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CAPTURING VALUE WORLDWIDE<sup>SM</sup>



## Country Profile: Mexico

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*The Thomas White organization was founded in 1992 with the goal of bringing the benefits of globalization to investors around the world. We believed that once investors understood that globalization was a positive force, they would also see the advantages of adding international equities to their portfolios. It only makes common sense that professional investors would begin searching the globe for the most attractive opportunities. Researching a wider universe of companies should improve long-term performance. Moreover, broad diversification typically lowers return volatility. Multinational corporations have been using this global strategy for years; why shouldn't investors do the same?*

*Now 15 years later, our firm growth and strong subsequent portfolio performance has confirmed our investment premise. Currently, Thomas White professionals are performing research and managing over one billion dollars in close to 50 countries. We believe one reason for our success is that the nationalities of these analysts are as globally diverse as our portfolios.*

A handwritten signature in dark ink, reading "James S. White, Jr." in a cursive script.

# Mexico: Striving for Sustainable Growth



Chichen Itza, the pre-Columbian archeological site in present-day Yucatan, Mexico, bears the remains of the ancient Mayan civilization. The Maya were noted for their stately ceremonial architecture, including temple-pyramids which were built without metal tools.

One of the most visited countries in the world, the land of ancient Mayans and Aztecs is dotted with a varied landscape from volcanic peaks to snow capped mountains, tropical rain forests and inviting beaches. Although Mexico echoes the cultural influences of its northern neighbor, the U.S., the country retains the cultural flavor of its varied past. The treasure trove of natural deposits, including petroleum, silver, copper, gold, lead, zinc, and natural gas, has helped Mexico become a significant energy and materials exporter. One of the larger emerging economies, Mexico is also a major source of manufactured products and temporary workers destined for the U.S. After braving major economic turmoil in the early eighties due to a low oil prices and again in the mid-nineties after a massive undervaluation of its currency, Mexico witnessed an impressive turnaround after the turn of the century. The country was relatively unaffected during the 2002 South American Economic Crisis. This growth phase lasted several years until the 2008 global recession took a heavy toll on the Mexican economy. The revival in global demand and higher commodity prices helped Mexico's recovery from the recession, though the pace of the revival has lagged some of its neighbors.

## The western hemisphere's cradle of civilization

The early footprints of the Mesoamerican civilization, the cradle of present day Mexico and other Central American countries can be traced back to nearly 15,000 years. The hunter-gatherer lifestyle gradually gave way to farming, as agriculture developed around 8,000 years ago with the domestication of corn. As agriculture flourished, the earlier nomadic people of this fertile land were succeeded by the Olmecs, Zapotecs, Mayans and Aztecs. The Olmecs appeared to be [www.thomaswhite.com](http://www.thomaswhite.com)

the most innovative, developing the use of mathematics, a calendar and a system of writing. The Aztecs were the most powerful of the lot, asserting their authority over a large area sprawling from the Pacific Ocean on the west, Gulf of Mexico to the east and the modern day Guatemalan border in the south.

But the Aztec civilization's 3,000 years of glory came to an abrupt end with the Spanish invasion in 1519. Unknowingly, the Aztecs welcomed the Spanish invaders instead of resisting them. The Spanish then cleverly took the Aztec King Montezuma II as a hostage and secured control of the region. Increasing resentment towards the Aztec rule helped the Spanish win over the native population. In 1535, the Aztec capital was transformed into the capital of Spanish Viceroyalty, which was formed as a new bureaucracy and bore the name New Spain.

Many diseases such as small pox and measles, which were carried by the European settlers, affected the native population and reduced their numbers drastically. This decline brought in a new hybrid class in the society formed by the intermingling of the Europeans, Native Americans and Africans, who were brought in as slaves. The four main divisions among the hybrid classes are: *Mestizos* who are of Spanish – Native American origin; *mulattoes*, or people of European and African descent; *zambos*, of Native American and African descent; and *Criollos*, people of Spanish origin who were born in Mexico. Large-scale exploitation of the remaining Native American population was quite rampant.

But the occupation of Spain by Napoleon Bonaparte in the early nineteenth century turned the tide for the country. Spain gradually lost control of New Spain, and after several uprisings by the *Criollos* and *Mestizos*, the people were granted independence in 1821. The Empire of Mexico was formed, succeeded shortly thereafter by the United Mexican States, a republic. Yet, the movement against the Spanish had taken its toll over the economy and the social stability of the

<b>Mexico and the World</b>	
Nominal GDP (\$)	1.086 trillion
GDP Rank	13/186
Per Capita GNI (\$)	9,980
Per Capita GNI Rank	74/210
Population Rank	11/227
Geographical Area Rank	15/249
Global Competitiveness Rank	60/133
Economic Freedom Index Rank	41/179
Human Development Index Rank	53/182
Major Industries	Manufacturing, tourism, energy, communications, financial services



The Alamo in San Antonio, Texas stands as a shrine to the fallen heroes of the Texan battle for independence from Mexico in 1835.

country. The nation plunged into decades of political instability. The annexation of Texas by the U.S. in 1835 became a thorn that festered and eventually led to the outbreak of the Mexican-American War in 1845. The war resulted in the cession of Texas, California, Utah, Colorado and most of New Mexico and Arizona to the U.S. By 1862, Mexico found itself neck deep in debt to Britain, France and Spain, due to the prevailing instability. The French, who came in to collect debts, colonized the country and later named Austrian archduke, Maximilian of Habsburg, as the emperor of Mexico. His reign had a bloody end, after forces loyal to the earlier President Benito Juárez took control.

The country then witnessed a dictatorship under Porfirio Díaz, who heralded Mexico into the industrial era. But this brutal administration, controlled by a cold-blooded army, suppressed the people and denied rights to free press and free elections. This spurred the Mexican Revolution (1910-1920), a ten year period of shifting loyalties and an ideological struggle between the radical leaders and the liberal reformers. The revolution cost one out of every eight Mexican lives.

## **A time of healing**

In 1932, the Institutional Revolutionary Party (PRI) came into power, ushering in an era of development focused on land reforms, social welfare, and education. The PRI dominated Mexican politics for the next seven decades, its reign characterized by several economic triumphs and failures. But the many social and political missteps eventually unraveled its foothold and the PRI's rule came to an end in 2000, as the country held its freest and fairest election since the Mexican Revolution. Vincent Fox of the National Action Party (PAN) took over the helm, but the PRI won the most seats in the Mexican Congress just three years later.

PAN retained the presidency in 2006 by a whisker after its candidate Felipe Calderón defeated populist leader Andrés Manuel López Obrador. Major programs implemented during President Calderon's early years were aimed at stabilizing corn prices and increasing job creation, though the efforts to foster macroeconomic stability and move the economy towards a higher growth trajectory achieved only limited success. The PRI's political fortunes have revived recently and the party now controls a majority in the Mexican Congress.

## A history reflected

Pre-Hispanic Mesoamerican civilization and the Spanish influences during the colonial occupation define the essence of Mexico's cultural identity. These influences lend a unique flavor to the cuisine, art, music, religion and its fiestas (festivals).

Mexico is known for its well-renown spicy cuisine such as *frijoles enchiladas*, *atole*, *tamales*, and *pozole*. Corn, a staple from pre-Columbian times, together with chili

peppers and beans form the basic ingredients of almost all popular Mexican dishes including tortillas and tacos. Although tequila is the national drink of the country, Mexico remains the largest per capita consumer of carbonated soft drinks. Food is also associated with nationalism in Mexico, as Independence Day is often celebrated with *Chile en Nogada*, a symbolic portrayal of the national flag in white walnut sauce, red pomegranates and green parsley.

Roman Catholicism spread fast in Mexico during the 300-year Spanish occupation and is now the dominant religion. The most significant icon of Mexican national culture is the Virgin of Guadalupe, viewed as the "mother" of all Mexicans. Mexicans also have various cultural beliefs attached to life after death, which date back to ancient Aztec beliefs. The festival of the Day of the Dead, coinciding with All Saints Day in November, is reminiscent of the Aztec celebration of the Lady of the Dead. On the festival days, Mexicans make a special arrangement of altars for the dead to welcome them on their return. These altars are decorated with food, beverages and many other objects like skulls made of chocolate or sugar.

Mexico's Spanish past is also reflected in the country's music and folk dances. The most renowned, the Mexican Hat Dance, is a colorful story of love and courtship set to music. Rural handicrafts made of clay and colorful embroidered clothes and rugs are also vibrant expressions of Mexico's culture.

## The rollercoaster economic ride

A country tattered by foreign rule and political instability, Mexico found it difficult to realize its economic potential for several decades after independence. Silver mining formed the backbone

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Reflecting the country's Spanish heritage, The Mariachi Band, a staple at Mexican fiestas and weddings, finds its origins in the Spanish theatrical orchestras of the colonial era.

of the economy before independence, but the fight for freedom left the mining sector in shambles. Invasion by the French, and later the Mexican-American war kept foreign investors away from the country. Yet, the administrations of presidents Benito Juarez and Porfirio Diaz opened the doors of economic modernization. Tax and tariff structures were regulated and infrastructure and communications were improved. Foreign investments were encouraged, giving impetus to the mining sector and the construction of a rail link between the U.S. and Mexico.

As most of the development remained limited to the northern areas of the country, there was widespread resentment in other areas. The Mexican Revolution and the ensuing depression wiped out most of the economic gains made before the period of revolution. The 1930s saw a turnaround, beginning with the agricultural sector and slowly spreading to the manufacturing industry. Although the country maintained an inward looking economic policy, growth during the period 1940-1970 continued at a healthy average of 3-4%. By the end of the 1960s, Mexico had diversified its exports, and had achieved self reliance in food crops, most consumer goods, and steel. Capital goods required for production remained the main imports.

Fiscal mismanagement by successive governments and the oil shock of 1973 hurled the Mexican economy to the brink of recession. However, new oil discoveries made later that decade and the recovery in oil prices rescued the Mexican economy. Income from rising oil exports were spent on transportation and basic industries. But on the flip side, agricultural growth fell drastically, and the peso became overvalued, hurting Mexico's competitiveness. The government's decision to increase the tariffs on all imports to protect domestic industries, and increased foreign borrowings slowed economic growth later in the 1970s.

Flawed fiscal policies, increasing interest rates, and an overvalued peso led to a debt crisis in 1982 and battered the economy into a recession. This led to a balance of payment crisis and flight of foreign capital. The government trimmed all public spending to bring the economy back to normalcy, but the economic growth for the decade averaged a meager 1.1%. A slump in oil prices in 1986 extended the economic woes. The economic crisis resulted in large scale unemployment and an exodus of people to urban areas and to the U.S. The policy reforms undertaken, such as the privatization of nationalized industries, deregulation of the economy, and reduction of foreign debt stabilized the economy.

A free trade agreement (NAFTA) between the U.S., Canada and Mexico signed in the year 1994, led to increased foreign investments in the country. The outlook for the Mexican economy appeared bright with the prospect of increased investments and external trade opportunities. But structural imbalances within the country led to the Mexican Peso Crisis of 1994-95. An unsustainably high fiscal deficit, relatively high inflation and rising interest rates precipitated the crisis. Political instability caused by the assassination of a leading presidential candidate worsened the situation. Efforts by the central bank to defend the currency led to steady erosion of the country's foreign reserves and the peso was devalued. A \$50 billion loan package from the

U.S., Canada, the IMF, the Bank of International Settlements and Latin American countries, insured that Mexico would emerge from the crisis relatively quickly.

## Revival of the economy

The period after the peso debacle witnessed significant progress towards macroeconomic stability. Structural reforms were put in place to further open the economy to trade and services, to develop the financial sector and to foster a better functioning of the markets. The services sector now dominates the economy with a more than two-thirds share, followed by industry, which contributes more than a fourth of the pie. GDP growth was above average until 2009 when the global economic downturn pulled Mexico into a deep recession.

Though the contribution of agriculture to the Mexican economy has steadily declined, the sector continues to employ a large proportion of the labor force. The country is the major supplier of



Post-NAFTA, corn production in Mexico has increased, but has not kept up with demand. Today, the land that began the cultivation of corn 8000 years ago is a net importer of corn.

many tropical fruits and vegetables and the fourth largest producer of corn. The U.S. is Mexico's primary agricultural trading partner, and farm exports to the U.S. have increased significantly since the introduction of NAFTA.

Industry has greatly benefited from trade liberalization. High technology industrial production in the automotive, metal mechanics and aerospace sectors form the core of the Mexican manufacturing industry. The country supplies components to the major global

auto manufacturers. With the assembly of helicopter and regional jet aircraft fuselages on the rise, aerospace component manufacturing has also expanded. As well, some domestic companies design and manufacture light propeller aircrafts and Unmanned Aerial Vehicles (UAV). With NAFTA and Free Trade Agreements inked with 44 other countries, Mexico attracted increased investments especially in the manufacturing sector.

The manufacturing sector has led Mexico's economic recovery since 2009, helped by increased export demand for manufactured goods. Vital to the manufacturing sector are the *Maquiladoras*. These are Mexican factories which take in imported raw materials and produce goods for export

to the U.S. It is estimated that around 3,000 of these facilities function along the northern border of the country employing over a million people. *Maquiladoras* primarily produce electronic equipment, clothing, plastics, furniture, appliances, and auto parts. Today, 80% of the goods produced in Mexico are shipped to the U.S., almost duty free. Sadly, these factories are generally regarded as sweat shops, with poor wages and substandard working conditions. Yet, they have been a major source of employment in these areas.

Energy exports form bulk of the government's non-tax revenues. Though the country holds less than 1% of the world's reserves, Mexico remains one of the largest oil producers in the world. Since its nationalization in 1938, the energy sector has been the preserve of a state monopoly, which has been riddled with problems ranging from insufficient finances, corruption, and poor governance to lack of investments for new projects. Oil production peaked around 2004 at 3.3 million barrels per day and has since declined steadily.

Aggressive price hedging by the government offset the losses from the steep fall in oil prices during the second half of 2008. Though energy prices have recovered, the prospects for the Mexican energy sector are restricted as production is forecast to fall further. Mexico is also the world's second largest silver producer and the leading supplier of fluorite, strontium, and bismuth.

The Mexican services sector is dominated by tourism, financial services, transportation and

telecommunications. As the seventh most popular travel destination in the world, the country's tourism industry is a huge revenue earner and employment generator. The global recession, the swine flu scare in 2009, and increased drug-related violence in Mexican cities led to a significant fall in tourist arrivals and the recovery has been rather slow.



*Maquiladoras* along the U.S. border in Mexico. During the late 1960s, *maquiladora* industries grew rapidly and by 1985 had become Mexico's second largest source of income from foreign exports, behind oil.

Road transport forms the lifeline of most of the trade in the country, but requires steady progress improvements. Though railways in the country are privatized, trans-national development is hindered by slow and cumbersome administrative processes and disputes between private concession holders. The telecommunications sector in the country is dominated by a single firm and the lack of competition has resulted in higher user charges and inefficiencies.

Remittances from Mexicans working abroad, mostly in the U.S., are another mainstay of the economy. It is estimated that more than one in ten Mexicans work as temporary migrants in the U.S. Further, more than 30 million American citizens have family ties in Mexico. Though the global recession has restricted inflows in recent years, annual remittances from the migrant

workers and Mexicans settled abroad are now calculated to be over \$25 billion.



The lure of sunny weather and pristine beaches, as well as Meso American ruins draws hordes of tourists into the country. The global recession and increased drug-related violence have slowed tourist arrivals.

### **Despite high incomes, social challenges remain**

Mexico now has a population of over 110 million and the urban-rural divide is stark, with large numbers flocking to urban centers in search of better employment opportunities. The metropolitan area around the capital Mexico City is one of the largest urban conglomerations in the world, with a population of over 21 million people. Widespread poverty and income inequality is a major challenge facing the nation, with nearly one in five Mexicans living in poverty. The inadequate social security coverage makes the plight of the poor even worse.

With its people in search of jobs, Mexico faces the huge problem of illegal immigration to the U.S. Relations between the two countries have often been clouded by the issue of Mexican immigrants, especially since high unemployment became a highly politically sensitive issue in the U.S. after the recession. Arizona's tougher immigration laws to restrict the inflow of Mexicans have been criticized by the Mexican government. But the U.S. government has recently stepped up border patrol

and allocated more funds for border protection. The only long-term solution to this problem is to create more employment opportunities within Mexico.

Drug trafficking is another simmering issue with its northern neighbor and probably the most difficult challenge facing Mexico. The country is the biggest source of marijuana and cocaine flowing into the U.S. The drug trade is controlled by cartels based in border areas and along the southeast coast. One of the cartel leaders is listed among the world's richest and they use their financial wealth to further the trade. These cartels readily resort to violence, extortion and murder to ensure smooth trafficking. Though President Calderon's administration has vastly expanded the campaign against drug trafficking, with the support of the U.S. government, it is estimated that more than 23,000 lives have been lost since 2006 in drug-related violence.

## **The missing emerging market glory**

Considering the large domestic market where the average income levels are nearly thrice that of China, an export-oriented manufacturing sector, and a relatively young population, Mexico should command a place among the most attractive emerging markets globally. That the country receives far less attention when compared to China, India, Brazil or even Russia speaks volumes about the poor economic management in the country. Dominance by select business groups over entire sectors have restricted domestic competition and made foreign businesses apprehensive about investing in the country. However, recent initiatives to address drug-related violence, political instability and poor governance will likely help improve Mexico's profile in the world.


Geographical proximity to the world's largest consumer market has benefitted Mexico significantly over the last several decades, despite the emergence of China as the preferred global supplier of manufactured goods. However, the high correlation of Mexico's economic fortunes with the U.S. business cycle also dulls investor perceptions about Mexico. During 2009, when China, Brazil and India were relatively less affected by the global recession, the Mexican economy slumped as U.S. demand slipped and remittances dried up. For more sustainable economic growth, it is imperative that Mexico reduces its excessive reliance on U.S.

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The country's capital, Mexico City, is one of the most powerful economic hubs of Latin America. The GDP of the city at \$315 billion made it the eighth richest urban conglomeration. The country has made enormous economic progress since the beginning of the decade and is expected to take its growth further with favorable policies.

demand and remittances. The country should take advantage of its free trade agreements with countries in other geographies to diversify its export destinations. More prudent utilization of energy and other natural resources with increased investments in better production facilities would also help.

Mexico's government needs to address these issues with detailed and comprehensively long-term strategies. Further opening up of the economy, more liberal foreign direct investment norms, higher social sector spending, strengthening competition, and improving corporate governance standards are some of the measures critical for success. Abundantly bestowed with natural, human, and industrial resources, the land of the ancient Mayans and Aztecs must continue to show the will to prevail. 

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