Economic Viewpoint
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Mexican economy: Its stability contrasts with the rest of Latin America

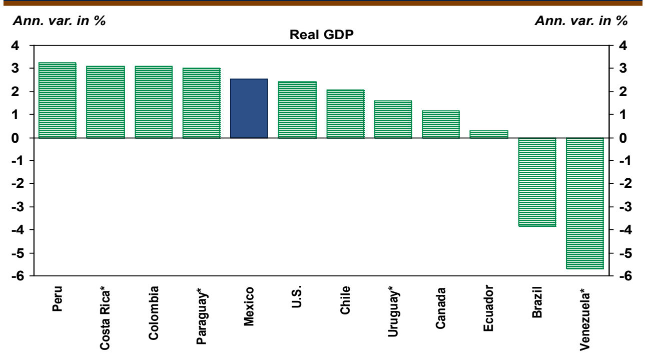
A NAFTA partner that could become more important

Recently, Latin America's major economies have run into a number of problems, especially its largest economy, Brazil. However, Mexico has been showing stability in the last few years. The country has managed to capitalize on both strong relative growth by U.S. domestic demand and a fruitful diversification of its economy. This *Economic Viewpoint* provides a brief profile of Mexico's economy. Mexico is still quite dependent on the situation in the United States, which could be beneficial in the near term. Oil exports are not as critical as they used to be and growth has received more support from manufacturing. However, the Mexican economy's growth is disappointing compared with that of other emerging markets. It is curbed by a number of negative factors, particularly poverty, security and confidence in public institutions.

GOOD RELATIVE PERFORMANCE IN 2015

Mexico's real GDP rose 2.5% in 2015, a much better performance than the 0.9% contraction recorded by Latin America as a whole. During this period, Brazil was in recession, and its real GDP contracted 3.9%, while Argentina only grew 1.2% (graph 1).

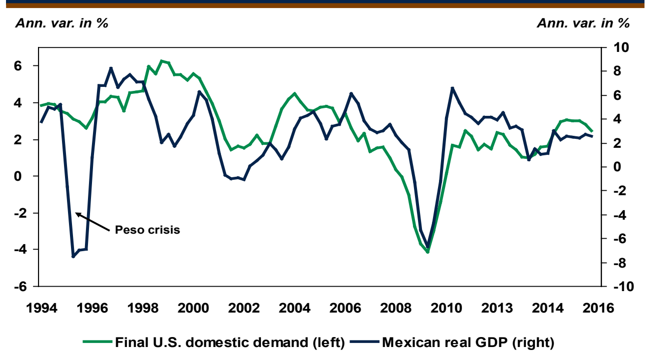
Graph 1 – Mexico posted good relative growth in 2015



* Estimates.
Sources: Datastream and Desjardins, Economic Studies

Mexico's growth also beats Canada's 1.2% real GDP growth. The gap is smaller with the U.S. economy, which advanced 2.4% in 2015. The latter comparison highlights the fact that the Mexican economy tracks its northern neighbour's economic cycles closely (graph 2), stressing the importance of U.S. demand for Mexican output.

Graph 2 – Mexican growth tracks U.S. demand closely



Sources: Bureau of Economic Analysis, Instituto Nacional de Estadistica, Geografia e Informatica and Desjardins, Economic Studies

GROWTH GENERALLY WEAKER THAN THAT OF MOST OTHER EMERGING NATIONS

While Mexico's recent performance is relatively enviable, that has not often been true in the last two decades. Mexico's real GDP grew an average of 2.4% a year from 2000 to 2015. During this period, BRIC nations (Brazil, Russia, India, China) saw their real GDPs rise an average of 7.3% (Brazil at 2.9%, Russia at 4.1%, India at 6.9% and China at 9.5%). The shortfall is also evident when compared with other Latin American countries like Chile (4.3%), Peru (5.2%) and Colombia (4.3%).

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Over the medium range, the slower growth is explained by several factors. Firstly, there are the close ties with the U.S. economy, which went through two recessions during this period, in 2001 and in 2008-2009. Mexico's institutional rigidity, political instability and lack of productivity also contribute to this relative weakness.

A MORE STABLE, MORE DIVERSIFIED ECONOMY

Although growth has been moderate in Mexico, it has also been relatively stable. In contrast with several emerging nations, particularly in Latin America, Mexico did not experience the full effect of the commodity boom in the last decade. On the other hand, it did not suffer the recent backlash. Mexico is enjoying stability thanks to a more diversified economy. The country is less dependent on the vagaries of international supply and demand for certain commodities. Conversely, it is more dependent on domestic demand. Note that Mexican private consumption accounts for 69.3% of GDP. This weight is 63.3% in Brazil, 64.4% in Chile and 63.8% in Colombia. It is even lower in BRIC nations, particularly China (38.2%), India (58.9%) and Russia (53.7%).

Manufacturing is also very important in Mexico, a contribution that makes the economy less dependent on natural resources. Mexican manufacturing accounts for 17.7% of GDP and 78.7% of the country's merchandise exports. In Brazil, manufacturing accounts for just 11.7% of GDP and 34.8% of merchandise exports. Manufacturing clearly dominates in China, accounting for 30.1% of GDP and 94.0% of merchandise exports.

Mexico's service sector (62.3% of GDP) is slightly smaller than Brazil's (70.8%) and Latin America's as a whole (64.8%). It is, however, much bigger than China's (48.1%).

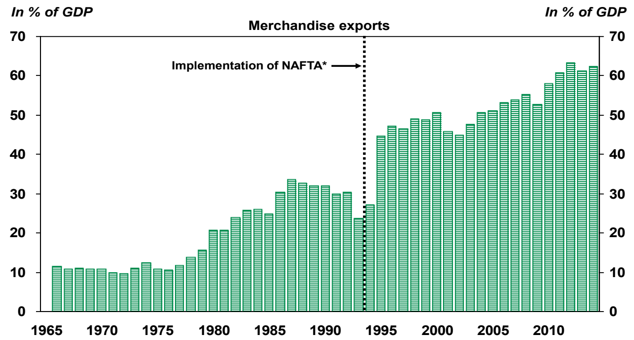
The resource sector remains important for Mexico, nonetheless. The country is still one of the world's leading oil producers, standing 11th in 2014 with 2,784,000 barrels a day, or 3.2% of the world's production. Its oil output has started to decline, however, beginning well before the market shakeout seen since mid-2014. From 2004 to 2014, global oil production rose 9.6% (including a 60.6% jump in the United States, thanks to shale oil, and a 39.4% increase in Canada), while Mexican output shrank 27.3%. The oil sector thus has less weight in Mexico's economy than it once did. Excluding the effects of price fluctuations, oil and gas extraction represented only 5.5% of GDP in 2015, almost half what it did in the mid-1990s. The oil sector is still important in terms of government revenues, but its share is in decline.

MEXICO'S COMMERCIAL BOOM

Mexico's manufacturing sector took off for the first time in the mid-1960s, when the maquiladoras were set up. These export manufacturers, frequently but not always established along the U.S. border, benefit from favourable tariff terms on the importing of equipment and material. The industrialization program attracted many U.S. companies, particularly from the 1980s onward.

A second, even bigger wave was touched off when the North American Free Trade Agreement (NAFTA) came into effect on January 1, 1994. It can naturally be seen in Mexico's merchandise trade, which went from around 10% of GDP in the 1960s to above 30% just before the recession in the early 1990s. In a single year, from 1994 to 1995, it jumped from 27.1% to 44.8% of GDP. Growth did not stop there: in 2014, the ratio hit a peak of 62.5% (graph 3). Mexican exports started to grow more slowly as of the 2000s, mainly due to competition from other emerging countries, with China in the lead.

Graph 3 – The weight of exports in Mexican GDP jumped thanks to NAFTA*



* North American Free Trade Agreement.
Sources: World Bank and Desjardins, Economic Studies

The auto industry is an important element in Mexico's industrial boom. Prior to NAFTA, in 1993, Mexico exported 358,000 vehicles a year to the United States. In 2000, that number had more than doubled, going to 812,900 vehicles. In 2015, 1,380,900 vehicles were assembled in Mexico for the U.S. market. That's more than Canada, which exported 1,332,500 vehicles to the United States last year. Note also that auto sector manufacturing has jumped 79.9% in Mexico since 2000, while it grew 24.1% in the United States and contracted 20.0% in Canada. Automakers have about twenty assembly plants in Mexico, and new plant investment announcements have recently favoured the United States and Mexico over Canada.

Mexico's main appeal for direct manufacturing investment is, of course, low labour costs. There is a huge gap between U.S. and Mexican hourly wages. According to the U.S. Conference Board, manufacturing labour costs (including direct benefits) were US$34.69 an hour in 2013 in the United States. In Mexico, that number drops to US$6.76. The figure is also advantageous compared with hourly costs in Brazil (US$10.59) and Argentina (US$20.07), the other Latin American countries included in the survey. However, China, at US$4.12, and India, at US$1.59 (in 2012) come in below Mexico. If we look specifically at the auto sector, hourly labour costs are US$46.55 in the United States, and US$41.06 in Canada, compared with US$8.19 for a Mexican worker.

Exchange rate movements are among the factors that affect foreign investors' decisions to invest in Mexico (compared with, for example, the United States or Canada). After the shakeout in the mid-1990s, the peso has been on a long, slow downtrend against the U.S. dollar. At the start of 2000, one U.S. dollar was worth about 10 pesos. It is now worth just over 17 pesos. The peso's depreciation therefore boosts the competitiveness of Mexican products in the North American market, and adds to the low labour costs argument. This effect also shows up against the Canadian dollar. A loonie was worth about 7 pesos at the start of the 2000s, and is now worth nearly 14 pesos (graph 4). Canadian dollar appreciation against the greenback or Mexican peso can be one more "against" argument for certain Canadian firms when deciding whether to expand (or keep) production here.

Graph 4 – Since the early 2000s, the Canadian dollar has appreciated almost constantly against the peso

Sources: Datastream and Desjardins, Economic Studies

On the other side of the coin from Mexico's lower production costs is much lower productivity. A study by the Organisation for Economic Co-operation and Development (OECD) ranked Mexico last out of 33 countries (most of them advanced) in terms of GDP per hours worked in 2013[1]. Mexico's performance is equivalent to production of less than US$20 per hour worked. The average for the OECD is nearly US$50. Compared with other Latin American countries, Mexican productivity is in the middle of the pack. The Conference Board data also shows US$20 in output per hour in 2015. This is slightly higher than Brazil (US$17) and Colombia (US$16) but less than Chile (US$27) and Argentina (US$22). Also, productivity growth is fairly deficient. In the last five years, the average annual increase in Mexican productivity is just 0.1%. Although it fell in 2015, Brazil's productivity has gone up by an average of 0.5% since 2010, while Chile's advanced 1.8% and Colombia's rose 2.3%.

AN ECONOMY INTERTWINED WITH THAT OF THE UNITED STATES

The United States is, hands down, Mexico's leading trade partner, as 79.4% of merchandise exports go to the country's northern neighbour. The weight is even higher than it is for Canadian exports to the United States (75.4%). Canada comes in second as a destination for Mexican exports, but a very distant second, at 2.9%. China ranks third, with 1.5% of Mexican exports.

Moreover, most of the more than 3,000 businesses set up under the maquiladora program have direct ties to the United States. About 40% are American-owned, and nearly 50% are Mexican-owned subsidiaries of U.S. firms. The statistics on foreign direct investment show inflows of US$15.1B from the United States, 53% of the total of US$28.4B.

Beyond trade ties, there are also major socioeconomic ties in terms of the Mexican-American population. In 2014, there were 11.7 million Mexican immigrants in the United States, 5.6 million of them unauthorized. Both categories have been declining in the last few years, as the migratory flow reversed a little as of the recession. A U.S. Census Bureau report states that, since 2013, immigration to the United States from China outstripped immigration from Mexico.[2]

People of Mexican origin in the United States maintain certain financial ties which, on the large scale, have a big impact. Fund transfers by Mexican-Americans to Mexico totalled US$24.8B in 2015. This considerable sum exceeds foreign revenue from oil during the same year (US$23.4B).

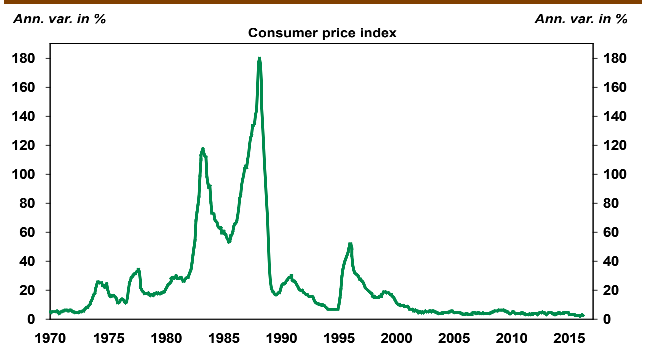
These ties mean that the Mexican economy is heavily dependent on the situation in the United States. Simultaneously, the country's financial health is also

[1] www.oecd.org/std/productivity-stats/oecd-compendium-of-productivity-indicators-22252126.htm.

[2] researchmatters.blogs.census.gov/2015/05/01/china-replaces-mexico-as-the-top-sending-country-for-immigrants-to-the-united-states/.

very bound up in financial movements that occur in the United States. Now that the country's inflationary history is behind it (graph 5), the Bank of Mexico's (Banxico) monetary policy is very tied to the Federal Reserve's (Fed), because it puts a lot of emphasis on minimizing movement between the peso and U.S. dollar. For example, the day after the Fed ordered key rate increases in December 2015, Banxico announced firming of the same amount. However, to keep the peso from depreciating too steeply against the greenback, Banxico leaders surprised markets in February 2016 by increasing its key rate by 50 basis points. In 2015, Mexico used 12.7% of its international reserves (US$24.5B) to support the peso in currency markets.

Graph 5 – Inflation is now quite low in Mexico



Sources: Instituto Nacional de Estadistica, Geografia e Informatica and Desjardins, Economic Studies

PERSISTENT PROBLEMS

Mexico's industrial boom and its economy's relative stability hide some weak factors that are quite persistent.

Poverty and income inequality – As in most emerging markets, there is substantial income inequality in Mexico. National income per capita was US$16,840 in 2014 (based on purchasing power parity), slightly above the level of US$15,226 recorded for Latin America as a whole, but well below the average for advanced nations, which sits at US$40,732. Moreover, approximately 40% of the revenue goes to just 10% of Mexicans. According to the United Nations (UN), 52.3% of Mexico's population was living below the national poverty line in 2012; extremely high, this level has gone up in the last ten years. Only 8.9% were below the poverty line in Brazil and 14.4% in Chile. This situation is fuelling some frustration among Mexicans, who don't feel like they are benefiting from the macroeconomic progress made in recent decades.

Regional disparities – Income disparities within the Mexican population are also apparent among Mexico's different regions. According to the OECD, about 76% of the population of Chiapas (the southernmost state) was living in poverty in 2014, compared with 20% in Nuevo León, the northern state with the least poverty. Mexico is the OECD member with the strongest regional disparities, followed by Chile, in second place.

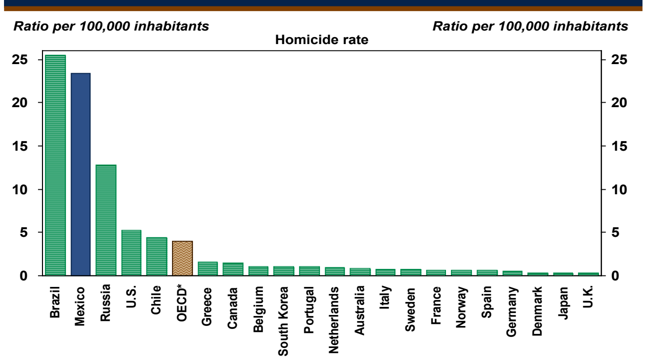
Informal employment – More than 50% of Mexicans held informal employment (undeclared, often individual ownerships). This rate went up substantially during the recession. It is much higher in Mexico than in Brazil (32.2%), Colombia (40.7%) and Chile (15.4%).

Pollution – In 1992, the UN declared Mexico City to be the most polluted city on the planet. Pollution is now much worse in the major cities of Asia, particularly in China and India. However, the problems, especially smog, have not been fully resolved, despite the substantial improvement of the last two decades. Mexico City recently had to institute measures to restrict use of passenger vehicles and temporarily suspend public works.

Crime – Crime problems often head the list of the main concerns about Mexico. One in five Mexicans was a victim of crime in 2014. The crimes of assault, fraud, extortion and threatening behaviour have been on the rise recently. These problems are often associated with drug trafficking. The homicide rate is 23.4 out of 100,000 in Mexico, well above the OECD average of 4.0 out of 100,000 (graph 6).

Corruption – Corruption is particularly endemic in Mexico. The Transparency International Corruption Perceptions Index,[3] in which rank increases as the perception of corruption rises, puts Mexico in 95th place out of 167 countries, ahead of Brazil (which ranks 76th) and Colombia (83rd). In particular, corruption affects the political parties, the police, and the justice system. Mexicans have very little confidence in their public institutions.

Graph 6 – Mexico continues to grapple with a crime problem



* Organisation for Economic Co-operation and Development.
Sources: Organisation for Economic Co-operation and Development and Desjardins, Economic Studies

[3] www.transparency.org/cpi2015.

Together, these negative factors hurt the country's reputation, affecting business confidence and curbing investment, particularly foreign investment. They are among the reasons that Mexico's economy has not flourished to the same extent as other emerging markets, after the initial surge stemming from the opening up of trade with the United States. For example, the proportion of companies that wanted to set up outside of China and showed interest in Mexico fell from 70% to 29% from 2011 to 2014. Among other issues, these investors reported concerns about security and corruption scandals.[4]

MANY CHALLENGES REMAIN

Mexico's economy is very well placed to capitalize on the current growth cycle in the United States. The strong ties with its northern neighbours and greater industrial diversification mean that Mexico is less plagued by the problems currently facing many emerging nations. Over the longer term, it will no doubt be profitable to broaden the avenues for Mexican production. Mexico's participation in the Trans-Pacific Partnership and other free-trade agreements is also encouraging. Making a larger proportion of its population wealthier would also be a good thing, to foster a middle class and sound domestic consumption. Achieving this would take more productive investment, improvements to the education system, additional efforts to enhance worker productivity, a stronger rule of law (to fight corruption and crime), and rebuilding a degree of trust in public institutions. Meeting all of these challenges would finally allow Mexico's economy to achieve the development and growth that has often been promised, but never truly realized.

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[4] www.wilsoncenter.org/article/mexico-the-unbearable-cost-distrust.