Euler Hermes Economic Research

Economic Insight

Mexican exports: Time to bring in the Mariachis?

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Executive summary

- Driven by U.S. demand, non-energy exports will continue to grow at a dynamic pace, increasing by +USD25 bn in 2015 and +USD30 bn in 2016, with the automotive and electronic sectors being particularly well performing.
- Mexico's export success relies on three pillars: (i) very competitive labor costs thanks to moderating wages; (ii) a rollout of sector reforms; and (iii) very effective Free Trade Agreements.
- In the short-run we see two main risks to this export success story: (i) volatile international financial variables (exchange rates, oil prices); and (ii) fiercer competition with China in the U.S. market (electrical and electronic goods).

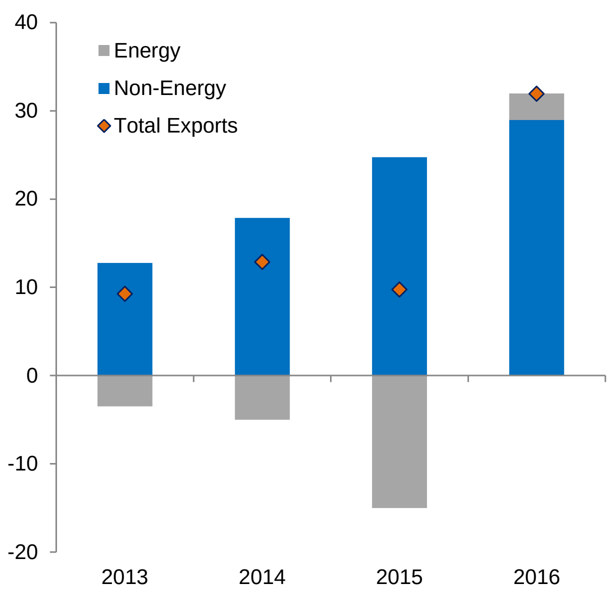
Mexico is among Euler Hermes' Top 10 export winners in 2015 and 2016

Mexico should continue to show strong export performance in coming quarters. Euler Hermes expects real exports to grow by +5.0% in 2015 and by +5.3% in 2016, driven by strengthening demand in the United States and improved competitiveness of local Mexican industry.

Cumulative export gains are estimated to reach +USD40bn in 2015-2016 (Chart 1), similar amounts to those recorded by Taiwan or Hong-Kong, placing Mexico among the top 10 export winners worldwide (see our Economic Outlook "Global Trade: What's cooking?"). These gains would bring the amount of total exports above USD450bn in 2016, slightly increasing Mexico's global market share to 2.2% (vs. 2% in 2012) and solidifying Mexico as the regional export leader in Latin America (Brazil, the second largest, exports around 60 % less).

Energy exports will be strongly affected by low oil prices. The fall in energy exports recorded by Mexico over the past three years (due mainly to a decrease in oil production) will accelerate in 2015, reaching -USD15bn. We anticipate a slight recuperation in 2016 (+USD4bn) due to the recovery of prices, as the volume of barrels produced should stagnate at around 2.5 mn barrels per day.

Chart 1: Mexican exports gains (USDbn)



Sources: IHS, IFS-IMF, National Sources, Euler Hermes forecasts

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Non-Energy exports will more than offset the fall in energy exports and are expected to gain +USD25bn in 2015 and +USD30bn in 2016. Export of Chemicals, Non-ferrous metals and Iron and steel will however show poor performance. The Chemicals industry will continue to be hampered by their better performing counterpart in the U.S. allowed by low natural gas prices following the exploitation of shale gas in the U.S. It will also suffer from the sharp slow-down in economic activity in other Latin American countries (Brazil, Argentina, Venezuela) as they account for 20% of total Chemicals exports. Exports of Non-ferrous metals and of Iron and steel will broadly stagnate, hindered by falling metal prices and Chinese economic deceleration.

U.S. demand will drive Mexico's export gains, supporting the automobile, electronic and electrical industries

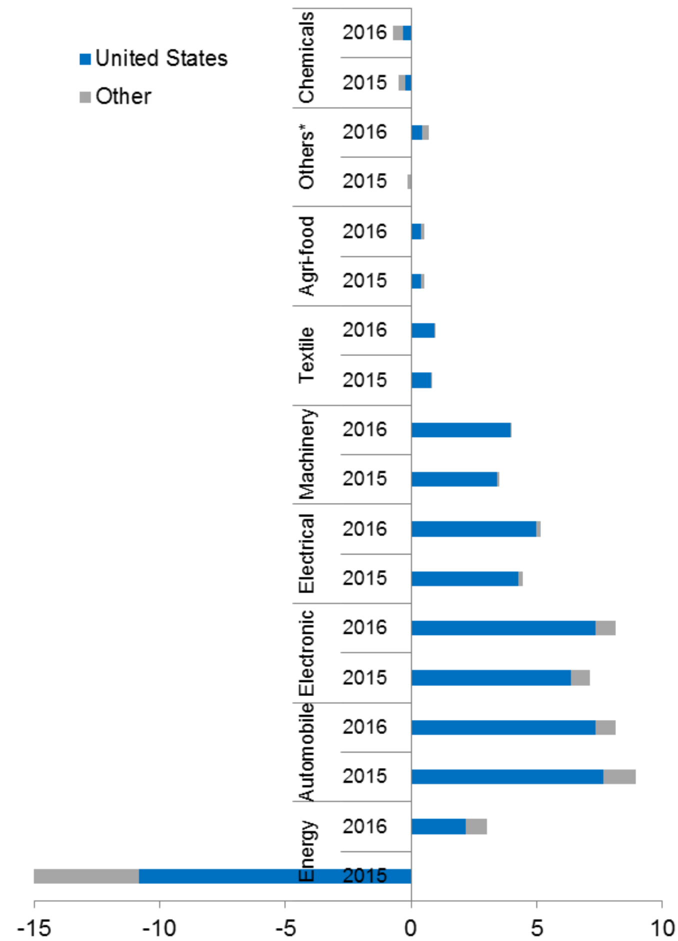
It is no surprise that the U.S. will be the main driver of non-energy exports gains, as it accounts for at least 70% of total exports in most of the sectors (Chart 2)**.** Euler Hermes expects GDP growth in the U.S. to reach +3.1% in 2015 and +3% in 2016, after +2.4% in 2014. In fact, American demand for non-energy Mexican goods should increase by +USD22bn in 2015 and +USD25bn in 2016, accounting for close to 90% of the country's exports gains.

Mexico is fully benefitting from the reindustrialization process ongoing in the U.S. In this context, the proximity of Mexico to the North American giant has become again a major asset. Over the past 3 years, Mexican (re) integration with the American manufacturing processes and value chains has been reinforced with the setting up of industrial zones and assembly factories (*maquiladoras*) along the U.S. border, that are producing mainly for the American market.

The automobile sector will be the major winner, with exports increasing by +USD9bn in 2015 and +USD10bn in 2016. Mexico has become an important player in the global automobile market. It is the 8th largest producer in the world, making over 3.5% of total units, and the 4th largest exporter, accounting for around 10% of global exports. More than three out of four vehicles produced in Mexico are exported, mainly to the U.S. Over 70% of Mexican vehicle exports and 90% of automotive equipment exports are bound for their American neighbor. The Latin American country is the U.S.' first supplier of vehicle and car components (Chart 3), where one of every ten cars sold comes from Mexico.

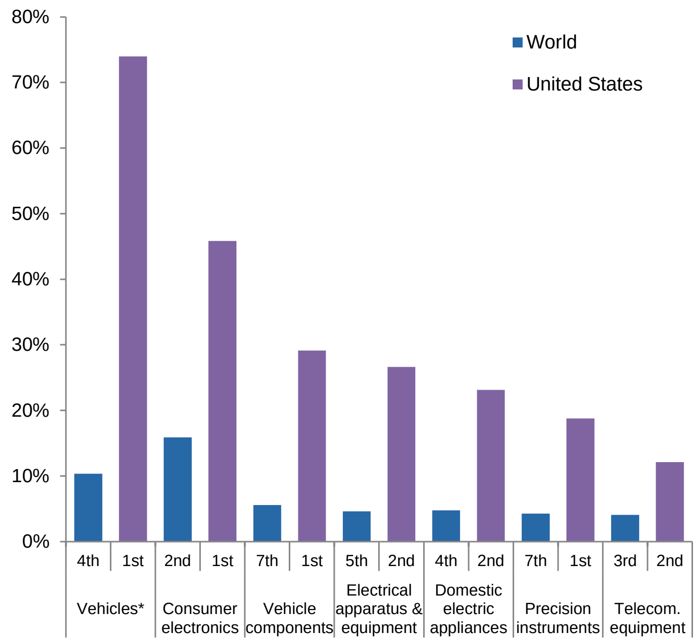
Electric and Electronic sectors will also fuel export revenues over 2015-2016. Mexico is well-positioned both in the U.S. and globally in these fields thanks to important foreign investment over the past years that allowed not only setting up of assembly industries, but also the development of engineering and design centers. Mexican exports of electronics have doubled since 2005, allowing the country to become the 2nd largest worldwide supplier in Consumer electronics, the 3rd in Telecom equipment and the 4th in Domestic electronic appliances.

Chart 2: Export gains – Top sectors by destination (USDbn)



**Iron and steel, Non-ferrous metals and Wood and paper*
Sources: Euler Hermes forecasts

Chart 3: Mexico's shares as supplier and exporter



**Mexico is the 4th supplier of Vehicles in the world and accounts for 10% of total global exports of vehicles. Mexico represents 75% of total U.S. imports of vehicles.*

Mexico's export successrelies on three pillars: labor costs, reforms and openess

In addition to the business cycle, Mexico has clearly adopted a medium-term strategy aiming to enhance the competitiveness of local industries and increase their export potential.

Pillar #1: Competitiveness and productivity

Mexican competitiveness in the manufacturing sector has significantly improved. According to U.S. Bureau of Labor Statistics, the hourly cost in the Mexican manufacturing sector stood at USD6.4/hour in 2012, below those of several Eastern European countries (Poland: USD8.3, Hungary: USD8.9, Czech Republic: USD11.9), and, notably much lower than those of other Latin American peers (Brazil: USD11.2, Argentina: USD18.9). Although it still remains far above Philippines', India's or China's (below USD3.0), the cost gap has significantly decreased since the early-2000s (Chart 3). This improvement is also notable in productivity as measured in the real unit labor cost (Chart 4)

Pillar #2: Sector reforms to improve the business environment and reduce costs

In 2012, Mexico engaged a very ambitious structural reform agenda. The **Energy Sector Reform,** that opened hydrocarbons and electricity sectors to private and foreign capital, should encourage investment in the sector in the short-run, driving up foreign direct investment, and lowering energy costs in the medium-term. The **Labor Market Reform** aims to increase flexibility which would result in improved cost-competitiveness of the Mexican labor-force, while the **Education Reform** aims to enhance human capital, strengthening Mexico's non-cost competitiveness. Last but not least, the **Financial Sector Reform** should ease corporations' access to financial products and services while reducing financial costs.

Pillar #3: Number 1 for Trade Openness

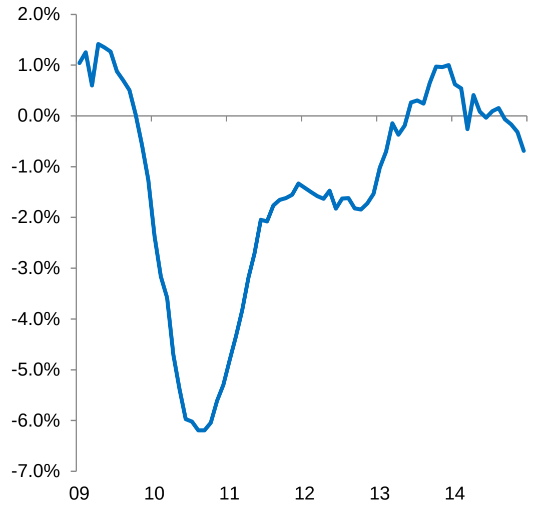
Although the proximity of Mexico to the United States counts, the framework of the North American Free Trade Agreement (NAFTA), signed in 1994 (with Canada too) is the real guarantor of their bilateral trade. Taking the example of the benefits that NAFTA brought, Mexico has multiplied its trade agreements over the past decades with the European Union (6% of exports), Northern European countries, Israel, Japan and Latin America, to become the top holder of FTAs worldwide. Even if for the moment Mexican exports remain extremely concentrated on the North American market (NAFTA accounts for 82% of exports), these agreements will be a major asset for the partner diversification targeted by the government. It's worth mentioning that trade with non-FTA countries has increased importance, and represent now 5.6% of Mexican exports against 4% in 2009. Among these, China and Brazil are major players in the development of non-FTA Mexican trade. Mexico is the most open country in Latin America, as the modulus of exports and imports represent 65% of GDP, a similar rate to Switzerland, Morocco or Portugal.

Table 1: Hourly compensation costs in the manufacturing sector (USD/hour)

2002			2012	
USD/hour	Country		Country	USD/hour
27.4	United States	higher cvost	United States	35.7
13.8	Spain		Spain	26.8
6.8	Taiwan		Argentina	18.9
6.7	Portugal		Portugal	12.1
5.6	Mexico		Czech Rep.	11.9
4.6	Czech Rep.		Slovakia	11.3
4.2	Hungary		Brazil	11.2
4.1	Poland		Estonia	10.4
3.2	Slovakia		Taiwan	9.5
3.1	Estonia		Hungary	8.9
3.1	Brazil		Poland	8.3
3.0	Argentina		Mexico	6.4
1.0	Philippines		Philippines	2.1

Sources: US Bureau of Labor Statistics, Euler Hermes

Chart 4: Unit labor cost evolution in the manufacturing sector (growth over 12 months)



Sources: Banco de México, Euler Hermes

Table 2: Structural reforms in progress

Sector reform	Date of approval
Financial sector reform	January 2014
Energy Reform	December 2013
Fiscal Reform	October 2013
Education reform	September 2013
Telecommunication sector reform	Mid-2013
Labour market reform	Late 2012
Governance and transparency reform	Pending

Sources: IMF Article IV on Mexico, Euler Hermes

What could go wrong?

Despite the good outlook for Mexican exporters, two major risks can hamper our central scenario.

Risk #1: Uncertain external conditions – Fed's rate decision will be key

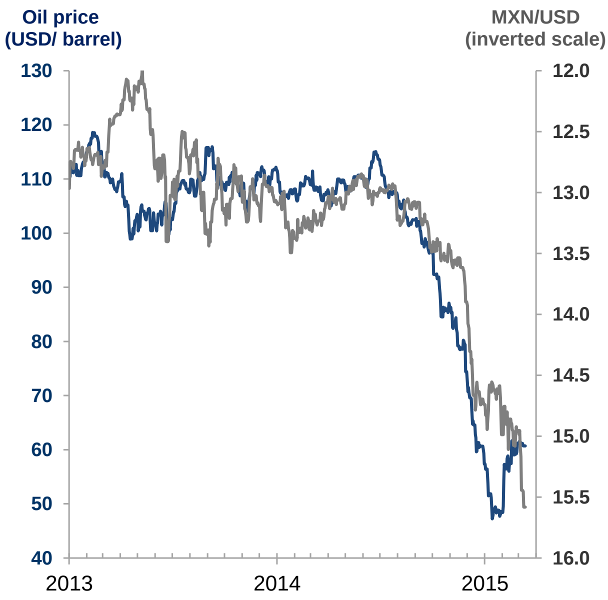
The external environment will remain extremely uncertain in 2015, and the Mexican peso will continue to be plagued by high volatility. Over September 2014 and March 2015, the peso depreciated to the USD by 15%. While the peso should strengthen, supported by gradually recovering oil prices (both are highly correlated, Chart 5), downward pressures might be generated by tighter external financing conditions derived by the Fed's tapering. Timing and spillovers of the Fed's key rate increase (expected in H2-2015) will be critical. If U.S. growth is affected, it could negatively impact demand of Mexican goods. If credit conditions worsen, the financing for Mexican exports could also be affected.

Risk #2: The race for the U.S. market currently has two front runners: China and Mexico

Enhanced export competitiveness over past years allowed Mexico to regain market share in the U.S. Mexico accounted for 12.5% of American total imports in 2014, against 11% in 2012 and 10% in 2010. However, this did not happen at China's expense, as its share in U.S. imports has continued to increase to nearly 20% in 2014. Since Mexico and China's main exports to the U.S. are similar, China will fight to maintain market share in the American market - its premier export destination. This is especially probable being that the transformation of the Chinese economic model might take more time than expected as Chinese authorities seem more inclined to preserve strong real growth for maintaining social cohesion. Consequently, exports will remain key in the short-run for Chinese authorities. As a matter of fact, the controlled currency appreciation led by Chinese authorities since 2007 stopped in late-2013, with a depreciation of the currency over 2014 (-2.5 % y/y in December 2014). We expect the authorities to maintain the currency at a favorable level for exporters in 2015 (6.25 RMB/USD) (see "China growth - what could possibly go wrong?").

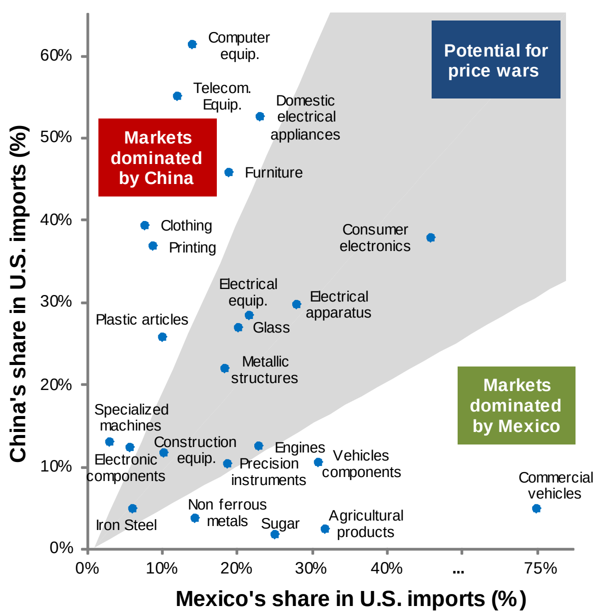
The sectors where China and Mexico have similar and high market shares in the U.S. are the most sensitive to Chinese competition. Without surprise, Electronic and Electrical industries, Consumer electronics, Electrical apparatus and Electrical equipment are in the war zone (Chart 6). Regarding the automobile sector, Mexico seems to be dominant, while China maintains control of Computer and Telecommunications equipment, along with Domestic electrical appliances and Furniture (Chart 6).

Chart 5: Exchange rate and oil price



Sources: IHS, Euler Hermes

Chart 6: Mexico and China market shares in the U.S. (% of total imports of the U.S.)



Sources: IMF-IFS, National sources, Euler Hermes

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