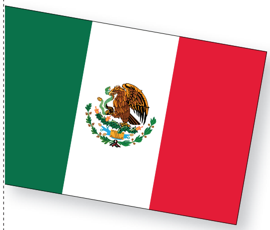


Mexico

Mexico's sound macroeconomic and financial fundamentals are reasons why it is tipped to be one of the great growth stories of the next decade, writes Carlos Serrano

Mexico is one of the countries that we at BBVA Research call 'EAGLEs'. This is an acronym for emerging and growth-leading economies, a term used to label those emerging countries that will grow at higher rates than the average of the leading advanced economies during the next decade. The EAGLEs are Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan and Turkey. Indeed, Mexico's growth over the past couple of years has been at around 4%, despite the difficult global economic environment.

Mexico's good prospects are based on sound macroeconomic and financial fundamentals. On the macroeconomic front, the country has followed a responsible fiscal policy for several years. As a result, it shows better indicators than many countries, advanced and emerging. It has a fiscal deficit of 2.5% of GDP and total government debt of 43% of GDP. Not only are these debt levels low, but the composition of the debt is quite resilient. Most debt is denominated in local currency and placed at relatively long terms. For example, in 2011, Mexico placed a 100-year bond in international markets.

On the monetary front, Mexico's central bank, Banco de México, has been independent for 20 years and it is widely recognised for its prudent policies. Inflation has been below 4.5% for several years and it is firmly converging on its 3% target. Financial authorities have adopted a flexible exchange rate regime that has helped to absorb external shocks in an orderly way. Foreign reserves stand at $180bn. On top of this, the country has a flexible credit line for $73bn with the International Monetary Fund. These credit lines are only given to countries with strong policy frameworks and are designed as precautionary tools. Moreover, the country shows comfortable levels of current account deficit: 1.2% of GDP.

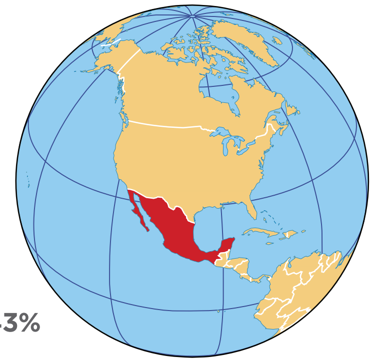
Adding to this picture of macroeconomic stability is the soundness of the Mexican financial system. Mexico's banking sector is among the best in the world in terms of solvency. In December 2012, regulators adopted the Basel III capital framework – without a transition period – and all banks complied with the minimum 10.5% capital adequacy ratio. The average for the system is 16%. In addition, banks are in a very good position from the standpoint of liquidity since the loan-to-deposit ratio is at around 90%. The good health of the banking system can be traced back to Mexico's financial crisis of 1994. The country learned the lessons that many other countries have been learning since the global financial crisis of 2008. As a result, the Basel III capital framework is surprisingly similar to the capital regulatory regime that Mexico already had in place. On top of that, Mexico created the Financial System Stability Council, which is composed of the main financial authorities and is in charge of spotting systemic risks and proposing macro-prudential tools to mitigate them.

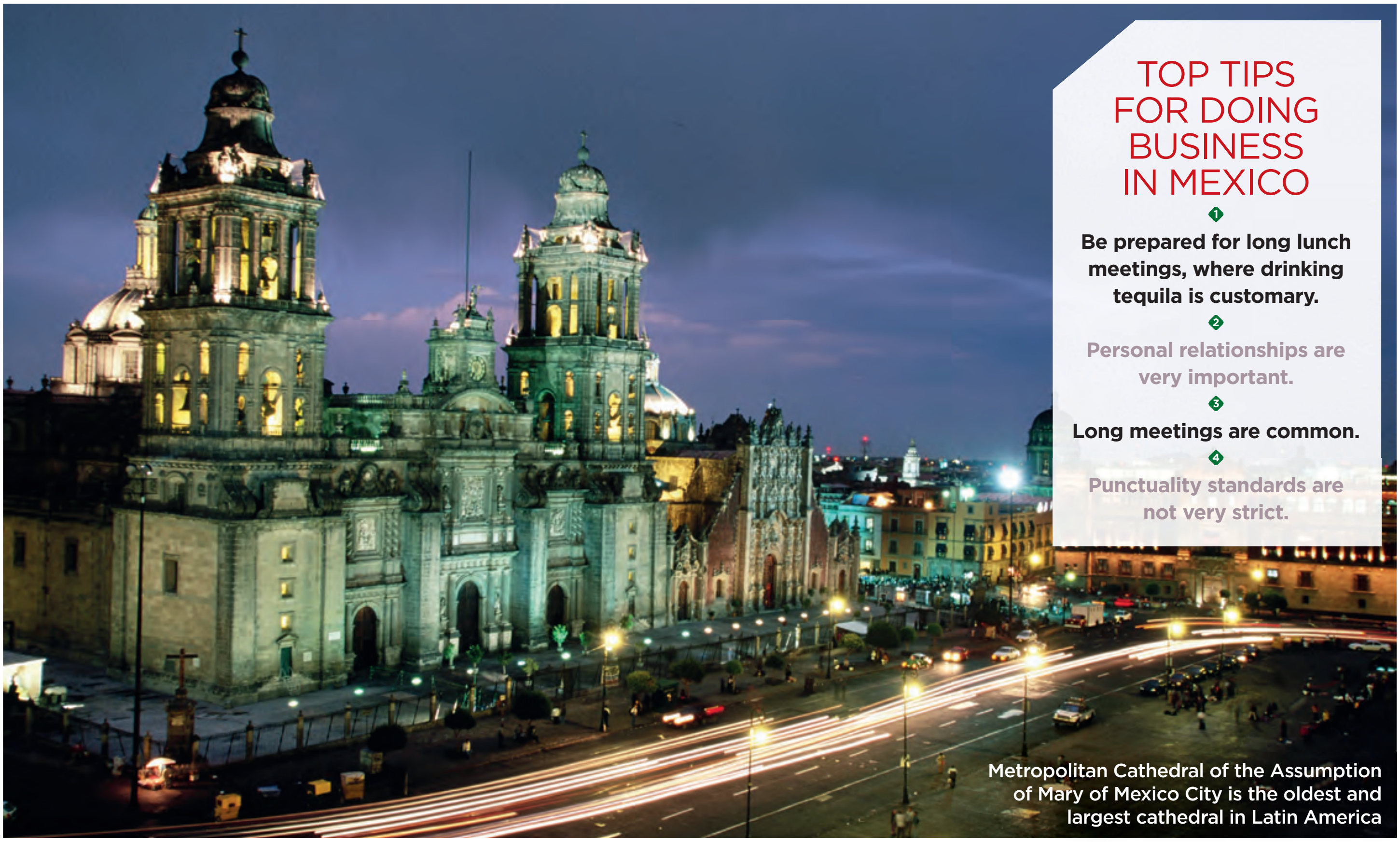
Mexican banks have huge potential to grow, since their level of market penetration is very low, considering the level of economic development. Bank credit to the private sector as a percentage of GDP is 25%, significantly lower than other Latin American countries, such as Brazil (54%) and Chile (62%). But the conditions are set for this situation to change. In fact, during the past few years, credit provided by the private sector has been growing at real rates of about 4%, around three and a half times the growth rate of the economy. This has been made possible by a consistent growth in financial savings.

Mexico has embraced free trade policies with a strong determination. It is one of the most open-to-trade economies in the world and its export sector has recently been very dynamic. The country has gained in competitiveness as the labour cost gap with China has narrowed and also due to its proximity to the US market.

COUNTRY FILE

Population size: **114.8 million**
Area: **1,964,375 km²**
% growth in 2012: **3.9**
Type of govt: **Federal presidential constitutional republic**
Official language: **Spanish**
Largest city and capital: **Mexico City**
Largest state: **Chihuahua**
GDP (PPP): **$1.758 trillion**
Central govt debt as a proportion of GDP: **43%**
Currency: **Mexican peso**
Currency rate against the dollar: **12.8**





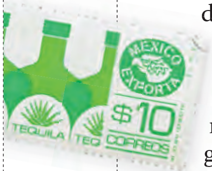
TOP TIPS FOR DOING BUSINESS IN MEXICO

1. **Be prepared for long lunch meetings, where drinking tequila is customary.**
2. Personal relationships are very important.
3. **Long meetings are common.**
4. Punctuality standards are not very strict.

Metropolitan Cathedral of the Assumption of Mary of Mexico City is the oldest and largest cathedral in Latin America

Around 75% of Mexican exports go to the US. Mexico is the US's second trading partner after Canada. Recently, exports have shifted from pure 'maquiladora' products (assembled items) to more value-added sectors, in particular in the auto and aerospace industries. Mexican workers have become highly productive in these sectors. As a consequence, many large companies have announced plans to build plants in Mexico, including Audi, Eurocopter, General Motors, Honda, Nissan and Volkswagen.

Despite all these strengths, the country faces big challenges. Government revenues are very low. Non-oil tax revenues are less than 10% of GDP, the lowest level in the Organisation for Economic Co-operation and Development. Oil revenues provide around a third of government income. With these low levels of government revenues, the country has not been able to make much-needed investments in infrastructure, something that has had a negative impact on productivity levels. One factor that explains the poor fiscal capabilities of the Mexican state is the high level of informality. Around 50% of the economically active population works in the informal sector (part of the economy that is not taxed), which has lower productivity levels than the formal one.



The current institutional framework in Mexico imposes severe restrictions on the oil sector. According to the constitution, only the state oil company (PEMEX) can exploit the country's vast oil and gas reserves. Not only that, it is not allowed to associate with private companies in order to do so. As a result, PEMEX does not have enough resources to invest since it cannot get them from the private sector and it cannot generate them internally due to the very harsh tax regime it faces. Hence, the country has not been able to exploit the vast oil reserves that lie in deep waters, nor the important stock of shale gas that it has within its borders.

In order to tackle these problems, the government is working on fiscal and energy reforms that are aimed at: i) increasing government revenues; ii) creating incentives for firms and workers to become formal; and iii) releasing PEMEX from its huge fiscal burden and allowing it to engage in partnerships with the private sector.

After years in which Mexico did not see any significant structural reforms, this time there is reason to be more optimistic about the prospects of the above reforms successfully passing through Congress. This reason is the *Pacto por México* or Mexican Pact. The pact is an agreement between the current government and the three main political parties to design and approve the necessary reforms that the country needs to boost its productivity and, as a result, achieve higher growth rates.

As part of this pact, the country has already approved a reform to the telecommunications sector, which will increase competition and attract higher levels of investment, as well as an educational reform that aims to improve the quality of education by introducing evaluation methods for teachers.

At BBVA Research, we estimate that if the main structural reforms that are contained in the pact are approved, Mexico's potential growth rate can increase by around 1.5 percentage points. Despite some important structural problems, there are reasons to be optimistic about Mexico these days.

Carlos Serrano is head economist for Mexico at BBVA Research