Chapter 8

Integrating Mexico into the World Economy through Trade and FDI

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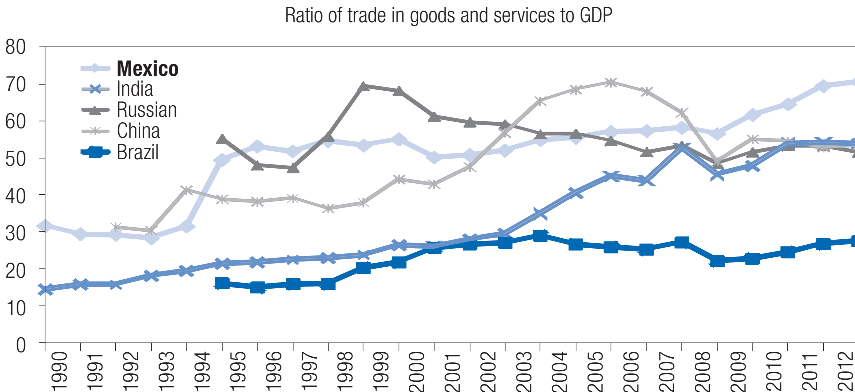
Over the past two and a half decades, Mexico has progressively integrated into the world economy and become a regional economic powerhouse. Yet, the country has the potential to realise even larger dynamic, growth-enhancing gains from trade. It would benefit from developing trade flows to new destinations, especially those that can allow a greater integration with fast-growing economies. Likewise, the sophistication of export activities towards higher-valued tasks would foster productivity. In this context, the development of its services sector would offer new opportunities for trade and for the development of a knowledge-intensive economy. This requires developing strong, innovative and flexible supply chains that can feed into global specialisation and distribution systems. Here, improving competitiveness and easing regulatory barriers – notably restrictions on foreign investment and on competition in "backbone services" of the economy – is essential. This would both help promote exports of goods and services, and support the overall competitiveness of the Mexican economy.

Mexico's economy has changed remarkably over the past two decades, with the abandonment of import substitution policies in favour of outward orientation and integration into global markets for goods and services. The country's sustained trade liberalisation led Mexico to become the world's 14th largest exporter of goods, and the 35th largest exporter of services. The degree of trade openness (ratio of total value of exports and imports to GDP) doubled over the same time frame, and now represents 60% of GDP – above the levels of all four of the "BRICS" economies (Figure 8.1). Mexico is thus one of the most integrated economies into world markets. This opening has helped support growth in jobs and living standards. Trade liberalisation has also made the economy more resilient to external shocks. In the aftermath of the global economic crisis of 2008-09, for instance, Mexico experienced a severe recession but also succeeded in making a rapid rebound, during which its trade openness increased further.

Figure 8.1. **Trade openness**

Ratio of trade in goods and services to GDP



Source: OECD Economic Outlook No 92 database.

Recent trade liberalisation efforts have been largely underpinned by unilateral trade reforms. The Mexican government was one of only a few member country governments to include trade liberalisation measures in its crisis response policy package. At the end of 2008, the government announced a unilateral import

tariff reduction over the period 2009-13, a move expected to reduce the average industrial tariff from 10.4% in 2008 to 4.3% in 2013. Consequently, consumers will benefit from lower prices in a wide array of final goods, as well as from a greater variety of products. Equally important, tariff reductions will lower the domestic costs of production, particularly since Mexico is a heavy importer of intermediate and capital goods. In effect, over three-fourths of Mexican imports are destined to international value chains.

Mexico's participation in bilateral and regional free trade agreements has also been important for promoting trade integration. Mexico currently has trade, investment and economic co-operation treaties with more than 40 countries, which jointly represent 75% of world GDP. Mexico recently enacted a free trade agreement (FTA) with Central American countries, reflecting its strategy to create new trade opportunities and export markets in the Latin America region, and complementing its consolidated position with the North American market within NAFTA. Last year, Mexico was invited to join negotiations for the Trans-Pacific Partnership (TPP); when concluded, these negotiations will further help the country expand its trade opportunities with the Pacific countries, which have a more diversified production structure.

Although the sharp export growth has yielded numerous benefits, Mexico can reap even greater rewards from opening its trade regime further. In particular, Mexico is well placed to capture greater dynamic gains from further trade, which has yet to deliver its full potential in terms of higher levels of economic growth. The rate of output growth since the mid-1990s has been slower than in previous decades (including the "lost decade" of the 1980s) (Table 8.1), reflecting a decline in the rate of physical capital accumulation and a downward trend in total factor productivity (See Chapter 1). Mexico can capitalise on its integration in world markets to increase its exposure to technological exchanges and attract higher physical investment levels.

Table 8.1. **Growth of GDP and exports**

(annual percentage change)

	GDP		Exports	
	1961-1093	**1994-2011**	**1961-1990**	**1994-2011**
Mexico	4.9%	2.6%	8.4%	9.7%
Brazil	5.1%	3.3%	8.5%	6.0%
India	4.2%	7.0%	6.4%	14.5%
China	7.3%	10.1%	6.3%	17.9%
Chile	4.2%	4.6%	7.3%	6.3%

Note: Data for China available 1979-2011.

Source: Data from World Development Indicators.

Key Challenges

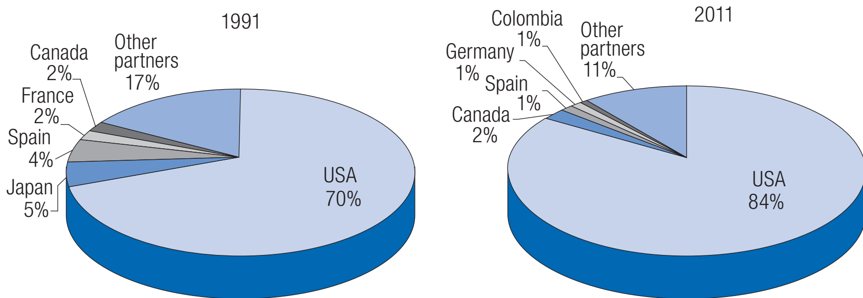
Consolidating trade ties with new partners to diversify markets

Product and market diversification constitute important elements of a growth-oriented trade agenda. There is mounting evidence that countries grow faster when they export a wider variety of goods, and when those goods have a higher degree of sophistication (see for example Hausmann *et al.*, 2007). Moreover, when countries diversify market destinations, they create opportunities to export a wider variety of products, catering to different profiles of preferences and demands. Market diversification also shields countries from export collapses due to changes in demand or competition in one particular market. Hence, the expansion of market destinations is important to develop a more diversified export supply.

While Mexico has made efforts to diversify its trading partners, the size and importance of the North American market dominates its trade relations. This reliance on the United States market contributes to output volatility, as shocks to US output are magnified in Mexico (OECD, 2011). This was evident during the 2008-09 economic crisis, when Mexican GDP fell by 8.5% at the time US GDP fell by 4%.

Currently, 84% of merchandise exports are going to the United States (Figure 8.2). This dependence on the US market has increased since NAFTA, although it is less than in previous years, when it reached 90%. The pattern is not as pronounced in the case of Canada, where the share of exports to the US market remained constant (about 75%) during the pre- and post-NAFTA periods. Canada has been more successful in diversifying its export markets beyond its traditional trading partners in North America and Europe. In particular, China has emerged as an important trading partner for Canada, receiving 4% of its exports.

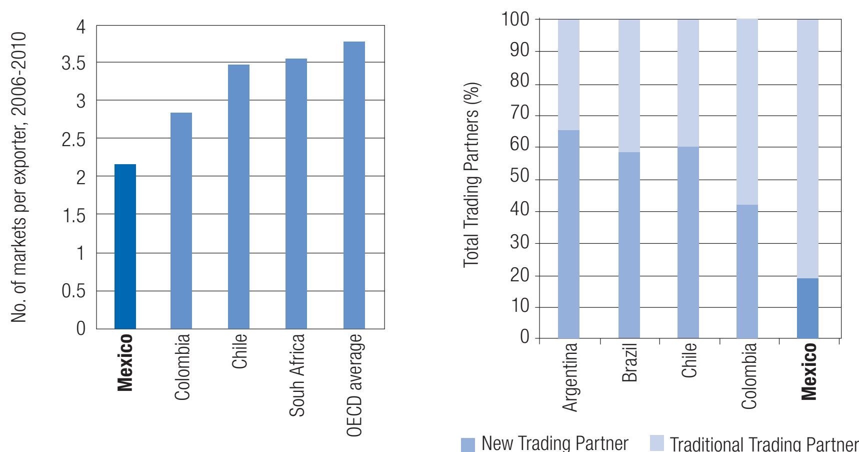
Figure 8.2. **Destination of Mexican exports, 1991 and 2011**



Source: Based on data from UN COMTRADE.

Mexico stands to gain from new trade ties with fast-growing economies other than the United States. On average, each Mexican exporting firm sends products to two countries, which is less than the OECD average (Figure 8.3). Mexico's exporting concentration is also pronounced by Latin American standards; most of the major exporters have diversified their trading partners over the past decades. At the beginning of the decade, over 60% of Brazil's and Chile's exports were to non-traditional trading partners (*i.e.* countries to which they were not exporting in the early 1970s). In contrast, new trading partners only account for 19.1% of Mexico's total export destinations. This suggests that Mexico has not yet fully exploited many of the market access gains that have been forged through FTAs with other countries. Clearly, it is important to promote better utilisation of those opportunities.

Figure 8.3. **Number of markets per exporter[1] and share of new trading partners**



Note: a traditional partner is defined by whether it was an export destination in the early 1970s.

Source: Based on data from World Development Indicators (left) and from Balza *et al.*, 2008 (right).

[1] The number of markets per exporter is drawn from the *World Bank's Exporter Dynamics* database. This new database is built from firm-level customs data and includes measures of exporter size, concentration, entry and exit, and diversification. The data cover 45 countries from 1997 to 2011, including 10 OECD countries (Belgium, Chile, Estonia, Mexico, New Zealand, Norway, Portugal, Spain, Sweden, Turkey). Data for Portugal are not complete, and so the OECD average is calculated on the basis of other member countries included in the dataset.

Exploiting the extensive margin of trade to spur growth

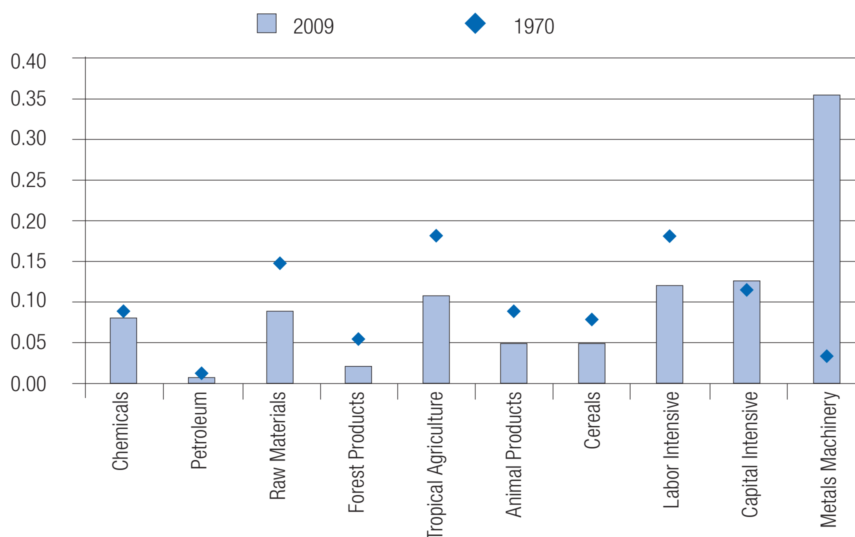
Mexico has the potential to realise more dynamic, growth-enhancing gains from trade. One possible avenue of trade creation can be pursued through further exploiting dynamic comparative advantages. While Mexico's export growth over the past two decades has been largely based on an intensive margin (*i.e.* exporting existing products to its usual trading partners), further trade creation can be generated through an extensive trade margin (*i.e.* creating new trade flows). Many emerging countries, including India and China, have based their trade growth on the extensive margin, transitioning to higher value-added exports. Mexico is well placed to pursue this trajectory, given the wide array of productive capabilities that it has developed in manufacturing, which can be redeployed in the discovery of new sources of value-added.

Remarkably, most of the products that Mexico currently exports were developed in the 1970s. Balza *et al.* (2008) find that 80% of product lines exported by Mexico in 2000-04 were already exported in 1970-74, when Mexico underwent radical structural transformation. By the early 1980s, even before NAFTA, Mexico had one of the most diversified export baskets of Latin America, with a degree of diversification and sophistication in products that made it an outlier considering its level of income. The country gained comparative advantages in a wide array of products, ranging from chemicals and raw materials to labour- and capital-intensive products.

Over time, and in particular since the mid-1990s, Mexico narrowed its export basket across a range of products where it had previously revealed a comparative advantage. The country strengthened its specialisation in machinery products, particularly machinery related to vehicles and electronic products, and significantly increased the range of products where it had comparative advantages (Figure 8.4). It also maintained or slightly expanded its comparative advantage in capital-intensive products. Meanwhile, it ceased exporting products in areas with lower technological requirements, such as raw materials, tropical agriculture and labour-intensive products.

This evolution largely resonates with the experience of the Asian emerging economies, with a first stage characterised by diversification followed by specialisation in high-technology products (OECD, 2012b). Mexico enjoys a relatively favourable pattern of comparative advantage, providing opportunities for future growth if a series of structural reforms are adopted. Approximately 72% of Mexico's manufacturing exports are classified as medium- and high-technology products, a share similar to that of Korea (OECD, 2009, 2012b). Mexico should therefore exploit the installed technological capabilities that already exist in its export profile to increase its productivity and "migrate" towards exports of high-productivity goods.

Figure 8.4. **Mexico's comparative advantages, according to Leamer product categories**



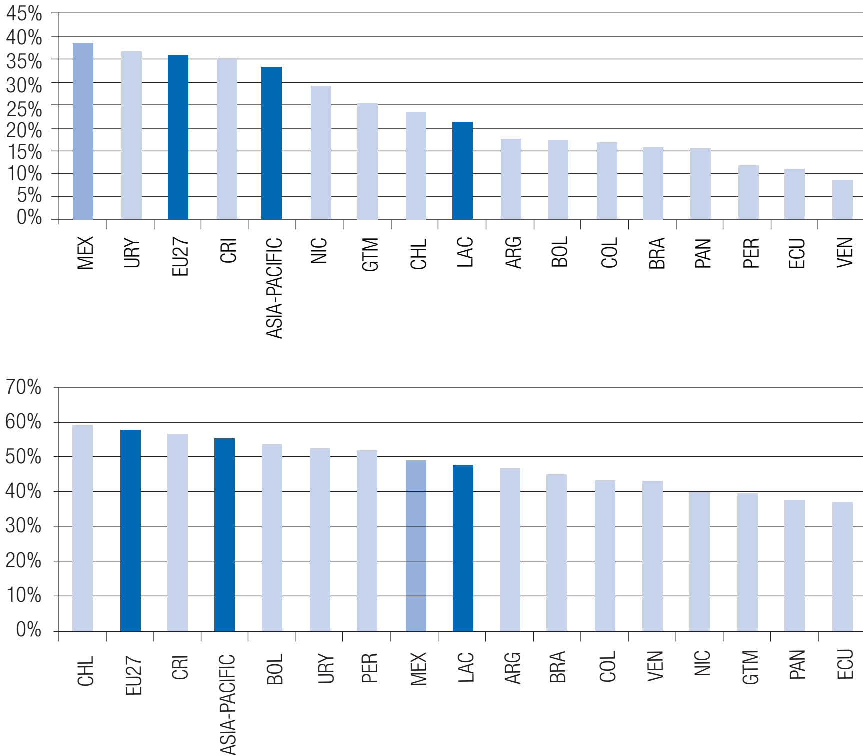
Source: Author's calculation, based on OECD (2012), *The Product Space and the Middle-income Trap: Comparing Asian and Latin American Experiences*, OECD Development Centre, Working Paper No. 311, April.

To realise this potential, however, Mexico needs to increase domestic value-added share in manufacturing activities. Whereas the value-added of the manufacturing sector in Mexico was higher than that of Korea in the early 1970s, it has since decreased – from a level of 21% to 17.6% by 2009. This decline results from the growing influence of *maquilas* and other final-assembly activities, which tend to generate less value-creating activity upstream and downstream in the production process. Conversely, Korean value added in the manufacturing sector has steadily increased over this time, from 18.5% in 1970 to a level of 28% by 2009 (OECD, 2012b).

Higher value-adding in regional and global value chains

The geographical fragmentation of production, and with it, the emergence of regional and global value chains (GVCs), offers new opportunities to expand trade and generate new export activities. For goods and services alike, the production process has been unbundled into multiple stages that take place in different parts of the world. In this context, comparative advantages can be created in certain

Figure 8.5. **Mexico's participation in global value chains**



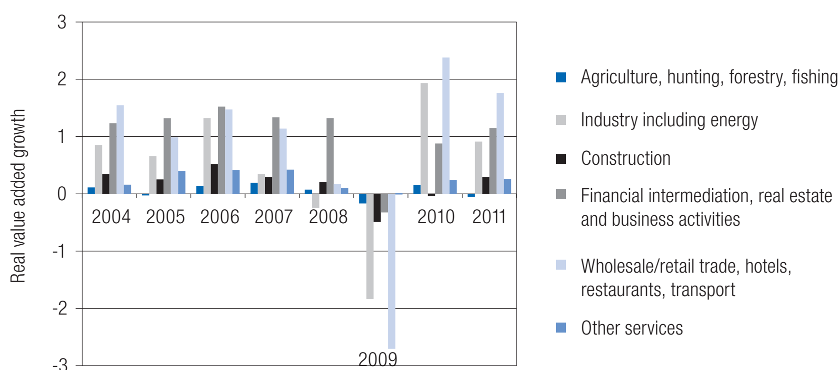
Source: Based on data from the Inter-American Development Bank.

"tasks" or intermediate parts of these value chain processes, rather than in final goods. The challenge remains, however, to move up the value chain to capture higher-productivity tasks, as well as to expand capabilities along a wider range of interconnected tasks in the value chain.

In fact, Mexico is already becoming an active participant in global value chains; a comparatively high proportion of foreign value-added is embodied in Mexico's exports (Figure 8.5). The country's participation in global value chains is also higher than the Latin American average, but lags behind that of Europe and Asia. Mexico has become one of the emerging locations for the supply of offshore services, and has been successful in capturing opportunities from its proximity to the US demand pole.

A challenge facing Mexico is how to create greater value-added in its export activities. A paradoxical trend in Mexico's trade structure is that as it has upgraded its specialisation patterns into more sophisticated, high-technology

Figure 8.6. **Contribution to real value-added growth**



Source: based on data from Instituto Nacional de Estadística y Geografía (INEGI).

products, factor productivity has been declining. While manufacturing plays an important role in Mexico's trade, its contribution to value-added growth is not as high as it was in previous decades. By contrast, most of the growth in value-added over past years is attributable to service activities, such as wholesale and retail trade, travel and transport, as well as financial intermediation and business services (Figure 8.6). Services activities thus seem to provide Mexico with more opportunities to generate internal value-added in global value chains.

Global value chains in services have immense untapped potential. Clearly, businesses are increasingly outsourcing not only the assembly of goods, but also many services related to their operations. The range of "non-core-business" services that are being performed offshore has increased in value-added and complexity, from data processing and call centres to financial and accounting services. In this context, Mexico can increase its participation in GVCs of services (*e.g.* the networks of services around tourism, the health industry, culture and the audiovisual sector), as opposed to specialising solely in services that are components of the manufacturing global chains (*e.g.* maintenance and repairs, marketing, logistics, after-sale services). Reducing the strong dependence on manufacturing can also be important for reducing macroeconomic volatility. Activity is normally more stable in the services sector than in manufacturing, particularly in services that are not directly linked to manufacturing – such as information technology and communications, passenger transport and retail banking.

Developing competitive, flexible and innovative supply chains

Mexico's success in attracting large multinational companies in highly globalised sectors – such as automobiles, aerospace, pharmaceuticals and a host of other manufacturing industries – heralds the opening of many avenues to

advance Mexico's integration into global value chains. Emerging opportunities in services value chains will also unfold new possibilities for diversifying Mexico's participation in world markets.

In order to fully exploit and expand these opportunities, Mexico needs to strengthen its supply chains feeding into the global production and distribution systems. It is important to develop networks of flexible, innovative and interconnected firms that can supply an array of goods and services to GVCs. Large multinationals increasingly need competitive local suppliers that can meet international quality standards. At the same time, the technological and knowledge spillovers can be maximised by enhancing local suppliers' capacity to absorb and integrate technological and managerial knowledge. Investments in human skills, research and development, and innovation are therefore called for to increase the capture of value. This includes enhancing the capabilities of small and medium-sized enterprises (SMEs), which are well placed to capture one or more concrete "tasks" along the value chain (see Chapter 10 on SMEs).

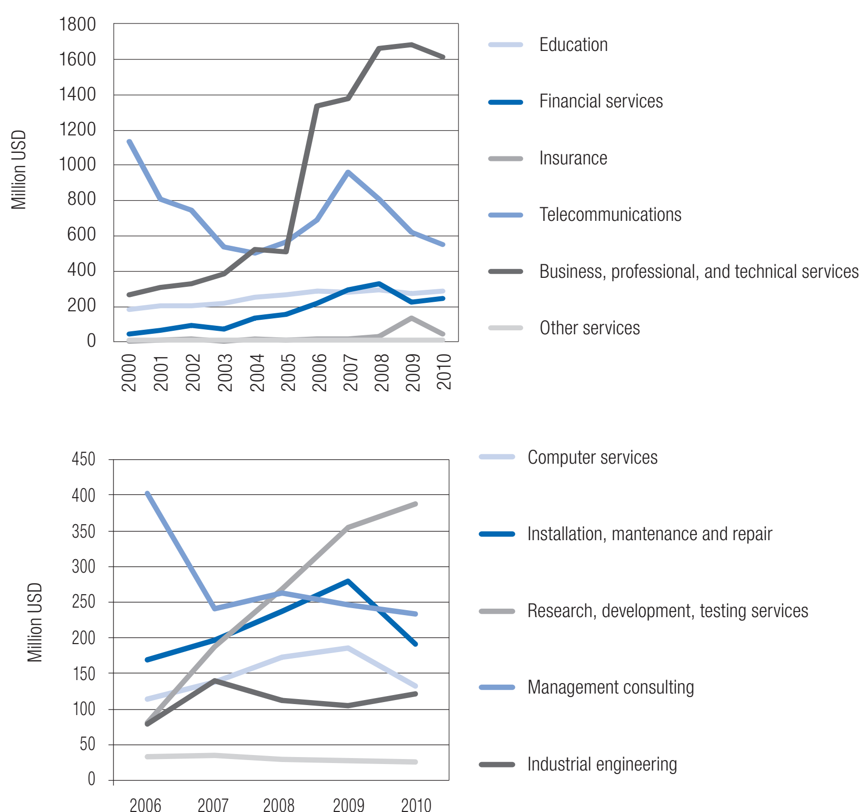
The emergence of stronger supply chains also hinges on the local business environment and institutional framework. One critical aspect in this regard is again the development of human skills; these are particularly important if Mexico is to diversify into services value chains, which rely heavily on knowledge and human capital. Another crucial element for supply chains to operate efficiently is the development of digital infrastructure. In particular, access to reliable communications at lower costs enhances suppliers' ability to compete on a global scale (see Chapter 9). Finally, an enabling institutional and regulatory framework provides greater transparency and predictability for all agents in the supply chain, thereby facilitating the co-ordination and integration of their economic activities.

Expanding the services sector and attracting higher levels of investment

Despite the fact that greater specialisation in services could be advantageous to the Mexican economy, the country's share of OECD trade in services remains below potential in contrast to its dynamic participation in merchandise trade. The share of services in Mexican GDP has remained fairly constant over the past decade, at just over 60% and below the OECD average of 73%. Similarly, 60% of Mexico's labour force is engaged in services activities, as compared to 70% in the OECD area. In most OECD countries, labour productivity in services outweighs labour productivity in goods. Furthermore, non-traditional services tend to offer greater wages and more transmission channels for technological change.

Mexico has the endowments to promote a more dynamic services sector, and should continue to invest efforts in generating a competent and bilingual labour force, an enabling digital economy, and good air connections among other critical factors for services competitiveness. In the A.T. Kearney Global Services Location

Figure 8.7. **Mexican service exports to the United States**



Source: Based on data from the US Bureau of Economic Analysis.

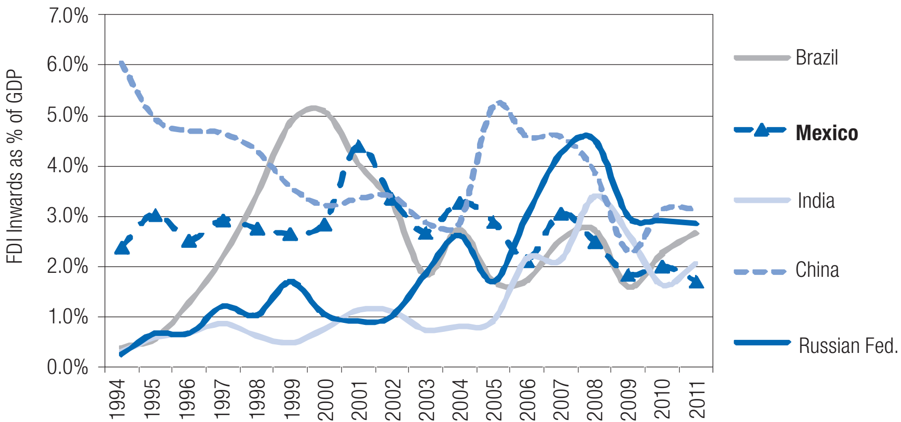
Index of 2011, Mexico is ranked 6th in the top 50 countries for service activities, based on financial attractiveness, personnel skills and availability, and the overall business environment. While Mexico shares with the top locations of India and China cost advantages and large talent pools, it has a further clear advantage relating to its geographical proximity to, cultural affinity with, and same time zone as the United States, the country that is likely to remain its largest demand pole for outsourcing services in the foreseeable future. Mexico also caters for the growing Spanish-speaking population in the United States and has strong links with its Diaspora.

As a promising offshore location for service activities, Mexico has already begun to show its potential in exporting key services. Business, professional and technical services exports to the United States have increased very rapidly over this decade, with an annual average export growth of 47% (Figure 8.7). This has been led mostly by high value-added research development services, which have grown by 70% on average each year between 2006 and 2010.

Regarding professional services, Mexico is also exporting management consulting services and industrial engineering services; in contrast, very few exports of legal services are reported, reflecting the high trade barriers in this sector. Mexican exports of financial services experienced important growth of over 30% annually in 2001-10, which has abated since the financial crisis. Finally, telecommunications exports contracted during the first half of the decade, and have remained highly volatile in recent years.

Mexico also needs to attract greater levels of investment for job creation and physical accumulation. In 2011, the country garnered close to USD 20 billion FDI and was the second largest recipient of FDI in Latin America after Brazil. Although still sizeable, inward FDI has fallen from the highs achieved of around USD 31.5 billion prior to the financial crisis (2007) and USD 30 billion at the beginning of the previous decade. At less than 2% of its GDP, Mexico's inward FDI is also lower than in the BRIC (Figure 8.8). The main investor is the United States (55% of FDI inflows) followed by Spain (15%), revealing a high concentration of investment partners (ECLAC, 2012). Services captured 52% of inward FDI, with financial services attracting the highest share of FDI (18% of the total) (ECLAC, 2012).

Figure 8.8. **Ratio of foreign direct investment inflows to GDP, 1994-2011**



Source: Based on the *OECD International Direct Investment* database, Eurostat, IMF.

Easing Regulatory Barriers and Increasing Competitiveness

While Mexico has broadened its international integration, its rigid regulatory framework and its overall competitiveness continue to pose challenges for deepening economic integration into world markets (Table 8.2). Bottlenecks

persist that limit the country's potential to compete globally. In light of rising competition from Asia and other locations in Latin America, Mexico needs to be able to generate higher levels of skills in its workforce as well as innovation, while ensuring that key inputs into modern production are competitive.

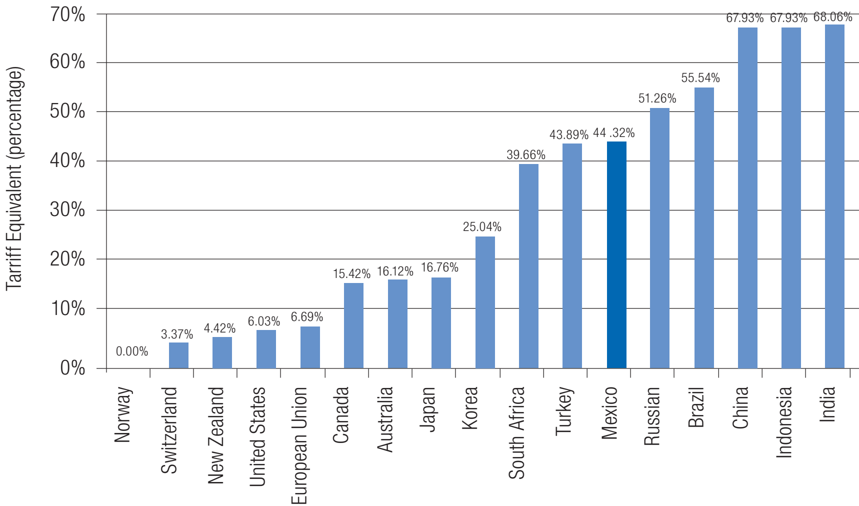
Table 8.2. **Mexico's international competitiveness in services**

Strengths	Opportunities
• Geographic proximity to the United States • Air transport: frequency, costs, duration • Cultural compatibility • Language: bilingualism • Availability of skilled labour force • Enabling digital infrastructure	• Strong diaspora in United States • Mature Business Process Outsourcing (BPO) market (finance, accounting) • Diversification of products and exports • Large internal market • New trade ties (Trans-Ppacific Partnership, Central America, International Services Agreement) • Rising costs in China & inflation in India
Weaknesses	**Threats**
• Concentration exports & markets • Government support & incentives • Perception of lack of security • Trade facilitation and logistics • Efficiency of domestic regulation • Services and investment statistics	• Costs (telecoms, real estate) of inputs • Competition (China, Philippines, Eastern Europe, Latin America and the Caribbean) • Brain drain of human qualified labour to the United States • Low rates of innovation • Political instability and insecurity • Regulatory barriers in "backbone services"

Given that Mexico has already made great strides in liberalising tariffs and reducing other barriers to trade in manufacturing, further liberalisation is likely to yield relatively modest marginal returns. In contrast, substantial welfare gains can be reaped through liberalisation of services, where barriers remain high. According to recent estimates (Figure 8.9), the tariff equivalent of regulatory trade barriers in services is about 44.32%, a reflection of Mexico's high regulatory entry barriers relative to most OECD countries. A 50% reduction of these barriers within the prospective International Services Agreement will yield important trade gains, with an increase of USD 5 billion in Mexican services exports (Hufbauer, Radford and Stephenson, 2012). Moreover, enhancing the competitiveness of a broad range of services (such as professional services, research and development, ICT) would help promote a more knowledge-intensive economy.

Many of Mexico's existing barriers to trade in services relate to the vested interest as in the case of restrictions on foreign direct investment in a number of sectors reserved for the State or for Mexican citizens, or where foreign participation is limited to ceilings. These barriers are prevalent in "backbone services", such as telecommunications (Chapter 9), energy (Chapter 12) and transport. As these services are also key inputs into the production of manufactures and

Figure 8.9. **Tariff equivalents of regulatory barriers to services**



Source: Based on Hufbauer, Radford and Stephenson (2012).

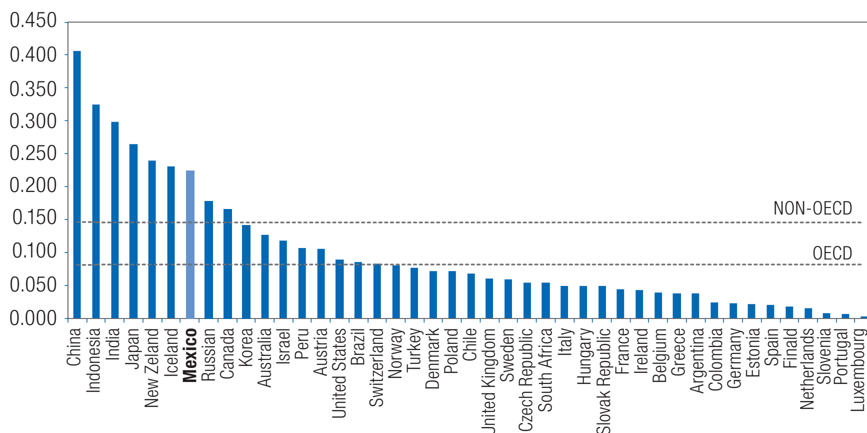
the extractive industry, reforms would translate into lower costs and higher competitiveness across the productive process. Therefore, envisaged measures in the Pact for Mexico aimed at lowering barriers to entry in strategic sectors (commitments 43, 44, and 57 on radio and TV, telephony and data services, and oil refinery, petrochemical industry and transportation of hydrocarbons, respectively) should enhance the competitiveness of the economy.

In the 56 countries that are reviewed in the OECD FDI Regulatory Restrictions (FDI RR) Index, Mexico is the country with the ninth-highest level of restrictions on foreign investment (Figure 8.10). As of April 2012, the country's FDI RR Index was well above the OECD average (0.225 compared to 0.083), but also above the average of non-OECD Members (0.146). The most stringent measures pertain to foreign ownership restrictions: up to a maximum of 49%, for instance in the case of fixed-line telephony. In energy gas is closed, and there are state-owned monopolies in the distribution of electricity and production of oil. In transportation, restrictions are particularly stringent in road and rail freight logistics services (notably storage services), which hinder the quality of trade facilitation. At a more horizontal level, one of the key deterrents for FDI in Mexico is the 10% cap on foreign employees, although this does not apply to managerial staff.

Finally, product market competition is weak in many sectors in Mexico, and this often hurts firms' competitiveness, productivity and consumer welfare (Chapter 1). Analysis conducted jointly by the Mexican Federal Competition Commission (CFC) and the OECD suggests that the average Mexican household

Figure 8.10. **FDI Regulatory Restrictions Index, 2012**

(1 = the highest level of restrictions, 0 = the most open environment)



*Notes: Preliminary scores, subject to modifications***.** The non-OECD average also includes the following countries, not represented in the graph: Egypt Jordan, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Mongolia, Morocco, Romania, Saudi Arabia, Tunisia and Ukraine.

Source: OECD, 2012 – updated as of April 2012.

spends close to a third of its budget on products that are produced in monopolistic or highly oligopolistic markets, and this share is even higher for the lowest-income households. In a number of sectors, regulations help market incumbents prevent new firm entry or effective competition from existing competitors. Further efforts to promote competition would lead incumbent firms to lower prices and become more efficient and innovate, thereby enhancing productivity growth and improvements in living standards.

Conclusions: a road map for further reforms

Over the past two and a half decades, Mexico has progressively integrated into international markets, becoming an important regional economic powerhouse. This success in using trade to foster development provides a vivid example for other countries in the OECD area and beyond of what market-friendly policies can achieve. Yet, with the global economy slowing, it would appear important for the country to continue its reform efforts, broaden and deepen past trade reforms, and make its growth truly inclusive.

In this context, several issues warrant the attention of decision makers:

- Mexico has successfully taken advantage of the opportunities provided by NAFTA, and has significantly increased its trade with Canada and the

United States. Indeed, the United States is by far the country's largest partner for exports and imports, and largest source of FDI. Yet, with the slowing of the North American market in recent years, Mexico has concluded a number of free trade agreements to broaden its commercial relationships. *Deepening integration with fast-growing economies, particularly those whose business cycle is independent of the United States,* will ease volatility in export earnings and output. Mexico's active efforts to participate in the Trans-Pacific Partnership (TPP) and similar initiatives are promising steps in that direction. It is also important to *consider how enterprises, including SMEs, can better take advantage of free trade agreements.*

- Mexico's export growth over the past two decades has been largely based on the intensive margin of trade (*i.e.* exporting existing goods to its usual trading partners). Considering the diversified and relatively sophisticated nature of its manufacturing profile, Mexico has the potential to *realise more dynamic gains from trade through developing the extensive margin* (*i.e.* exporting new products to new partners). In this context, it is necessary to take advantage of *technological spillovers from its existing export basket* to spur innovation and increase productivity in other high value-added activities.
- Mexico is already emerging as an active participant in global value chains (GVCs), and has been striving to attract activities that require higher productivity. The highest growth in value-added in Mexico over the past decade is attributable to service activities, such as financial intermediation and business services. Mexico could therefore usefully *deepen and expand its services capabilities as a means of generating higher value-added in GVCs.* This will require strengthening supply chains, so that firms can capture higher value in these chains.
- Mexico has the right set of endowments to promote a more dynamic services economy, and it should continue and reinforce its efforts in the area of pro-competitive regulatory reforms. The current share of services in Mexico's GDP and total employment is below the OECD average, suggesting that there is potential to increase services output. *Easing regulatory barriers to services – which have, by one estimate, a tariff equivalent of 44% – promises substantial welfare gains. Just as Mexico has made great strides in the liberalisation of merchandise trade, it could boost the benefits of trade by addressing distortions in service sectors*. A strong services sector will also provide a good foundation for the development of a more knowledge-intensive economy.
- In particular, Mexico should consider addressing *restrictions to foreign investment and competition in some of the "backbone services" of the economy, such as transport and logistics, telecommunications and energy.* Since these sectors provide key inputs for agriculture, manufacturing and other

services, competition-enhancing regulatory reforms would translate into lower costs and higher levels of competitiveness across the entire productive portfolio, and benefit consumers as well.

OECD Key Recommendations

- Diversify trading partners and export markets, exploiting more fully the opportunities from new and existing free trade agreements.
- Focus on the extensive margin of trade (*i.e.* export new products to new destinations); above all, specialise in "tasks" and other activities of the global value chain that entail higher productivity levels.
- As part of a strategy to become a more diversified and knowledge-based economy, deepen and expand services capabilities to take advantage of new export opportunities in services markets.
- Promote the development of flexible, competitive and innovative chains of domestic suppliers that can feed into worldwide specialisation and distribution systems.
- Reduce barriers to foreign participation and competition in "backbone services", such as transport and logistics, telecommunications and energy.

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