as well as cross-border migration, wage increases have also been higher than in other regions.

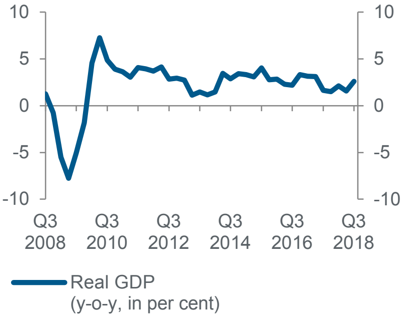
Mexico's migration balance is now only slightly negative. For decades, emigration from Mexico increasingly exceeded immigration. The main destination was the US, generating the world's largest migration corridor. This changed fundamentally in the mid-2000's, however. The lower emigration to the US and increased immigration flows from the US have since nearly converged. According to analyses by the Pew Hispanic Center, immigration from the US may even have predominated. Between 2009 and 2014 approximately 1 million Mexicans and their families, including children born in the US, returned from the US to Mexico. Their destinations are not only the traditional home regions of migrants but also regions that have previously had little to do with migration.

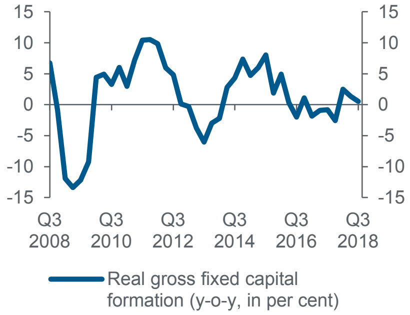
Returnees need to be integrated into the labour market. Returnees bring skills and abilities acquired abroad, particularly for entrepreneurship, and some also bring savings. But it is becoming more difficult for them to actually turn them into advantages in Mexico's labour market. This may be partly due to the fact that they (must) return too soon before they reach their goals and bring fewer resources than they hoped for because of the recession of 2009, the ensuing slow recovery and more intense migration control in the US. At the same time, returnees may potentially be able to help mitigate the skills shortage if they have the right qualifications.

Mexico has a lot of catching up to do in income per capita. Real GDP per capita has been around 40% of the G7 average since the end of the 1980s. Mexico's macroeconomic position is so good that the country can withstand external shocks. But labour productivity remains low and the growth of the past decades has been achieved by more workers, not by higher productivity, which is higher and growing faster in export-oriented large corporations than in traditional businesses. Among the causes identified for unsatisfactory growth performance are high levels of informal activity and in some cases low worker skill levels. This shows that Mexico still has scope to exploit the benefits of its open economy more effectively. ■

Charts

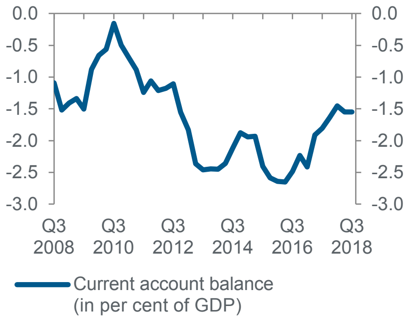
Economic situation

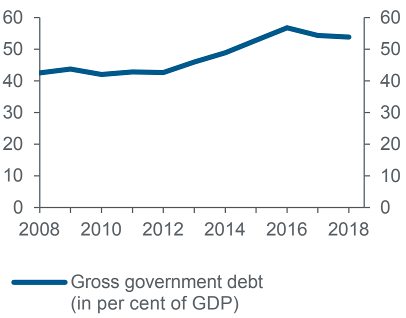


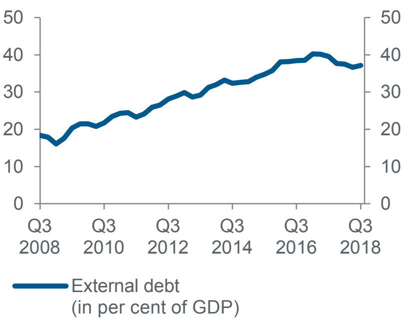


Source: Thomson Reuters Datastream; OECD, World Bank, INEGI; own calculations

Growth financing

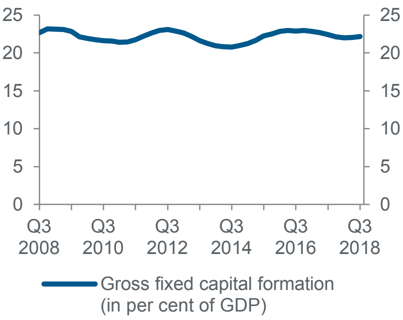


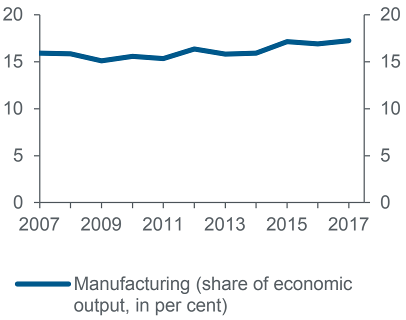


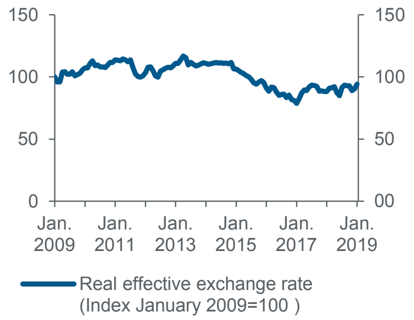


Source: Thomson Reuters Datastream; IMF, own calculations

Growth resources

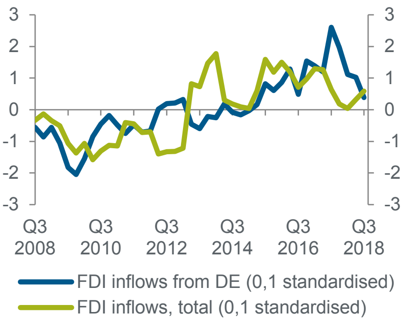






Source: Thomson Reuters Datastream; World Bank, OECD, BIS; own calculations

Economic relations with Germany



Source: Deutsche Bundesbank; Thomson Reuters Datastream; IMF; own calculations.

Method

The Emerging Markets Spotlight examines a selected country on the basis of various macro-economic indicators. These indicators are summarised into the following four blocks: economic situation, growth financing, growth resources and economic relations with Germany

- Quantile 1
- Quantile 2
- Quantile 3
- Quantile 4
- Quantile 5

On the basis of the indicators, we analyse how well the country performs within a comparison group. The comparison group comprises Brazil, China, India, Indonesia, Mexico, Russia, South Africa and Turkey. The examined country is situated within the country group on the basis of the quantile rank. The distribution quantiles are distinguished by different colours (see colour scheme).

The country is assigned to a quintile of the country group for each indicator observed. The identification of the best quintile may vary depending on the indicator. For example, higher growth rates are better, so here the top quintile is coloured dark green, while higher debt ratios are worse, so here the top quintile is coloured dark magenta.

Disclaimer