

Mexico Rides Global Recovery but Still Faces Hurdles

By *Jesus Cañas, Roberto Coronado and Robert W. Gilmer*

The Mexican economy has grown robustly following the worst recession since the peso crisis of 1994. Gross domestic product (GDP) growth surged 5.4 percent in 2010, surpassing expectations. Though the pace of expansion slowed in early 2011 as the U.S. engine sputtered, forecasts call for a slight pickup in the second half.¹

The recovery is the product of primarily three factors: first, a rebound in manufacturing exports, mostly to the U.S. but also to other markets; second, a strengthening internal market fueled by a healthy domestic financial sector; and third, significant capital inflows from advanced economies seeking higher rates of return in emerging markets such as Mexico.

In spite of the recovery, the country faces significant challenges both in the short and long run, including the worst violence since the Mexican Revolution.

Export-Led Recovery

Mexico's rebound began in summer 2009, led by manufactured goods exports to the U.S., where the recession had ended that June. Factory production accounted for 82 percent of Mexican exports in 2010, with oil representing 14 percent and mining and agriculture 4 percent. The U.S. took in 80 percent of all Mexican exports.²

Mexico has increasingly looked globally, especially to fast-growing developing countries such as China, Brazil and Colombia, to offset its largest trading partner's relatively slow growth. Activity with the rest of the world jumped 152 percent from 2000 to 2010, while exports to the U.S. expanded 28 percent (*Chart 1*). Though non-U.S. exports accounted for just 20 percent of the Mexican total in 2010, sales to developing nations bounced back from the recession further and faster than exports to the U.S.

Domestic Demand Rises

Rapid revival of internal markets is an important part of Mexico's recovery. Both

bank lending and employment are driving personal consumption higher.

Damage to the domestic banking industry was limited, and unlike in the U.S., there was no housing crisis or excessive consumer debt. These factors allowed the quick restoration of broad-based bank lending that now exceeds precrisis levels (*Chart 2*). Mortgage lending barely paused during the global crisis, while commercial lending slowed before expanding in 2010 and early 2011.

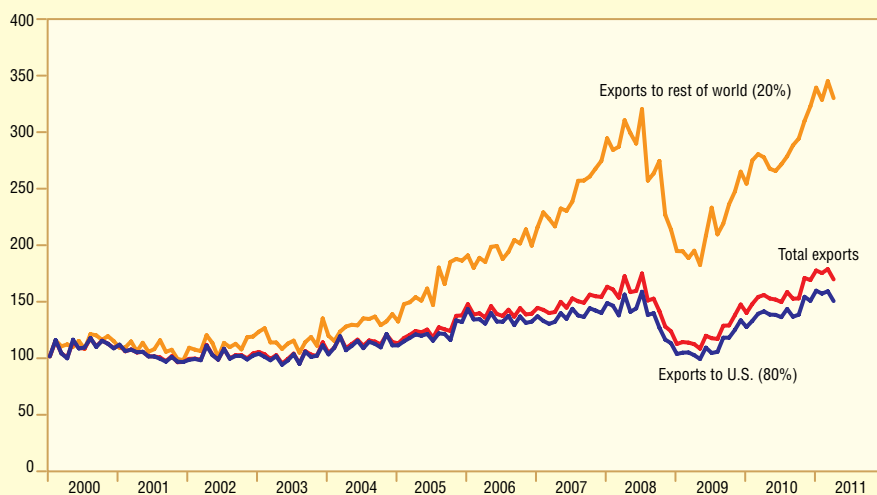
Consumer lending, mostly involving credit cards, contracted significantly during the crisis. It began to rebound in early 2010 but remains roughly 20 percent below pre-recession peaks. One positive: Lending for consumer durables has recovered to precrisis levels.

The job market quickly responded to the recovery. Formal employment—jobs with government protections and pensions—grew

The central question is not if Mexico can expand, but whether it can do so fast enough to significantly improve living standards.

Chart 1
Mexico's Non-U.S. Exports Take Off

Index, January 2000 = 100*



* Real, seasonally adjusted.

NOTE: Percentages reflect share of Mexican exports.

SOURCES: Banco de México; authors' calculations.

by 700,000 positions in 2010, the best year since 1998. Mexico added another 280,000 jobs from December 2010 through June, and formal-sector average wages neared precrisis levels (*Chart 3*).

Led by consumer lending and employment growth, real (inflation-adjusted) personal consumption moved upward beginning in first quarter 2010, expanding at an average rate of 5 percent per quarter. Additionally, retail sales, which fell 7.8 percent during the downturn, are now within 2 percentage points of the prior peak.

Investment Resilient Despite Violence

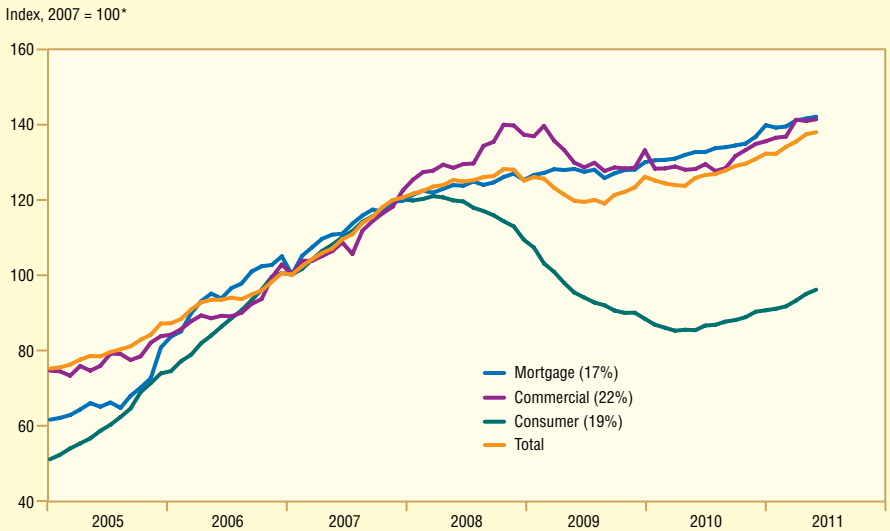
Mexico's higher rates of return vis-à-vis advanced economies have attracted significant flows of foreign direct and portfolio investment.³ Portfolio investment such as publicly traded debt and stock reached \$24 billion in 2010, surpassing foreign direct investment (FDI) for the first time since 1993. Partly as a result, the peso has appreciated 10 percent against the dollar since December 2009.

The relatively strong currency helped mitigate inflation pressures from high commodity prices, allowing Banco de México to keep its benchmark lending rate at a record low 4.5 percent for two years. The accommodative monetary policy permitted quick restoration of domestic business investment, with spending in construction and machinery and equipment growing for almost two years. A recent central bank survey of Mexican business executives indicated that the current environment is likely to encourage further investment in coming months.

FDI has also contributed to the recovery, bouncing back in 2010 after falling in 2008 and 2009. It totaled \$19 billion in 2010, up 20 percent from the previous year, but is still 40 percent below 2007 levels. Despite unprecedented, drug cartel-related violence, particularly along the northern border, 42 percent of FDI was channeled to states adjacent to the U.S. Five of the most violent states, Baja California, Chihuahua, Durango, Nuevo León and Tamaulipas, were among the country's top 10 FDI recipients in 2010 (*Chart 4*).

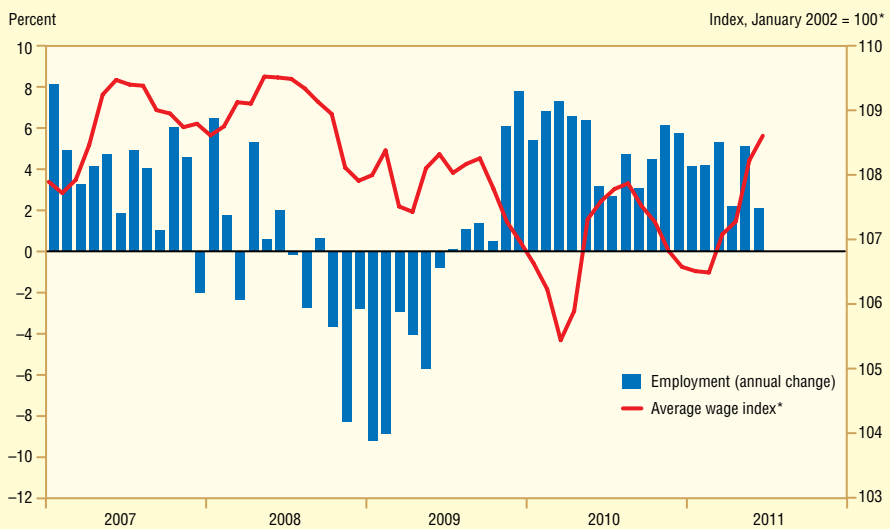
Maquiladoras, or offshore manufacturing plants, have a strong presence along the U.S.-Mexico border and, consequently, are responsible for a significant share of FDI.⁴ More than 140,000 jobs have returned in these export-oriented facilities along the border since December 2009.

Chart 2
Bank Lending Surpasses Precrisis Levels



* Real.
NOTE: Percentages reflect share of lending; industrial, government and other lending categories not shown.
SOURCES: Banco de México; authors' calculations.

Chart 3
Recovery Marked by Strong Job Growth



* Real.
SOURCES: Instituto Mexicano del Seguro Social; authors' calculations.

The auto and electronics sectors account for the majority of maquiladora activity in northern Mexico. After China joined the World Trade Organization in 2001, several maquiladoras closed as China's lower wages lured away production. However, recent anecdotal evidence suggests that some plants have returned to northern Mexico.

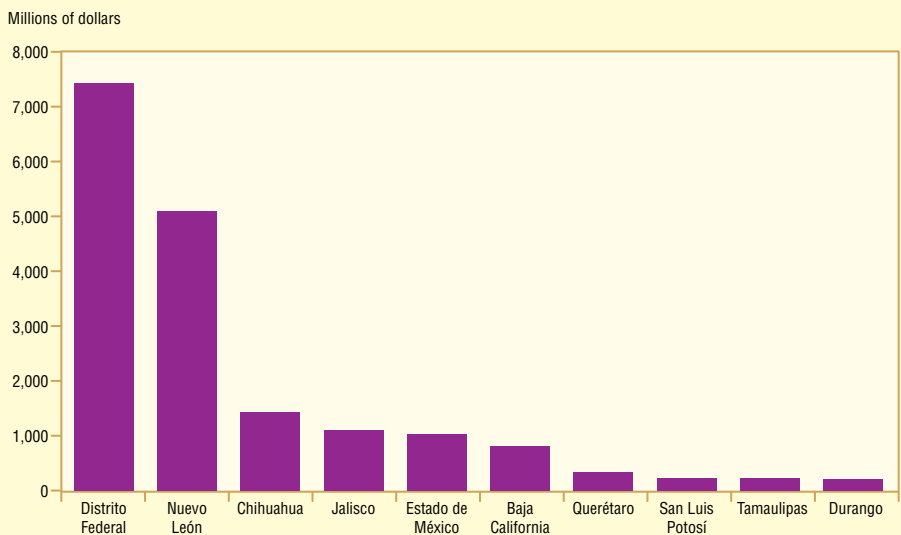
There are several explanations for this emerging trend. First, higher energy prices raise transportation costs for products

headed to the American market. Second, consistent Chinese worker pay increases have narrowed the wage gap between China and Mexico. Third, while the peso has recently appreciated against the dollar, China's currency has retained its strength against its U.S. counterpart. Finally, anecdotal evidence suggests that China hasn't consistently delivered the quality standards of Mexico, especially within the transportation and high-tech electronics sectors.

Chart 4

Foreign Direct Investment Flowing Despite Violence

(Mexico's top 10 state recipients in 2010)



SOURCE: Secretaria de Economía.

Immediate Obstacles

Potential challenges confront the Mexican recovery, five of them in the near term.

Significantly, Mexico's economy remains coupled to the U.S., which still suffers from uncomfortably slow growth even though demand for durable goods such as autos, home appliances, televisions and other consumer electronics led the Mexican manufacturing export rebound. The U.S. faces the combined effects of the Japanese earthquake on global manufacturing, the housing market's inability to find a definitive bottom and spillover from the European sovereign debt crisis. This soft patch has quickly extended into Mexico, where private-sector analysts have revised down their forecasts for 2011 GDP growth.

Second, developing nations that buffered Mexico from U.S. sluggishness now face their own threats. Rapid growth, capital inflows and higher commodity prices have bred inflation in several countries. As these nations tighten monetary policy and rein in bank lending to slow their economies, they risk overshooting and reducing growth too much. Conversely, policymakers may not be sufficiently vigilant in controlling inflation and risk harming development and longer-term growth. A potential emerging-market cooldown would, in turn, slow Mexican exports.

Third, while it appears escalating vio-

lence hasn't yet significantly slowed investment, it may take a toll on the economy in the near future, particularly among small businesses. Mexico's central bank recently published its first regional economic report.⁵ It highlights northern Mexico as the fastest-growing region and one where more than 68 percent of companies have been touched by organized crime. Extortion, which local media as well as anecdotal evidence suggest has accelerated, has caused small-business closures.

Fourth, to the extent Mexico confronts the rising inflationary pressures noted in other emerging-market economies, its central bank will need to step in, possibly slowing the recovery and braking growth in the short run. The country's comfortable fiscal position—a budget deficit of around 2.5 percent of GDP and public debt at about 35 percent of GDP—will facilitate central bank movement toward monetary tightening, if needed.

Fifth, capital flows could potentially reverse amid global investor fickleness, weakening the peso, driving up interest rates, depressing asset prices and reducing funding availability. Policymakers have two main weapons to combat capital flight: international reserves and an International Monetary Fund contingent credit line. By combining the two, Mexico's central bank has around \$200 billion in reserves to defend the peso, if needed.

Longer-Term Challenges

The development of oil production, which is critical to government finances, and the implementation of structural economic reforms lead the list of medium- to long-term challenges confronting Mexico.

The country is the world's seventh-largest oil producer, though output has declined about 24 percent from its 2004 peak. Production is contracting twice as fast as expected at Cantarell, national oil company Pemex's largest field. Oil exports account for about 40 percent of public revenue, with higher prices offsetting tumbling production. Nevertheless, the combined effects of falling prices and accelerating oil output declines could significantly depress government finances. Mexico may need to open its energy sector and expand production by allowing foreign capital.

Mexico successfully implemented several economic reforms during the second half of the 1980s and the early 1990s, most notably privatization of some government enterprises, trade liberalization and deregulation. Mexico has enjoyed macroeconomic stability, thanks largely to an independent central bank and fiscal discipline.⁶ However, a large informal sector (characterized by off-the-books businesses outside government regulation), tax loopholes and weak competition in key industries such as telecommunications must be addressed in a new round of structural reforms if Mexico is to achieve greater economic growth and, ultimately, a higher living standard.

Mexico's informal sector is a drag on the country's economic development. By some estimates, it accounts for as much as one-third of Mexico's \$1 trillion economy. Informal-sector firms lack access to credit and legal protections—limiting their ability to innovate and grow. Labor informality also suppresses the accumulation of human capital required for sustainable economic growth.⁷ Finally, the informal sector pays no taxes. Mexico's tax revenue totals only 20 percent of GDP. That figure drops to 12 percent when oil revenues are excluded from the calculation.⁸ To secure medium-term sustainability of public finances, fiscal reform must achieve a more efficient tax system less dependent on oil.

In addition to the challenge posed by a large informal sector, key industries lack meaningful competition. Mexico started privatization of its public sector during the '90s. Unfortunately, the effort was flawed

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and public monopolies were replaced by private ones. As a result, consumers still face expensive and outdated electricity, telecommunications and Internet services.⁹ Enhancing competition and lowering market entry barriers would promote a higher quality and greater variety of consumer-related services.

Mexico joined the global recovery not only via the external sector but also through a healthy domestic market. The current U.S. slowdown is diminishing growth prospects. The central question is not if Mexico can expand, but whether it can do so fast enough to significantly improve living standards. This can be accomplished by building on structural reforms principally aimed at reducing informality, promoting business competition and boosting public finances.

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Notes

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¹ The Mexico GDP growth rate is calculated year over year. Measured quarter over quarter, Mexico GDP growth slowed to a 2.4 percent annual rate in first quarter 2011 but bounced back in the second quarter, growing at a 4.4 percent rate. Year over year, GDP growth slowed to a 3.3 percent rate in second

quarter 2011 from 4.6 percent in the first quarter.

² For more details behind the strong trade ties between both nations and the recent trade recovery, see "Trade Conference Explores U.S.–Mexico 'Common Bonds,'" by Jesus Cañas, Roberto Coronado and Robert W. Gilmer, Federal Reserve Bank of Dallas *Southwest Economy*, First Quarter, 2011.

³ In 2010, Mexico was included in the World Government Bond Index, which further spurred capital inflows.

⁴ For more details on maquiladoras, see "Maquiladora Recovery: Lessons for the Future," by Jesus Cañas, Roberto Coronado and Robert W. Gilmer, Federal Reserve Bank of Dallas *Southwest Economy*, no. 2, 2007, and "Maquiladora Industry: Past, Present and Future," by Jesus Cañas and Roberto Coronado, Federal Reserve Bank of Dallas *Business Frontier*, no. 2, 2002.

⁵ The Banco de México report on the regional economy can be found at www.banxico.org.mx/publicaciones-y-discursos/publicaciones/informes-periodicos/reportes-sobre-las-economias-regionales/reportes-economias-regionales.html.

⁶ For more details, see comments by Banco de México's Governor Agustín Carstens in "Mexico's Economic Reforms Propel Postrecession Rebound," Federal Reserve Bank of Dallas *Southwest Economy*, Second Quarter, 2011.

⁷ See *La Era de la Productividad*, by Carmen Pagés, Washington, D.C.: Inter-American Development Bank, 2010.

⁸ See "Economic Survey of Mexico 2011," Organization for Economic Cooperation and Development, May 2011, www.oecd.org/document/34/0,3746,en_2649_34569_47781730_1_1_1_1,00.htm.

⁹ See *No Growth Without Equity? Inequality, Interests, and Competition in Mexico*, Santiago Levy and Michael Walton, ed., Washington, D.C.: World Bank, and Houndmills, U.K., and New York: Palgrave Macmillan.