Insights on Mexico - NAFTA, Reforms of Mexico & Lessons learned from China

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We will start our article with a hypothetical case and a positive scenario for a future Mexico and then explore what would be necessary for Mexico to achieve this.

This is what a future Mexico could be looking like:

The country is finally lifted from its historical weariness. It is caught up in growth with dynamic Emerging Markets such as China, India or Asian cubs and is no longer associated with the growth of developed markets. Tackling crime in full still has a long way to go. However, Mexico has at least assured the majority of its citizens a degree of security and rule of law that was for a long time thought to be unreachable.

This scenario has been inspired from the momentum in 2012/2013 when current President Enrique Peña Nieto had just been elected and offered something his predecessors did not: He was able to get all parties to sit at the same table for the first time in Mexican history and reverse the legislative deadlock that had plagued Mexico's former leaders – as they had failed to proceed with reforms. Following elections, President Nieto accomplished several reforms, including the energy reform and telecommunications reform.

Pemex, the national oil company of Mexico, used to be a symbol for national pride. Pemex's monopoly was written in the constitution and it was widely assumed it could not be challenged because in people's perceptions, it was the monopoly that ensured that oil produced in Mexico would only belong to the people of Mexico. In spite of these past perceptions, the energy sector slowly opened up under President Nieto. By now, legislation for energy reform has been passed. Regulation is complete. Pemex has already done several rounds of bidding. Hard to believe, but foreign firms can indeed look for oil and manage fields in Mexico now. Solutions for Pemex's inefficiencies, debt problems and lack of technology are finally underway.

Telecommunications reform is also complete. TelMex was the national telephone company that was bought by Carlos Slim. It used to be run with monopolistic features as Carlos Slim arguably kept the regulator under his thumb for over twenty years. Recently, TelMex was forced to open up also. Subsequently, TelMex profitability suffered, but telecom prices fell dramatically, leading to a positive momentum for consumers.

The progress on these crucial reforms is encouraging and meaningful, but they may not necessarily translate into growth right away. Observers sometimes assume "reforms=growth" and they get overly excited. In reality, a true definition is "growth= labor + capital + productivity". This means any progress in reforms needs to be accompanied by progress in these real drivers of growth.

First of all, productivity has never been a strong suit of Mexico. A genuine solution will take a long time. Productivity among small businesses has fallen by 6.5% a year and it has grown among midsized businesses only 1% a year between 1999 and 2009.[i] To this date, there has been no improvement in these numbers.

Many explanations have been put forth to justify traditionally low levels of productivity in Mexico. These include a lower ability to access bank credit compared to average rates in OECD countries or a lower capability for innovation in manufacturing sector compared to competitors.

Another suggestion is that Mexico entered manufacturing around the same time as China. This suggestion makes a lot of sense. This is because it is really hard to beat China. The reasons can be found in the differences in education and labor for both countries. China has moved from a peasant based uneducated rural economy to an educated manufacturing focused society in one generation flat. The country has moved a third of its population from rural to urban areas in about 25 years. In fact, it is very interesting that China never even did proper reforms, but even in the absence of major reforms they were able to raise productivity to much higher levels simply by moving the labor force from primary to tertiary industries. They also increased productivity by emphasizing education. This is how China beats its competitors.

China's example brings us to the education reform of Mexico. Mexico will make a genuine progress in productivity if they can confront education.

Secondly, capital is crucial in this equation. Access to capital is almost always deeply intertwined with rule of law in a country. The willingness of people to invest (both domestic and foreign) is impacted by how much investors are able to trust in government institutions.

Unfortunately, right after low productivity, weakness in the rule of law may be the next most important obstacle Mexico will need to overcome to be able to achieve higher growth rates in the future. Rule of law is worse compared to many EM countries because flaws exist in all levels of Mexico's institutions. A few examples are as follows: banks don't lend as much as they should because they require more trust in court systems for collections; people are not entrepreneurial beyond "mom and pop shops" because of lack of trust in institutions; many large corporations have weak corporate governance in a system that has thrived for many years in form of monopolies/duopolies and their close ties to the government. This situation is most certainly detrimental to the flow of capital into Mexico.

All that said, Mexico has been successful in attracting capital in markets governed by NAFTA exports to the USA as foreign investors get comfort that the ultimate market is the U.S. and not Mexico through the NAFTA trade agreement. They feel reassured by the protection of the U.S. rule of law. According to an article in the Financial Times, Mexican officials recently have been contemplating to incorporate some of the institutional safeguards of NAFTA into their constitution— just in case NAFTA talks fail. [ii]

NAFTA trade agreement also produces a defined rule of law and clarity for many businesses, which operate in cross border trade. Crucially, FDI in Mexico is mainly focused around NAFTA benefits, which is very different than FDI in Asia where investments flow targeting the domestic market. This may explain why, over the years, Mexico fell behind China as an FDI recipient. In 1995, China was the largest FDI recipient to emerging economies, accounting for 33%, while Mexico was second, accounting for 8.5%. Since 2008, China has remained the largest, 14.8%, and Mexico has fallen to seventh, at 3.2%.[iii] China to this date remains the largest FDI recipient among emerging markets.

Purely from Washington's point of view, it would also not be sensible if NAFTA trade negotiations did not end up succeeding. The United States currently experiences many uncertainties related to its immigration policies. United States would then be eliminating one of its best possible solutions to resolve immigration-related concerns, because more prosperity in Mexico means much fewer people migrating to the U.S. in the future.

So far involved parties seem intended to continue NAFTA trade agreement during a time when capital markets are shaken by thoughts of trade wars elsewhere.

Lastly, we will discuss one final reform with significant impact - the fiscal reform. As stated at the beginning of the article, reforms will not do anything on their own. Reform is not equal to growth. The fiscal reform in Mexico is a great example; it was meant to set the fiscal situation in order but was initially negative for growth and depressed the economy in early 2014. The hope was that over time a stable fiscal situation would make Mexico more attractive for investors and encourage growth as foreign capital flows in. The fiscal reform indeed was successful. When oil prices declined, the fiscal reform helped increase the non-tax revenues.

Investors joke these days about the timing of the decline in oil prices in the case of Mexico. In the years prior to energy reform, oil prices ran a bull market but Mexico was not ready. As soon as Mexico was ready for change and passed the energy reform, oil prices collapsed. But then no one has ever accused Mexico of being too lucky.

Recently, we saw other encouraging news related to Pemex: they made the largest onshore oil discovery in 15 years. [iv] It was an irony that in the past Pemex was sitting astride a similar geology, however at a time when its northern neighbor (United States) was seeing a resurgence of technologically led oil boom, offshore U.S. Gulf of Mexico saw its production fall. Maybe, in the future, as more international technology flows into Mexico, we will see a booming oil sector there too. Hopefully, all this will materialize soon. Mexico is certainly due for some good luck come its way for a change.

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