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Economic Analysis

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Brazil and Mexico: changing perspectives and remaining challenges

- **Changing perspectives: Mexico's turn?**

  Brazil has grown more than Mexico in the last years due to the strength of its domestic demand and the better performance of its trading partners. Nevertheless, the signs of exhaustion of the Brazilian model and the gains made in competitiveness in Mexico are contributing to a shifting relative vision of the two economies, in favor of the Mexican economy.

- **Remaining challenges: the ability to adopt reforms reducing their weaknesses will help to determine Brazil and Mexico's outlook**

  Future performance will also be shaped by their different exposure to the global environment. In any event, Mexico and Brazil are two large economies with good growth potential over coming years.

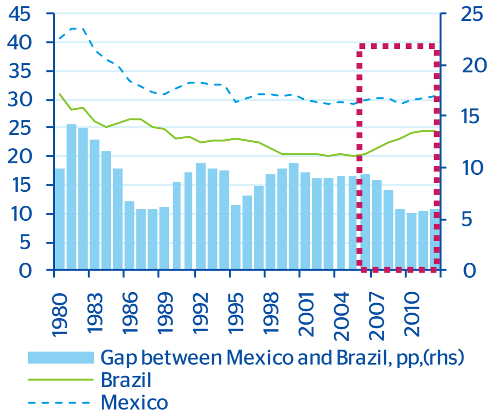
Brazil and Mexico: changing perspectives and remaining challenges[1]

There has been an outlook change in recent quarters regarding the Brazilian and Mexican economies seen, for example, in consensus growth of 3.8% for Mexico in 2012, nearly two points above that for Brazil. If this turns out true, 2012 would be the second year in a run where Mexico grew more than Brazil, after four years where the average growth gap in Brazil's favor was 3.5pp.[2] In short, the question over what factors drove the relative performance of both economies arises; is there a type of pattern showing a preference for one or the other in terms of performance in the medium-term?

Both Mexico and Brazil belong to the "eagles" group, comprising countries which, in the next decade, will contribute more to global GDP than the average of developed economies[3]. Mexico belongs to this group more for initial size than for growth which, in recent years, has been lower than other emerging economies and, specifically, than Brazil - the other Latin American "eagle". Brazil's GDP is almost 50% larger than Mexico's and has seen average growth of 3.8% in the last 10 years, around one and half points more than Mexico.

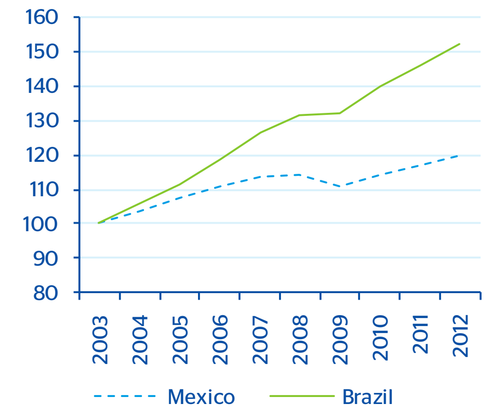
Brazil's relative better position in terms of income per capita growth is a recent phenomenon. As the attached chart shows, until the first half of the last decade, both economies saw a very similar real convergence process with the US. In general, their profile was relative poverty in the 80s, relative income level stability in the 90s in Mexico and a slight decoupling in Brazil, to major decoupling in the middle of the last decade in Brazil with US income levels while Mexico maintained earlier levels.

Chart 1
Brazil and Mexico: real convergence
GDP per capita relative to the US, %



Source: BBVA Research, with IMF data

Chart 2
GDP of trading partners 2003=100, average weighted GDP level with weight of exports from the country



Source: BBVA Research

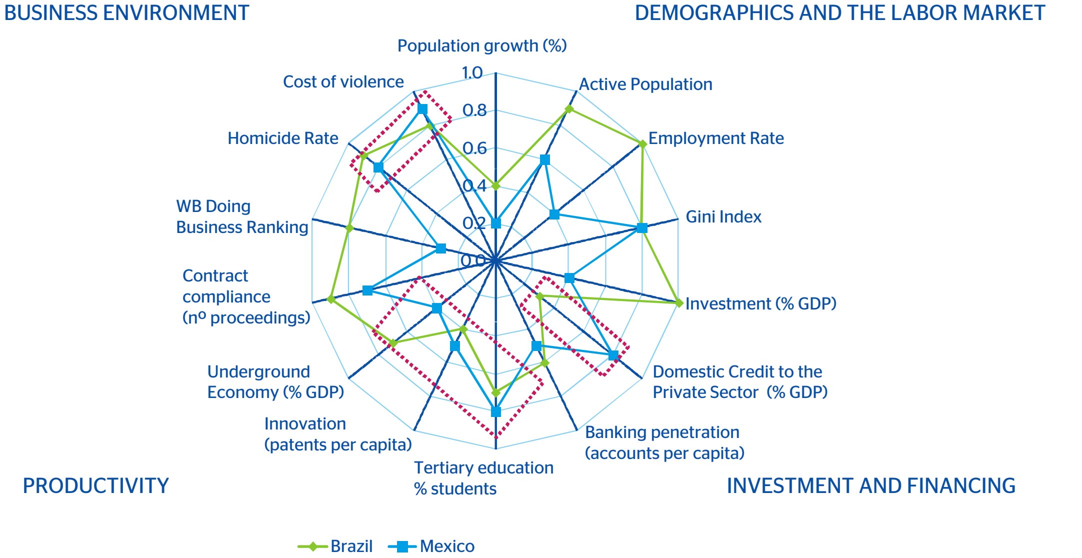
This performance coincided with a global shift in growth sources, with an increasing contribution from emerging Asian and Latin American economies and the standstill and decline of developed economies. This has had important effects on foreign demand from Brazil and Mexico, given their very different exposure to the aforementioned areas. In this sense, the main export destinations for Mexico are developed nations, with a total predominance by the US where around 83% of overseas sales of goods go. On the other hand, Brazil's exports to the US account for 12% of sales, while 68% go the high performance areas such as China, Asia and the rest of Latin America (in Mexico the figure is 12%). In this way, as the attached chart shows, the GDP of destination

1: This report benefits from comments from Arnoldo López, Alma Martínez, Cecilia Posadas, Arnulfo Rodríguez, Pedro Uriz, and other BBVA Research members. Alfonso Moguel provided support on preparing the data used in the report.
2: A result magnified by the exceptional difference of six percentage points seen in 2009: -6.3% in Mexico vs. -0.3% in Brazil.
3: For more details: www.bbvaeagles.com

economies for Brazilian exports grew 50% from 2003 while for the destinations for Mexican products, growth was only 20%. Nonetheless, the trading openness of both economies is very different, three times larger for Mexico[4], which makes direct comparisons problematic.

In the medium term, the balance between both economies does not show a clear dominance for either, with advantages for each country in some of the more important factors. If we take an economy from a supply perspective, the capacity to expand by the appropriate interaction of production and efficiency factors, there are four major elements to consider: demography and the job market, investment and savings, productivity and, finally, the business environment. As the attached chart shows, 14 representative variables have been chosen for these four axes. In addition, their level with regard to a reference group of emerging economies is shown.[5]

Chart 3
Brazil and Mexico:
vulnerability radar for emerging economies. The lower the value, the better the relative position



Source: BBVA Research with IMF, World Bank and UN data

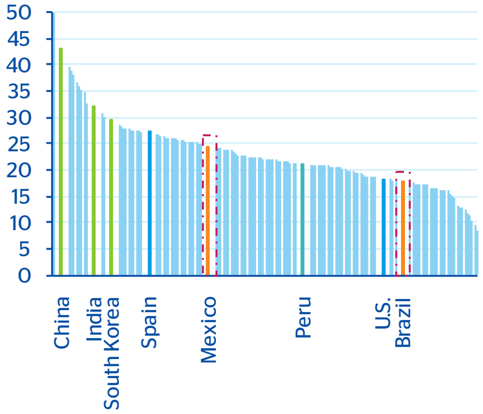
As for population and the job market, it would seem that the demographic boon is higher in Mexico than Brazil, with higher population growth and a higher share of the population in the job market. The low employment rate in Brazil stands out, measured as a percentage of those in work out of the working age population. According to available figures, this sits at 40%, around 20 points below the average for the group of countries looked at.

Both economies contrast in investment and bank financing with a better position for Mexico in the former and for Brazil in the latter. On average for the last decade, Mexico saw an investment ratio of GDP over five points higher than Brazil (24.6% vs. 18%), although without hitting levels in countries which, at times, are seen as reference points such as South Korea (29.4% over the same period). In short, the investment level in Mexico is rightly substantial for a country which does not have the domestic savings rate of an Asian emerging economy or that has not obtained savings from the overseas sector at an important level[6]. The domestic savings rate in Mexico is 23.6% of GDP versus 17.3% in Brazil on average between 2001 and 2011. This is a clear limitation without help from overseas for increased investment. Both public and private sector consumption has a greater weight in Brazil, further boosted by greater access to bank credit, both for that offered by the private and the public banking system. As the attached chart shows, domestic banking sector credit is over 50% of GDP in Brazil, almost 30pp higher than in Mexico, with a higher gap in loans

4: Goods exports accounted for 30% of Mexican GDP in 2011 and 9% in Brazil.
5: Reference emerging economies are: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela, China, India, Indonesia, South Korea, Malaysia, the Philippines, Thailand, Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Russia and Turkey. The lowest value, 0, would be the most favorable position in the variables for all countries reviewed; meanwhile, 1 would be the least favorable.
6: The average annual current account deficit between 2001 and 2011 was 1% of GDP, around the same figure as in Brazil (0.7%).

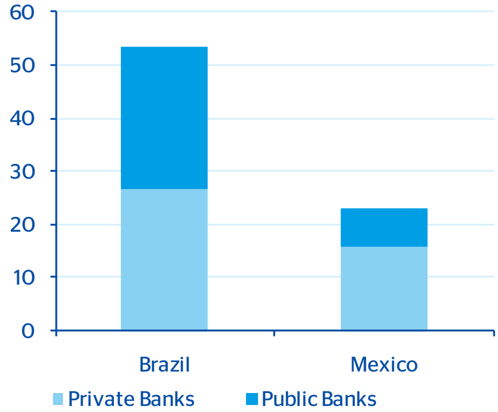
granted by public banking than in private banking. The higher bank credit penetration rate in Brazil is due to the continual drive from public policies aimed at improving loan conditions and access to the banking system for population groups who normally have low access. Products such as payroll deductible loans and simple accounts are behind the aforementioned developmen[7]t. In addition, the credit drive intensifies with the higher growth in the Brazilian economy over the last decade.

Chart 4
Investment as % of GDP, average 2001-11



Source: BBVA Research, with IMF data

Chart 5
Banking Credit as % of GDP, 2011



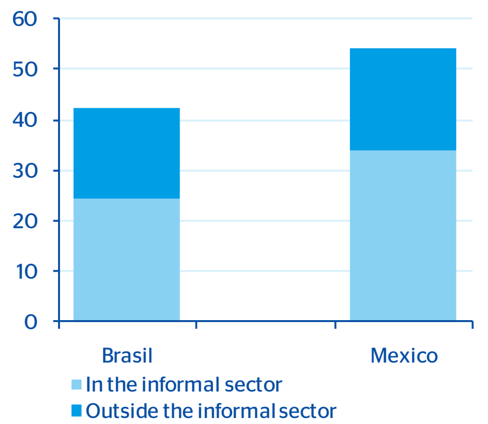
Source: BBVA Research with World Economic Forum data

Improving the business environment still requires work in both Brazil and Mexico. Although Mexico has a clear advantage over Brazil in terms of ease of doing business according to the World Bank's Doing Business chart, increased violence creates uncertainty for the Mexican economy. In any event, both countries would clearly benefit from reduced costs linked to lack of public safety and additional advances creating a more favorable business environment.

The key to growth lies in efficiency using available productive factors. Measuring productivity, the ability to produce more with less, is problematic since it is not a directly observable variabl[8]e. Productivity is usually calculated as the part of output not resulting from the amount of resources used and, therefore, it would be a result of how efficiently they combine. In the radar chart, as part of the selected variables as representative of productivity, figures do not favor Brazil. Quite the opposite, in fact: among other things, the weight of the black market as part of GDP is much higher in Brazil than in Mexico. Informality is a good sign of productivity since if the activity functions outside current regulations, mainly in fiscal matters, then economic agents cannot take advantage of economies of scale or adequately access the financial market to improve efficiency and increase its value in physical and human capital. In this sense, as shown in the following chart, according to ILO data Mexico has a higher level of informality in the job market.[9]. In any event, it would seem that the challenge for both economies is to reduce the black market so that the main source of long-term economic growth (productivity) improves.

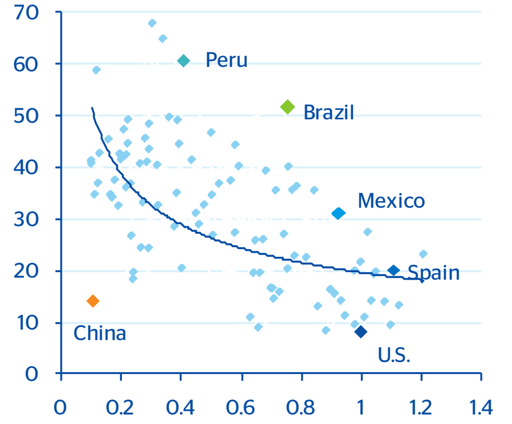
7: This path is also being taken in Mexico with payroll loans and basic accounts.
8: In reality, GDP is not "observed" either in the same way as employment can be tallied. Rather, it is a synthesis of different statistics on demand, output and income spread across economic agents.
9: Measuring informality is, by definition, controversial since it attempts to reckon those activities free from obligations imposed by the state, especially in tax, and the jobs do not have social rights (healthcare, retirement).

Chart 6
Informality, % of total



Source: BBVA Research with ILO data

Chart 7
Informality
(% of GDP) and productivity (relative to US)

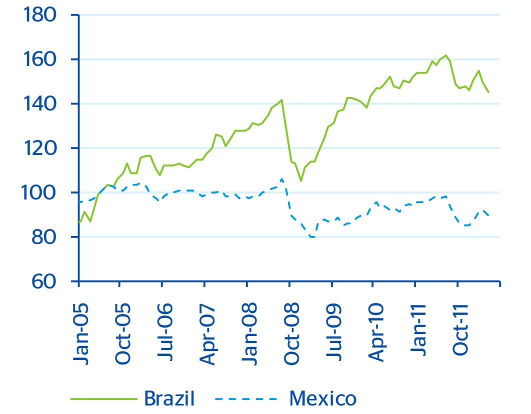


Source: BBVA Research with Schneider (2009) and World Bank data

Brazil's strength of demand (not necessarily its supply capacity) and higher performance from its trading partners have created better perspectives in recent years. Nevertheless, the signs of exhaustion in the Brazilian model (too centered on higher demand) and the gains made in competitiveness in Mexico with regard to Brazil are contributing to a shifting relative vision of the two economies, in favor of the Mexican economy. In line with this analysis, it would appear that greater growth capacity in the medium term for Brazil cannot be justified by demography, labor participation or investment rates. In this way, the better GDP record must be linked from the supply side to efficiency or productivity where there seems to be no major differences in either economy in terms of the variables able to estimate it. On the demand side, the more favorable external environment and higher access to bank finance support higher growth in Brazil with regard to Mexico. However, both factors are not necessarily permanent: the performance of emerging Asian economies could slow and/or Brazil could lose competitive advantages in terms of prices. Borrowing ability could be less important for growth from a certain debt level for economic agents.

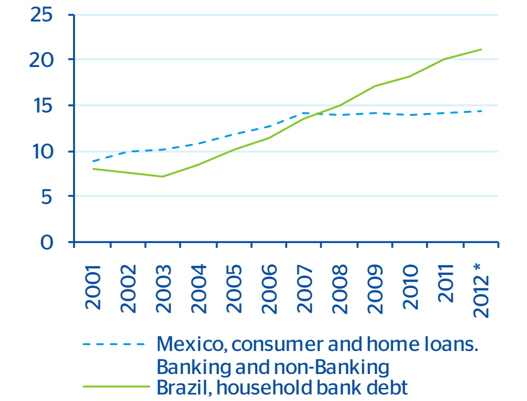
Indeed, there has been a recent change in market perceptions of both countries, in Mexico's favor, in line with the slowdown in China, fatigue on Brazilian credit markets and the negative impact that labor costs and the higher exchange rate had on Brazilian industry. The last two factors contrast with the recent dynamism on credit markets and signs of increased competitiveness in Mexico. In any event, they are two large economies with good growth potential over coming years. In addition, respective outlooks will continue to be determined by their different exposure to the global environment and by their ability to adopt reforms reducing their weaknesses.

Chart 8
Price competitiveness, real effective exchange rate (2005=100) Increases in the index point to strengthening



Source: BBVA Research with Haver data

Chart 9
Household debt (% of GDP)



(*) Last data.
Source: BBVA Research with CNBV data for Mexico and BCB data for Brazil

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