

Submission:

To: Senate Foreign Affairs, Defence and Trade References Committee

From: Australia-Latin America Business Council
Jose Blanco, Chairman

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Re: Australia's Relationship with Mexico

Executive Summary

With a growing economy that ranks as the 15th largest in the world and reform-focused political leadership, Mexico has much to offer Australia as an important ally in multilateral forums and as a trade and investment destination. On the economic front, Mexico appeals not only for its sizeable domestic market, but also for its gateway status into the wider Americas' market and its role in select global value chains.

Though the country has been saddled with a reputation for corruption and violence, Mexico has been successful in attracting growing levels of foreign direct investment and in positioning itself as a manufacturing base capable of competing with China on many levels. The country's push to liberalize its trade policies and a more recent raft of structural reforms has helped build a strong, global manufacturing base, with preferential access to significant consumer markets in North and South America, and beyond.

Like China, Mexico has fast-growing, low-cost manufacturing capabilities, but whilst China's labour costs have risen sharply in recent years, Mexico's have remained stable for the last decade, enabling the country to capture a growing share of the investment in manufacturing that would in the past have gone into China.

In terms of the Australia-Mexico economic relationship, the statistics on the composition, volume and value of the trade and investment exchanged until now are not an accurate reflection of the potential that exists in these areas. They merely reflect the very limited efforts that businesses in both countries have made to date in engaging with one another and in developing such flows.

That these flows have not been greater can be attributed to a number of factors. The primary ones being a mutual lack of awareness and a focus by each country on alternative markets - NAFTA in the case of Mexico and Asia in the case of Australia - which has meant a lack of engagement.

However, the significant reforms introduced by the Peña Nieto government are helping to change perceptions about Mexico and to overcome these stumbling blocks, by thrusting Mexico into the international spotlight and drawing widespread attention to the country's growth potential.

These developments have not gone unnoticed by Australian business. They are the reason why over the past 12-18 months a growing number of Australian companies have opted to investigate the opportunities on offer and some of them have chosen to set up operations in Mexico.

Whilst the flow of trade between Australia and Mexico will increase, it is more likely that the bilateral commercial relationship will be based on investment flows, with Mexico's appeal being:

- (a) the size of its consumer market,
- (b) its credentials as a low-cost manufacturing base with preferential access to some 45 markets,
- (c) its involvement in select global value chains,
- (d) its capacity to grow in sectors where Australia possesses world-class capabilities - including mining, energy and agriculture - and
- (e) its need to invest in areas where Australia has proven credentials, e.g. infrastructure.

Despite ongoing volatility in international financial markets and indications that the global marketplace may be entering a low-growth phase, the low starting base from which we are seeking to develop the bilateral economic relationship means that there is every reason to expect that the pace of Australia-Mexico engagement will quicken as the two countries become more familiar with one another.

That engagement will extend beyond the economic arena, with an increasingly interconnected world making it inevitable that Australia and Mexico will also expand and deepen their political dealings. The platform for doing so already exists through their involvement in forums such as the G20, APEC, OECD, MIKTA and the proposed TPP.

The frequent exchanges and ongoing dialogue necessitated by these forums can only accelerate and deepen the engagement between the two countries.

In a rapidly changing and increasingly interconnected world, Australia cannot afford to base its international strategy on too narrow a footing, relying only on its historical allies and on its key Asian trading partners. Mexico, through its involvement in the above forums, plus membership of NAFTA and the Pacific Alliance, and close affinity with the Spanish-speaking countries of Latin America, presents itself as an important ally for Australia on the international arena and an intermediary capable of helping Australia build valuable relationships with the nations of the Americas' region.

Mexico's Economic Credentials

Given that Mexico has the second-largest economy in Latin America and that a much smaller regional neighbour such as Chile has over 100 Australian companies with a presence in the country, it is surprising how small the Australian footprint is in Mexico. Even more so given that Mexico has a sizeable mining sector, which is the sector that currently most connects Australia to other countries in Latin America.

This low level of engagement to date is difficult to understand given the potential synergies on offer, but suggests that there is ample potential for the situation to change.

The following features of the Mexican economy highlight some of the reasons why Australian business should be more focussed on connecting with the important emerging market that Mexico has become:

1. In economic terms, Mexico ranks as a 'middle power' nation, having an economy with a GDP of some A\$1.75 trillion, making it the 15th largest economy in the world, and the 11th taking into account purchasing power parity.
2. With a population of some 122 million, Mexico's GDP per capita of about A\$13,900, ranks it as an "upper middle income" nation. That said, Mexico is the OECD country with the second highest degree of economic disparity between the rich and the poor. It is estimated that 26% of the nation's GDP is made up by the informal economy, in which almost 60% of the workforce is engaged.

3. Mexico's economy is tied to that of the US rather than China's. Leveraging its membership of the North American Free Trade Association (NAFTA), Mexico has evolved into one of the United States' largest trading partners. Some 80% of Mexico's exports go to the US, mostly as manufactured goods, industrial goods and motor vehicles (with Mexico exporting more cars than any country outside Germany, Japan and South Korea). Mexico has a positive trade balance with the US.
4. Mexico ranks as the 15th largest exporting nation in the world, with approximately 80% of its exports being manufactured goods. This trade capability is underpinned by Mexico having in place a network of 12 Free Trade Agreements and being party to trade agreements that give it preferential access to 45 countries.
5. Mexico also has extensive natural resources, including the largest proven reserves of silver in the world and the 10th largest reserves of oil. It is also generally acknowledged that there is considerable scope to expand Mexico's mining sector, which has important reserves of gold, copper and other minerals.
6. Mexico's macroeconomic management has followed orthodox principles over the past two decades and under the government of President Enrique Peña Nieto has introduced extensive and ambitious reforms, including an overhaul of the taxation system, cuts in government spending, and the liberalisation of certain economic sectors such as energy and telecommunications.
7. Mexico was granted an 'A' credit rating in 2014 by Moody's, underpinned by substantial international reserves (approximately US\$190bn) and a low debt-to-GDP ratio.
8. Economic growth is forecast to be approximately 2.5-3.0% in 2015, which is lower than previously forecast, but can be explained by the volatility in global markets and the sizeable fall in commodity prices, which has impacted Mexico's income from exports.
9. Mexico became the first Latin American country to enter the Organisation for Economic Co-operation and Development (OECD) in 1994. Its political system is essentially stable.

Doing business in Mexico is not without its challenges, but the rewards on offer justify the effort. That is certainly the conclusion to be drawn from the significant flow of foreign direct investment that Mexico has captured in recent years and continues to capture from a broad range of countries.

At present, Mexico ranks as one of the most prospective emerging markets in the world. Its economic potential is founded on the significant scope that exists to enhance the nation's competitiveness and growth through continued structural reform, improved infrastructure, a low-cost manufacturing base and its integration into the important North American market through NAFTA.

Also important for the future is Mexico's membership of the Pacific Alliance and the potential that this initiative has to increase trade between the four member nations and to drive the integration process within Latin America.

The perception of Mexico as a difficult place to operate is gradually changing. Thanks to ongoing government reforms, Mexico now ranks a very competitive 36th in the world for ease of starting a business, according to data gathered by the World Bank and International Finance Corporation (IFC). This represents a jump in the rankings of some 38 places in a single year.

Those reforms have also made the Mexican transportation, energy and telecommunications sectors more globally competitive and thus provided a platform future growth.

Mexico's Challenges

Any analysis of the opportunities that Mexico holds for Australian business should also entail an assessment of the factors that have held back the country's economic development.

To this end, the following issues constitute some of the major challenges confronting Mexico and, as such, are ones that have the potential to impact upon Australian companies wishing to operate in the local market:

1 Inequality

Although membership of NAFTA has benefitted Mexico, overall economic growth has been weaker than expected and there has not been a strong connection between growth and poverty reduction. Despite decades of reforms, Mexico has so far failed to bridge the gap between its rich minority and poor majority, with Mexico's Gini Index - which measures a nation's income inequality - ranking amongst the highest in the world. Recent economic growth has failed to generate the required number of jobs or enough jobs that pay reasonable wages to lift people out of poverty, and it is estimated that about 25% of Mexico's population live in moderate or extreme poverty. Inequality is a common cause of social unrest and a driving factor pushing migration north to the US.

2 The 'informal' economy

As stated previously, it is estimated that some 26% of the nation's GDP is made up by the informal economy and that this involves almost 60% of the nation's workforce. These small, unregistered businesses operate outside the taxation systems and are not serviced by the banking sector. It is estimated that over the past 15 years, the productivity of Mexico's largest companies has grown by 5.8% per annum, while that of the smallest has fallen by 6.5% per annum.

3 Corruption

According to Transparency International, Mexico ranked 103rd among 175 countries on the Corruption Perceptions Index in 2014 with a score of 35 out of 100 points. The high levels of corruption in Mexico, in combination with the lack of substantive results from political parties over the years have led to generalized disappointment, poor enforcement of the 'rule of law' and lack of trust between the citizens and the government.

4 Insecurity

The high incidence of income inequality, widespread poverty, the influence of drug cartels and poor enforcement of the 'rule of law' are primary reasons why Mexicans suffer from a high level of insecurity. Despite ongoing government campaigns to address the issue, the overall security situation in Mexico shows little sign of improvement.

5 Structural Reform

The Peña Nieto government has made progress in its structural reform agenda in the areas of labour, education, competition policy, financial sector, telecommunications and energy sector legislation - all of which are aimed at raising productivity, competitiveness and potential output growth. However, the implementation phase of the process has yet to deliver the expected benefits. That said, the opening of the energy sector to private sector participation is particularly promising for boosting growth, as it is expected to increase the production of oil and gas and provide Mexican manufacturers with cheaper energy inputs.

6 Education

The overall quality of education in Mexico is generally considered to be low. Only 37% of Mexicans have managed to achieve higher secondary education — the second lowest average among OECD countries. According to the OECD, young Mexican students are substantially behind the average level of mathematical skills in comparison with other countries and there is a tendency to drop out of school prematurely. These lowered educational standards prevent the country from developing and make it impossible to achieve equal opportunity among the population, thus exacerbating problems like poverty and inequality.

7 Infrastructure

Despite the introduction of a public-private partnership law that makes it easier for the government and the private sector to finance infrastructure projects together and an increase in investment in infrastructure in recent years, the World Bank estimates that less than 45 per cent of Mexico's roads are paved, a statistic that remains largely unchanged over the last decade. Other infrastructure also suffers serious problems. Much of Mexico's 27,000km of rail were laid over a century ago. Ports, airports, and highways have not kept pace with the growing population and economy. As far as basic services are concerned, nearly a third of Mexicans lack adequate sanitation. The infrastructure deficit is markedly greater in the southern states of Oaxaca, Chiapas, and Guerrero than in the central and northern states of the country.

Daunting as these issues may be, it is worth noting that they have not prevented Mexico from growing its economy or deterred companies from throughout the world from investing in Mexico. They are issues that need to be acknowledged and managed as required, but they should not prevent Australian companies from seeking to do business in Mexico.

Opportunities for Australia

Whilst there is undoubted scope for an increase in the flow of trade between Australia and Mexico, it is more likely that the bilateral commercial relationship will be based on investment flows that seek to exploit the advantages that each nation has to offer as an end market and as a platform for accessing other markets.

From an Australian perspective, Mexico's appeal lies in:

- (a) the size of its consumer market,
- (b) its credentials as a low-cost manufacturing base with preferential access to some 45 markets,
- (c) its involvement in select global value chains,
- (d) its capacity to grow in sectors where Australia possesses world-class capabilities - including mining, energy and agriculture - and
- (e) its need to invest in areas where Australia has proven credentials, e.g. infrastructure.

An indication of the breadth of the opportunities on offer is highlighted by the diversity - *if not yet the number* - of Australian companies that already have interests in the country. These include: BHP Billiton (resources), SEEK (IT), Incitec Pivot (agribusiness and mining), Nufarm (agribusiness), QBE Insurance (services), Azure Minerals (mining), Lend Lease (construction), Howe Leather (automotive), Amcor (packaging), Worley Parsons (services) and Boral (construction), to name a few.

The pace at which opportunities in Mexico will be identified and exploited by Australian businesses will depend on how quickly our businesses are able to overcome their preconceptions about the dangers/difficulties of doing business in Mexico, on their willingness to invest the time and money needed to get into the Mexican market, and on their success in identifying the appropriate strategy for getting into and operating in the market.

In broad terms, the range of opportunities on offer includes, but is not limited to, the following sectors:

1. Mining

Despite Mexico being ranked as one of the world's largest producers of mineral resources and the fifth most popular destination for mining exploration investment in the world, the Australian presence in its mining sector - either through mining companies or suppliers to them - is almost negligible. Why this is so is unclear, given that Australian mining companies and mining equipment technology and services (METS) companies are well entrenched in other countries in Latin America, including Brazil, Chile, Colombia and Peru.

Even though there are some important Mexican mining companies - including Grupo Mexico and Peñoles - and Canadian mining companies are well-represented in Mexico, there is still ample scope for Australian mining companies to enter the market.

Large areas of Mexico remain unexplored or under-explored, so there is ample scope for investment in exploration, acquisitions and development. There is also scope for joint ventures with Mexican companies.

The size of Mexico's mining sector and the potential that exists for it to grow also means that there are extensive opportunities for Australia's METS companies to sell their services and products into the market. The success that these companies have had in other markets in the region suggests that they would have strong prospects of succeeding in Mexico. There is no reason why Mexico should not be host to as many Australian companies as Chile.

2. Energy

The opening of the energy sector to private sector participation is particularly promising for boosting growth in Mexico and has the potential to generate considerable opportunities for Australian oil and gas explorers and producers, as well as for service companies linked to them.

The opening up of the sector to foreign companies has already seen companies such as BHP Billiton and Worley Parsons establish offices in Mexico. Others are likely to follow.

As Mexico's population grows and its economy expands, demand for energy will expand. Australia stands to benefit through increased exports of coal, potential exports of LNG, investment in the development of Mexico's oil and gas fields, and the supply of services and other inputs to energy companies operating in Mexico. There is also significant potential for the export of renewable energy technology.

At the same time, Australia can invest in the development of Mexico's energy infrastructure, including renewable energy facilities, pipelines, etc.. Our superannuation funds in particular, crave stable long-term investments in utilities and other essential infrastructure assets, and Mexico will offer a growing pool of them.

3. Infrastructure

As already stated, improving the nation's infrastructure is one of the priorities of the Mexican Government, as it is seen as crucial to economic growth. This will require significant investment in new roads, ports, airports, railways, water management, sanitation and energy production.

Macquarie Capital, Industry Funds Management ('IFM') and Lend Lease are already active in this area, but there is ample scope for other Australian funds and companies to become involved.

Whilst the likelihood of Australian construction companies entering the Mexican market is low, there is every reason to expect that Australian engineering and design companies, as well as companies with expertise in one or other of the areas of infrastructure, would find opportunities in Mexico.

The investment that IFM made in early 2015 in acquiring an interest in a Mexican toll road also suggests that there is considerable scope for other Australian investors to participate in the financing and ownership of Mexican infrastructure.

4. Education

Given Mexico's strong commitment to improving its level of education and the strong reputation that Australian institutions have in this field, there is considerable scope for Australia's education sector to benefit from the investment that the Mexican government plans to make in this sector and from the demand that Mexicans have for high-quality education.

Mexico is currently the fourth-largest education export market for Australia in Latin America, behind Brazil, Colombia and Chile. However, there is considerable scope to increase Australia's involvement in Mexico's education sector, including the recruitment of students from the country and the roll out of joint research initiatives with counterpart institutions in Mexico.

5. Agriculture

The fact that Australia and Mexico produce many of the same agricultural commodities will limit the scope for trade in this field, but does mean that there is ample scope for cooperation in addressing common challenges and shared objectives, such as improving land productivity through soil management, water technology and other initiatives, e.g. animal and plant genetics.

There is also scope for investment in Mexico's agricultural sector in order to benefit from the country's access to the wider America's market. The use of Australian capital and know-how could help to enhance Mexico's production of food and provide an ideal base for exporting into other markets in the Americas.

6. Automotive

With the decline of motor vehicle production in Australia, Australian automotive component suppliers have an opportunity to benefit from Mexico's well-established and growing automotive industry. Mexico's appeal is that it is currently the world's eighth-largest producer of cars, trucks parts and components. By 2020 Mexico is expected to be number six behind China, the US, Japan, India and Germany, with an annual production of 4.7 million vehicles. With US\$19 billion in new investment, production has doubled in the past five years to an estimated 3.2 million vehicles in 2014. Vehicles manufactured in Mexico sold in the domestic market and exported to the US (primarily) and to other markets in Latin America, Europe and beyond.

7. Other Manufacturing

As previously indicated, Mexico is beginning to challenge China as a manufacturing base for many companies, with manufacturing accounting for some 35% of Mexican GDP. Beyond the automotive sector, manufacturing activity is focused on appliances. Mexico's four key advantages as a manufacturing base are:

- (a) Manufacturing wages, adjusted for Mexico's superior worker productivity, are almost 30 percent lower than in China.
- (b) Mexico has more free-trade agreements than any other country, covering 45 countries - compared to less than half that number for China.
- (c) Mexican manufacturing has a significant advantage in energy costs, with China paying from 50% to 170% more for industrial natural gas. Mexico also has an edge over China in electricity costs.
- (d) Industry clusters, especially in motor vehicles and appliances, are growing. Mexico has developed an expertise in certain industries, which makes it more attractive for companies to locate or expand plants there. Mexico's status as a major automotive manufacturer means that 89 of the world's top 100 auto parts makers have production facilities in the country. In appliances, more than 70 manufacturers are in the country, ranging from components makers to assemblers of both small and large appliances.

Australian manufacturers that are looking for a base outside Australia could benefit from having a presence in Mexico. If not as a substitute for existing plants in Asia or Europe, then as a base from which to supply the sizeable markets of North, Central and South America.

At the same time, Australia can also benefit from exploring opportunities to access Mexico's substantial consumer market. Despite the wealth inequality and significant level of poverty previously highlighted, it is also true that Mexico has a large and growing middle class, plus a sizeable tourism sector that adds significantly to the country's consumer base.

Pursuing these opportunities requires that Australian businesses overcome the erroneous preconception that the Mexican market is totally dominated by US and Canadian firms. There is no denying their extensive presence in the market, but there is scope for other players. This means that there is no reason why Mexico should not be on the radar of Australian fashion designers, our wine companies and any business able to offer world-class products and services.

Mexico's Investment Capability

In assessing the potential of the Australia-Mexico economic relationship it is important for Australia to recognise that, despite its emerging market status and problem of wealth inequality, Mexico has 16 billionaires and quite a number of companies with considerable international presence. It may not be distributed in an equitable manner, but there is no shortage of capital in Mexico.

With a net worth of US\$77.1 billion (equal to 6.1% of Mexico's GDP), Mexican telecom mogul Carlos Slim Helú ranks as the world's second-richest man. Similarly, Mexican companies such as Cemex, Grupo Bimbo, Grupo Mexico and Gruma are well established in the growing list of 'multilatinas' - the group of Latin American companies with a global reach or global potential.

This is important because it shows that the flow of investment between the two countries need not be solely from Australia to Mexico and, in fact, it isn't, with Mexico already having flexed its investment muscle in Australia.

Gruma, a Mexican multinational corn flour and tortilla manufacturing company has been active in Australia since 1994. Initially through exporting its products to Australia, but subsequently through local production, primarily under the brands 'Mission' and 'Rositas'. In 2006, Gruma acquired two small tortilla-producing plants in Australia (Rositas Investments and Oz-Mex Foods) and in 2008 it invested a further US\$60m in the construction of a tortilla-producing plant in Epping, Victoria.

An even more significant investment was made by Cemex - a global player in the building and construction materials industry - in 2007, when the company paid around US\$15bn to acquire ASX-listed Rinker Limited, a company that had previously been spun-off by CSR Limited.

The business was divested by Cemex a couple of years later as a consequence of the impact of the global financial crisis and the company's need to reduce its debt level, but the acquisition still ranks as one of the largest foreign investments ever made in Australia and proof that Mexican companies do have global aspirations and the capacity to invest substantial amounts for the right assets.

The likelihood of Mexican investment into Australia should not be overstated, but nor should it be dismissed. There is merit in Australia making a more concerted effort to raise its profile in Mexico and striving to attract inward investment.