A tale of two Mexicos: Growth and prosperity in a two-speed economy

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Is this finally Mexico's moment?

WALL STREET JOURNAL

Countries **like Mexico**, where the economy is more balanced, are **potential bright spots.**

BARRON'S

Welcome to the A-club. Yesterday, Moody's upgraded Mexico from Baa1 to A3. . .

REUTERS

Pepsico said it would **spend $5 billion** in Mexico over five years Nestle said it planned to **invest $1 billion** in Mexico over five years…

The New York Times

It is an **economic renaissance in Mexico**,… "We are attracting investments that 10 years ago went to China," says Finance Minister Luis Videgary.

FT FINANCIAL TIMES

..upgrade into the 'A-Class' rating…and…disciplined, market-friendly, non-interventionist policies…**positively differentiate Mexico from other large EM economies…** ."

– Alberto Ramos, Goldman Sachs

Institutional Investor

"If I were 22 years old and I didn't know what I wanted to do, **I would move to Mexico** right now because I think the **opportunity is huge there**."

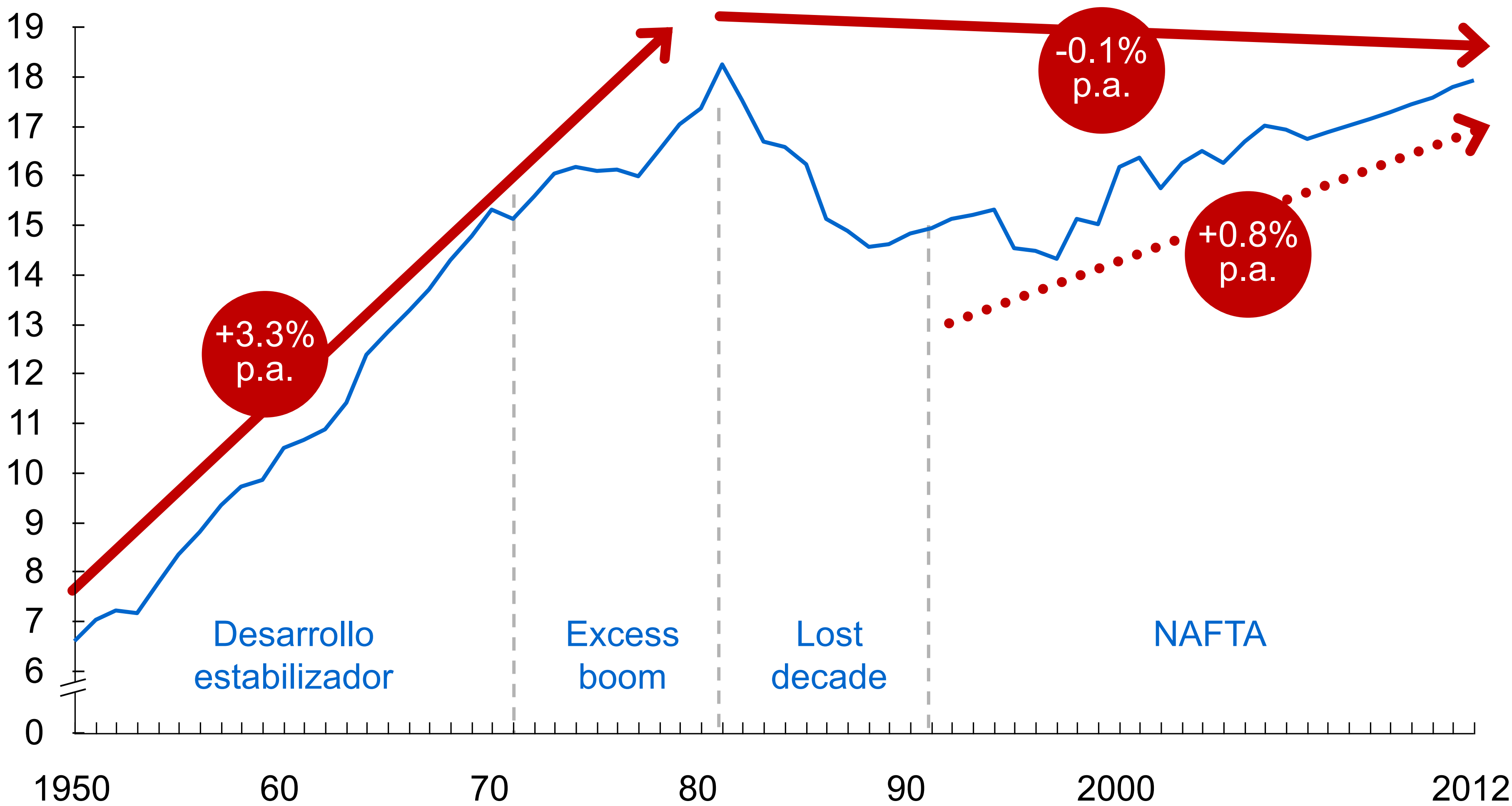
–Laurence Fink, CEO BlackRock

SOURCE: *The Economist*; *Financial Times*; The *New York Times*; analyst reports

Despite NAFTA and reforms, Mexico has not raised its average productivity in 30 years

GDP per hour worked

2012 purchasing power parity dollars

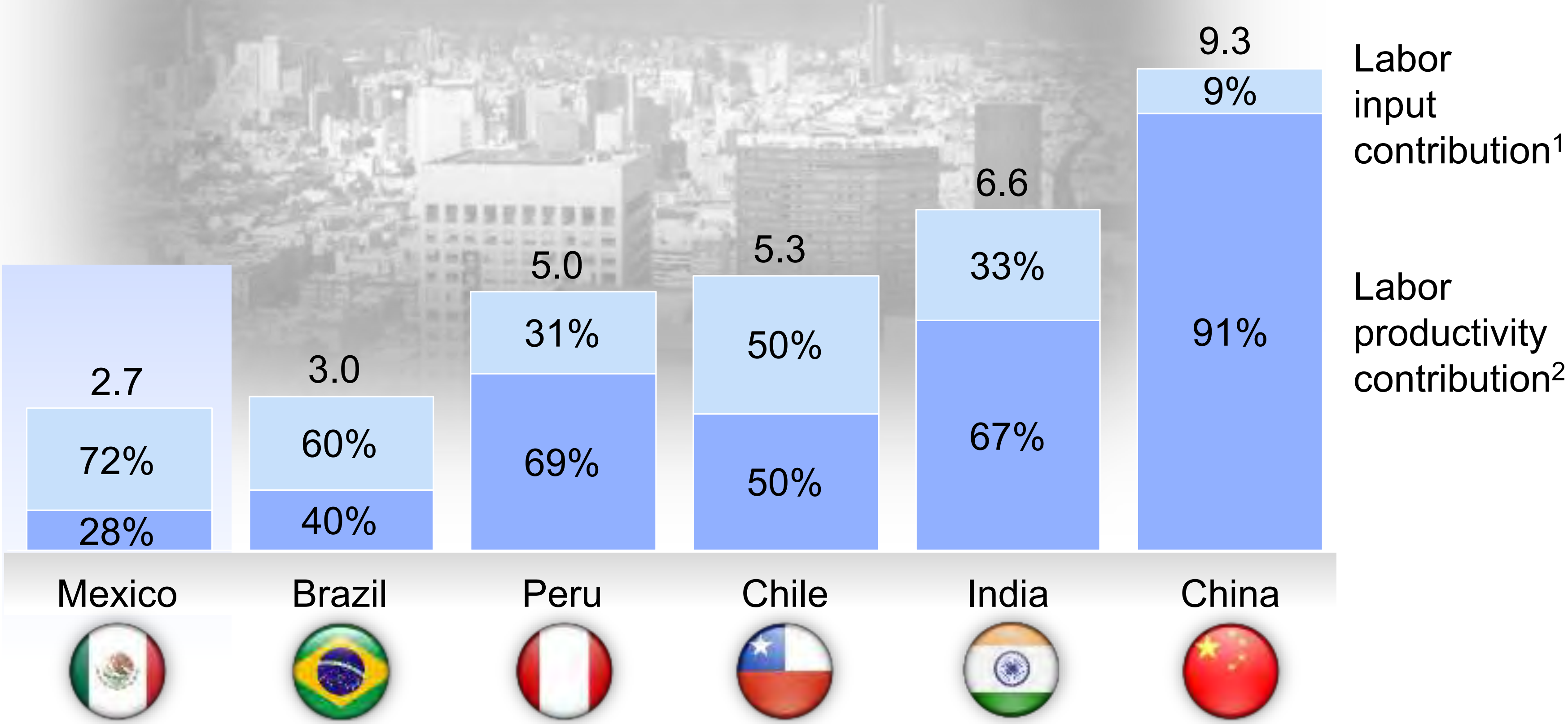


SOURCE: Conference Board Total Economy Database 2013; McKinsey Global Institute analysis

Population growth, not productivity has fueled Mexican GDP growth

Contribution of labor inputs and productivity increases to GDP growth, 1990-2012

Compound annual growth rate, percent



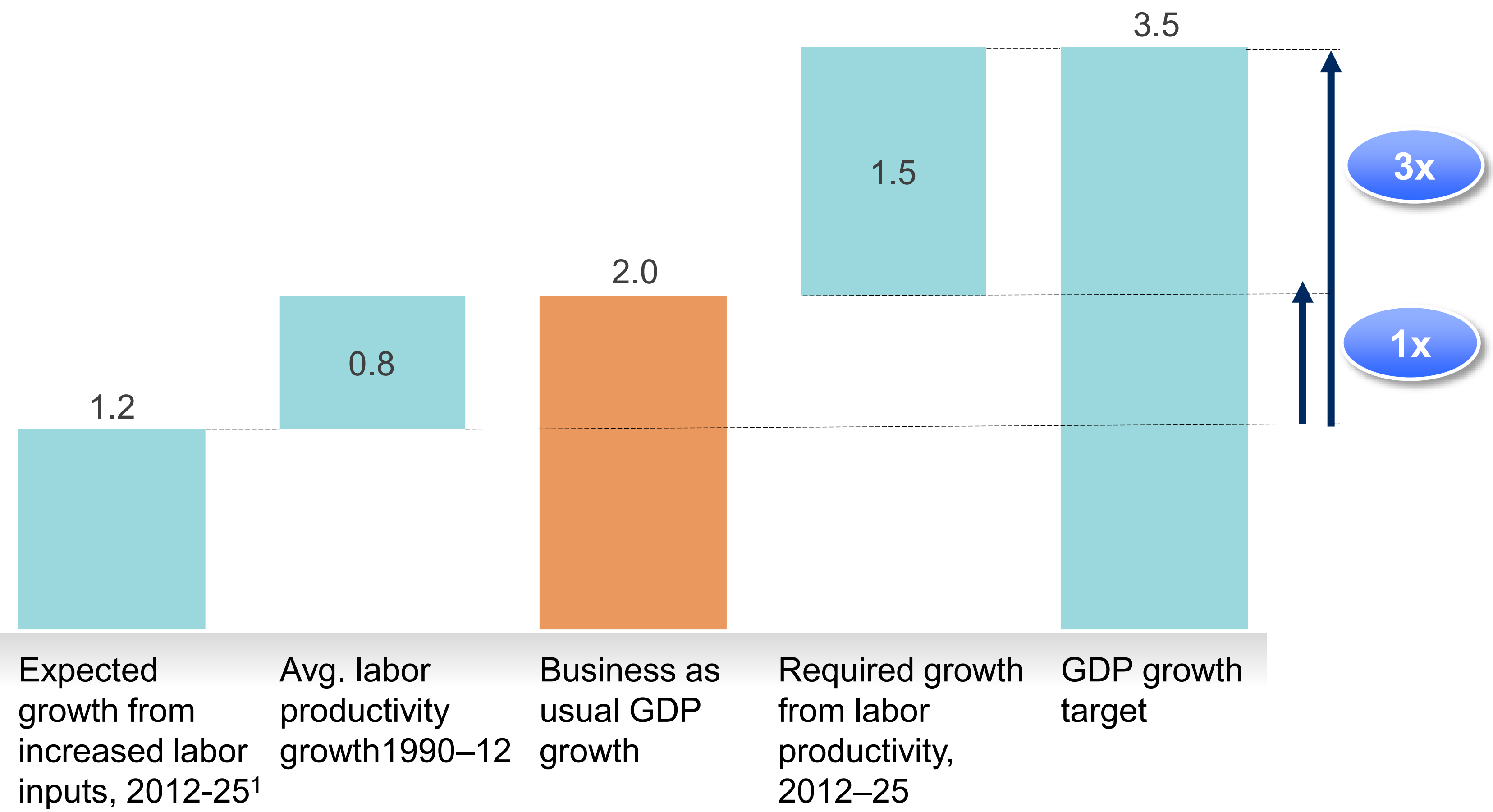
1 Higher labor input reflects increased population and changes in participation and employment rates; calculated as a residual

2 Labor productivity growth is measured as real GDP per employee

SOURCE: Conference Board Total Economy Database 2013; McKinsey Global Institute analysis

Without a boost in productivity, Mexico's growth will slow further to 2% per year

Annual real GDP growth rates
Percent



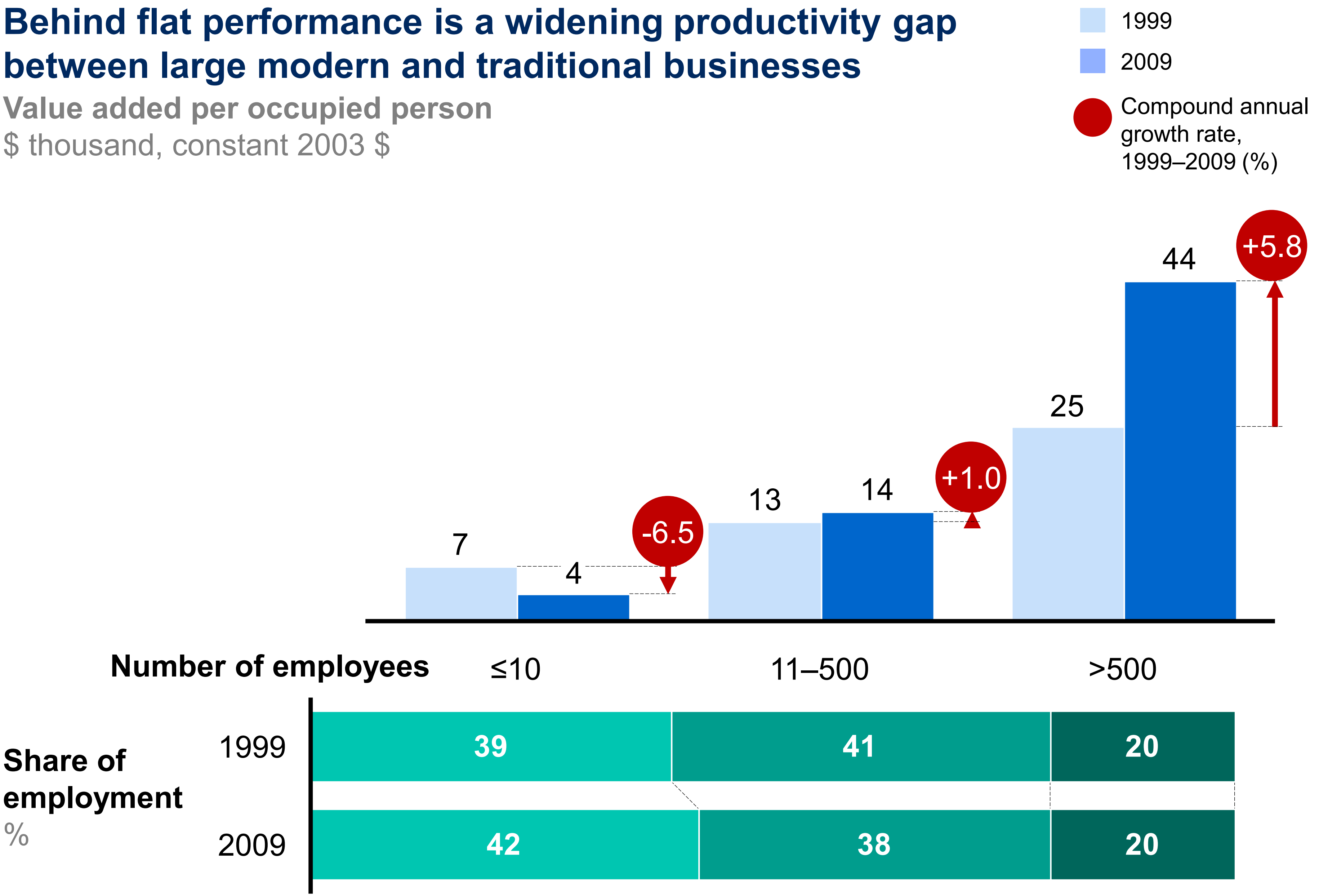
1 Driven by additional workers joining the workforce due to demographics and increased participation in workforce, employment rate assumed constant at 2012 level

SOURCE: ENEO, INEGI; McKinsey Global Institute analysis

Behind flat performance is a widening productivity gap between large modern and traditional businesses

Value added per occupied person

$ thousand, constant 2003 $



SOURCE: *Censos Económicos 1999, Censos Económicos 2009*, Instituto Nacional de Estadística y Geografía; McKinsey Global Institute analysis

3 key levers to boost productivity growth across the economy

- **Help traditional enterprises evolve into modern, formal SMEs**
- Expand access to capital, particularly for midsized companies
- Continue to make Mexico a place where world-class companies prosper

High cost of formality and poor enforcement discourage growth

28%	Social security cost of formal workers – avoided by informal hiring
11th	Mexico's rank on labor laws restrictiveness among OECD countries after the 2012 reform
7x	Cost of starting a formal business in Mexico vs. the US (as a percentage of average income)
73%	Electricity cost premium for commercial users vs. the US. small businesses pay 80% subsidized residential rates

Companies therefore stay…

- Small
- Informal

And they…

- Grow fragmented
- Limit geographic expansion

SOURCE: OECD; Doing Business, World Bank; McKinsey Global Institute analysis

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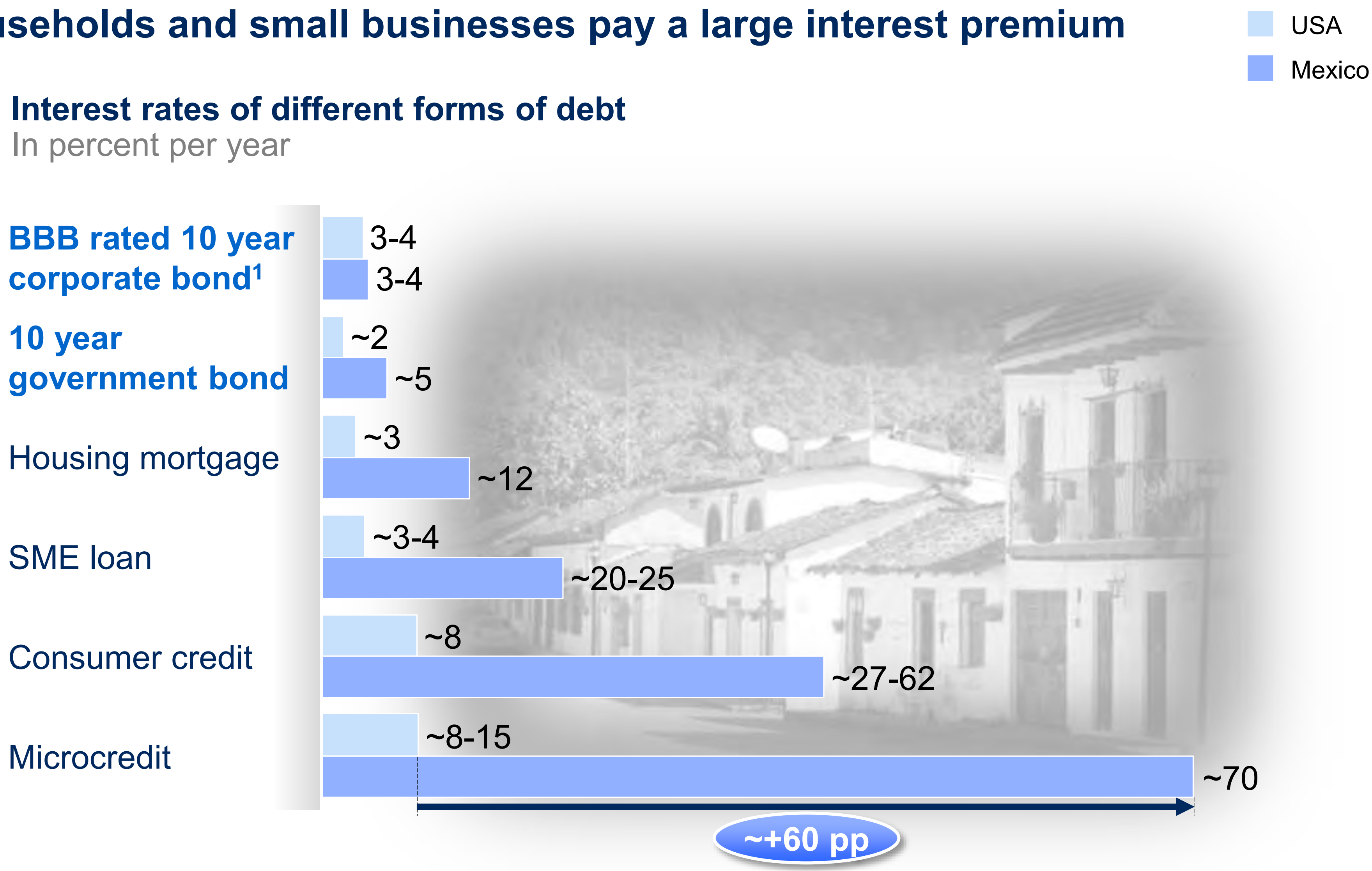
Households and small businesses pay a large interest premium

Interest rates of different forms of debt
In percent per year



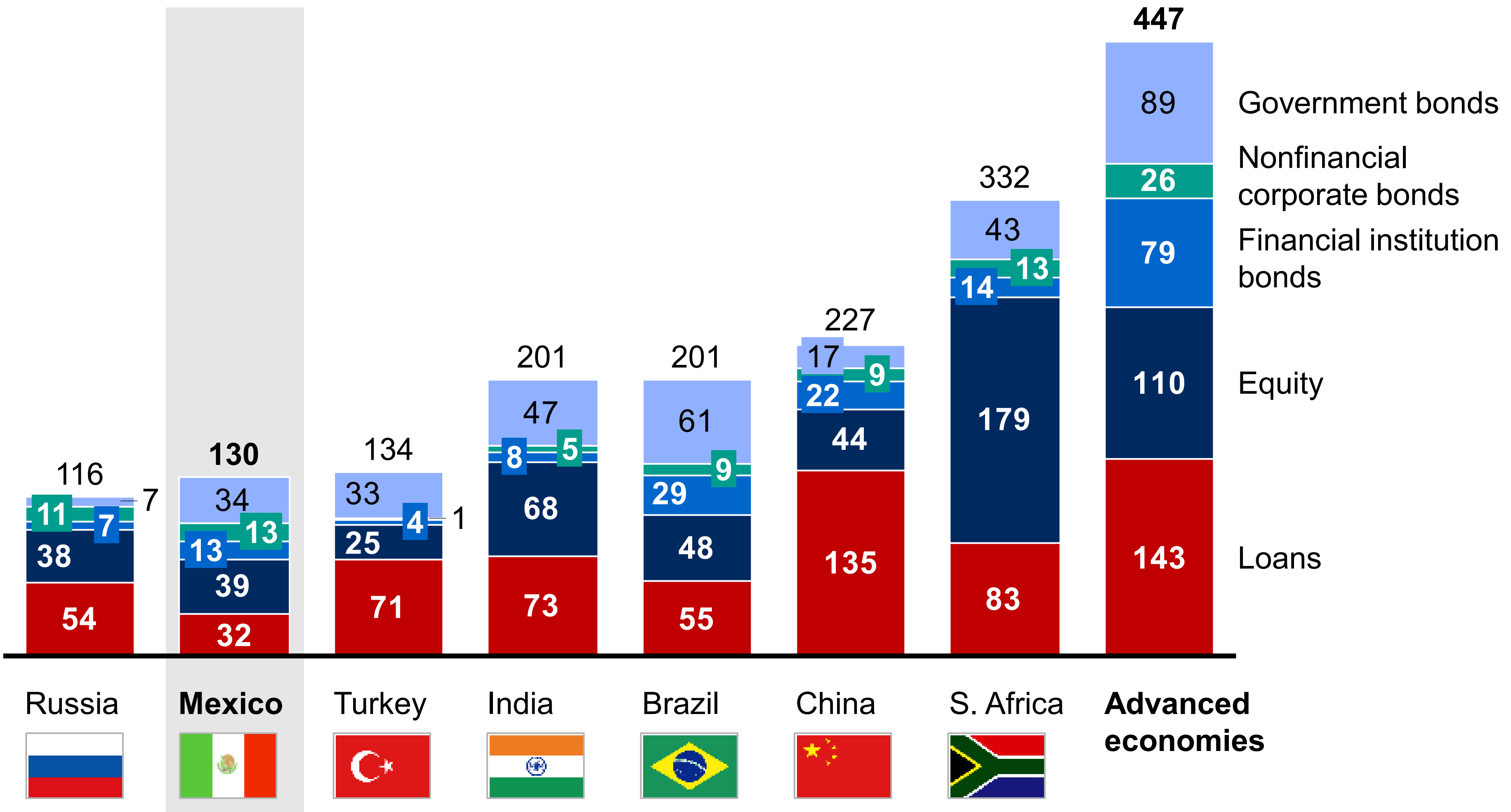
1 PPL Energy Supply LLC in the US and Banco Santander de México in Mexico

SOURCE: Bloomberg; Banco de Mexico; national sources; McKinsey Global Banking Pools; McKinsey Global Institute Financial Assets database; McKinsey Global Institute analysis

Access to capital is limited relative to other emerging economies, with particularly wide gap in loans

Financial depth, 2013

Stock of debt and equity as % of GDP



SOURCE: McKinsey Global Institute Financial Assets database; McKinsey Global Institute analysis

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Concluding thoughts

1. Closer North American integration has dramatically improved the performance of some industry segments

2. The biggest challenge is to jumpstart Mexico's domestic business growth engine to raise productivity and incomes among SMEs

3. There is plenty of room to boost productivity and continue to expand modern segment – more than enough to meet growth targets

Thank you

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