Mexico's *Año Horrible*: Global Crisis Stings Economy

By Edward C. Skelton and Erwan Quintin

Over the past few months, optimism has been replaced by increasingly dire predictions for the country's near-term economic outlook.

Until last September, the global economic slump was expected to take a fairly limited toll on the Mexican economy. There was even talk of decoupling—that, for once, a U.S. recession would leave Mexico relatively unscathed. Over the past few months, however, this optimism has been replaced by increasingly dire predictions for the country's near-term economic outlook.

This deterioration is hardly surprising. The global crisis intensified markedly in September 2008, and the true magnitude of the slowdown began to emerge. World trade flows dried up, which is particularly damaging for nations like Mexico whose economic activity depends critically on exports. At the same time, international financial uncertainty led investors to withdraw capital from emerging markets.

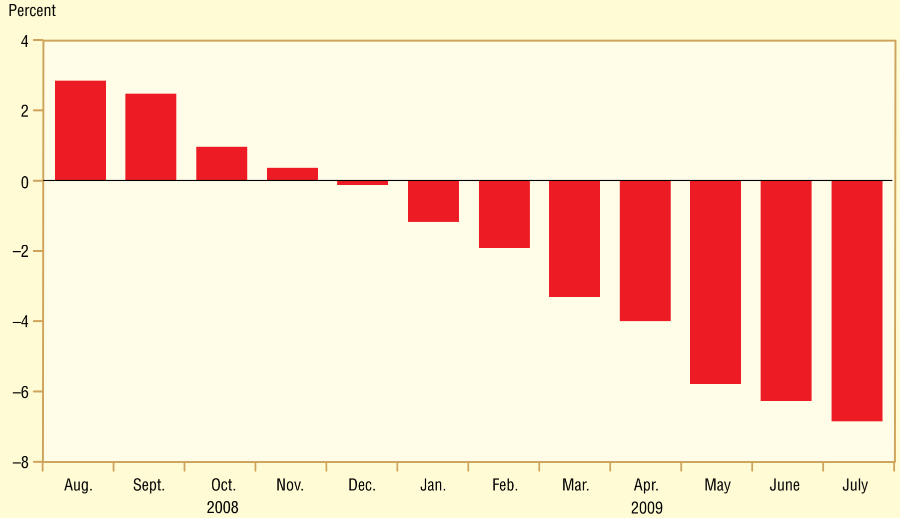
As if that weren't enough, Mexico was confronted with a number of idiosyncratic shocks: a crackdown on drug cartels and local corruption, a flu epidemic and trade disputes with its most important partner. The result of this confluence of bad news and bad luck is that Mexico is experiencing a truly horrible 2009.

But even this darkest of clouds has a silver lining. Twenty years ago, circumstances such as these almost surely would have caused a financial collapse in Mexico. To date, none has occurred. In fact, recent data suggest the financial system is exhibiting stability even as a severe recession plagues the country. This resilience demonstrates the strides Mexico has made toward reducing its financial vulnerability.

Anatomy of a Recession

Officially, the U.S. recession began in December 2007. Yet, Mexico's economy continued to expand for much of 2008. Through November of that year, most forecasts for 2009 gross domestic product (GDP) growth called for Mexico to avoid recession (*Chart 1*). Forecasters cited Mexico's strong

Chart 1
Forecasts Point to Deteriorating Mexico GDP Growth
(Projections for full-year 2009 as of each month)



SOURCE: Banco de México, Survey of Private Sector Analysts.

macroeconomic fundamentals and lack of exposure to the problems afflicting the U.S. and Europe.

Forecasts of decreasing economic activity gained momentum after the beginning of 2009. Since then, however, forecasts for growth have tumbled well into negative territory. Mexico's economy is now expected to contract by over 6 percent this year.

Recent data support this pessimism. Surprisingly resilient for a while, Mexican exports plunged—as they inevitably do when U.S. manufacturing activity weakens (*Chart 2A*). This is a big reason Mexico, together with other trade-dependent nations such as Germany and Japan, now ranks among the countries hardest hit by the global slump. When exports collapse, industrial output is never far behind. Despite talk of possible decoupling last year, Mexico is once again tracking the U.S. almost step for step in industrial output (*Chart 2B*).

Weakening economic activity has accelerated job destruction. As tends to be the case during severe contractions, employer-initiated job terminations are rising (*Chart 3*). Recent research has demonstrated the importance of this indicator.[1] During tranquil times, job flows are a natural part of well-functioning labor markets. During deep

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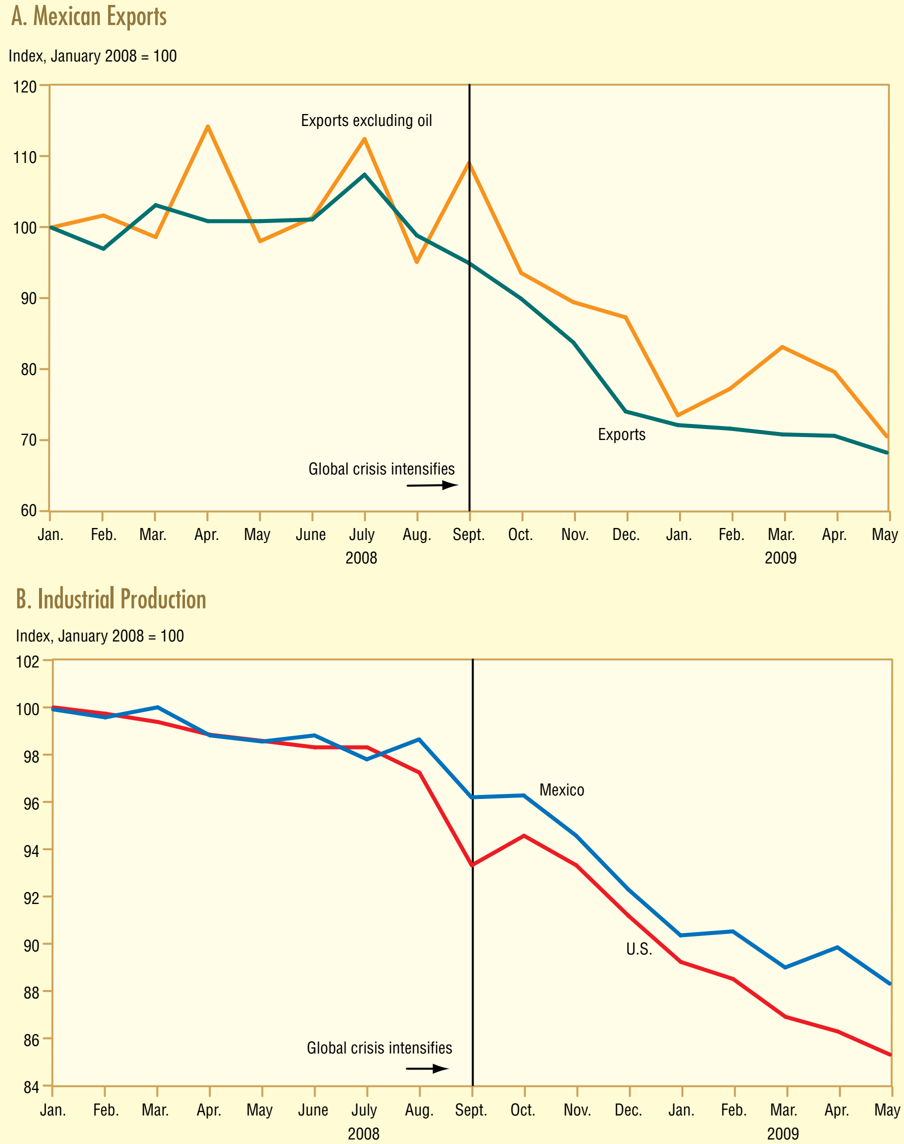
Chart 2
Exports and Industrial Production Plummet



SOURCES: Instituto Nacional de Estadística y Geografía; Banco de México; Haver Analytics; Federal Reserve Board.

slumps, however, many workers are forced to move to occupations and sectors for which their skills may be ill-suited, resulting in productivity losses.

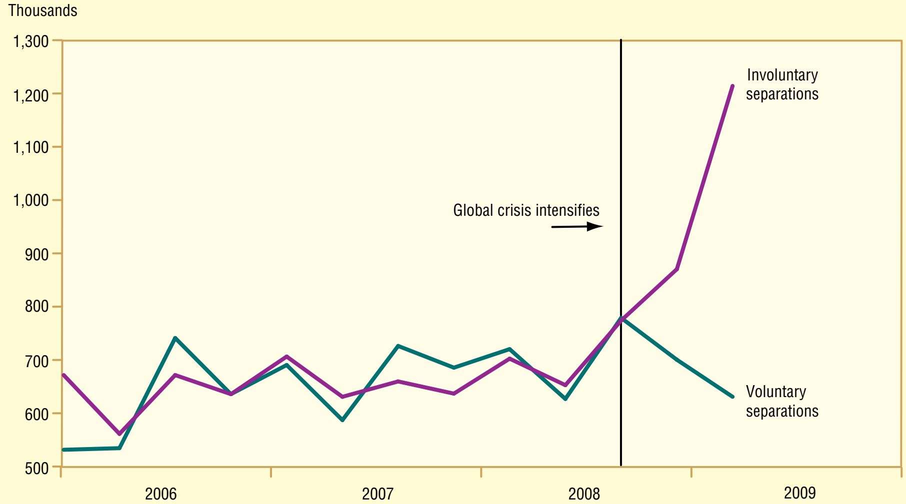
Further cutting into growth in Mexico is the weak labor market in the U.S. Money sent home by Mexican workers in the U.S., called remittances, plunged 20 percent in the 12 months ending in May. The impact fell largely on poorer families.

A 2009 Banco de México survey pointed to a key factor in the falling remittances: Mexicans in the U.S. are disproportionately employed in sectors that have declined most dramatically, with construction a prominent example.[2]

Uncertain employment and income prospects, domestic shocks and the loss of help from relatives in the U.S. have greatly weakened Mexican consumer confidence and spending.

Unfortunately, consumers aren't the only ones cutting back. Domestic investment has dropped over 10 percent since October, which bodes ill for the country's near-term outlook. Even foreign direct investment, a typically resilient engine of Mexico's growth and one of Mexico's strong suits over the past two decades, is heading in the wrong direction.

Chart 3
Mexico's Job Destruction Accelerates



NOTE: Involuntary separations refers to workers who are unemployed because their employers laid them off or went bankrupt, their contracts expired and weren't renewed, or their employers moved.
SOURCE: Instituto Nacional de Estadística y Geografía.

'Tequila'-Size Slump

This litany of depressing economic news made bad GDP numbers inevitable. Indeed, recent readings have been jaw-dropping.

The last quarter of 2008 seemed disastrous enough, with an annualized decline of 10 percent. But the pace of contraction more than doubled in the first quarter of 2009 (*Chart 4*). In the second quarter—a period affected by the swine flu scare—real output fell by 4.5 percent. The contraction has slowed, but it remains quite steep. Economic activity is 10 percent below its level at the same time last year.

To put things in historical perspective, Mexico hasn't experienced a GDP contraction like this since its infamous Tequila Crisis of the mid-1990s. The episode's name refers to the economic hangover that resulted from an abrupt drop in the peso's value. What worries some observers is that the magnitude of the current downturn isn't the only similarity with the Tequila Crisis.

Last fall, when the global economic picture took a turn for the worse, the peso suddenly collapsed as Mexico's borrowing costs soared. Between August and April, the peso lost 40 percent of its value vis-à-vis the dollar, a depreciation not seen in Mexico since December 1994.

Also reminiscent of pre-Tequila tensions is the vast amount of foreign reserves the central bank is spending trying to contain peso pressures. Since the peso weakness began in October, the central bank has provided almost $20 billion in liquidity to ease peso volatility.

Evidence of capital flight also materialized in the cost of the country's debt. The premium Mexico pays relative to comparable U.S. instruments more than tripled last fall. Although the initial spike has moderated, Mexican debt is still significantly more expensive than in recent years.

As a result of these financial disruptions, some firms have reported difficulties getting credit through standard means. The central bank, federal government and development banks have all taken steps to ensure businesses can obtain the working capital they need.

It's important to note that Mexico is not alone in this financial predicament. The response to last fall's global financial turbulence mirrors what often happens in a global crisis: Investors, perceiving heightened risk, pull their money out of emerging markets.

Currencies have depreciated sharply and country risk premia have risen since last August throughout the emerging world

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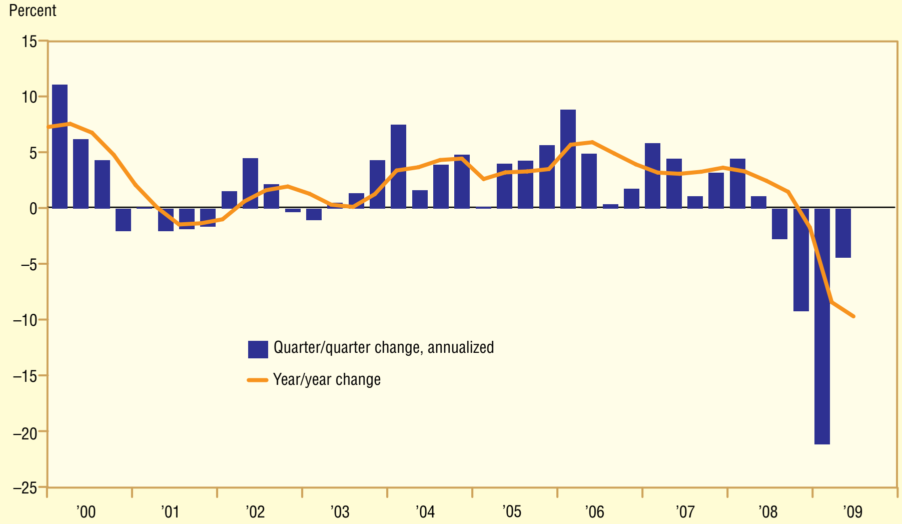
Chart 4
Mexico's Real GDP Collapses



SOURCE: Instituto Nacional de Estadística y Geografía.

As recently as 20 years ago, the collection of real and financial shocks now confronting Mexico would have set off debt defaults and a banking crisis. To date, nothing of the sort has occurred.

(*Chart 5*). In other words, there's nothing Mexico-specific about this capital flight.

More important, Mexico is in a far stronger position to deal with these shocks today than it was prior to the Tequila Crisis.

Greater Policy Discipline

As recently as 20 years ago, the collection of real and financial shocks now confronting Mexico would have set off debt defaults and a banking crisis. To date, nothing of the sort has occurred.

Since the Tequila Crisis, Mexico has displayed a steadfast commitment to monetary and fiscal discipline.[3] This has enabled the country to stop relying on short-term, foreign-currency-denominated debt. It now routinely issues 10-, 20- and 30-year peso-denominated, fixed-interest bonds. As a result, Mexico no longer lives and dies with the mood swings of fickle foreign investors.

The banking sector is in much better shape than it was in the early 1990s, adding to the country's stability. Although currently on the rise, problem loans are a fraction of what they were even five years ago. And Mexico's banking system has little direct exposure to toxic assets.[4]

Mexico's banking system, in fact, bears little resemblance to what it looked like in 1994. At that time, the banks had just been privatized under a poorly designed auction process. In the five years leading up to the Tequila Crisis, credit quadrupled as a share of GDP. Back then, Mexico's financial system lacked the type of regulatory, risk management and legal infrastructure necessary to support credit growth and a healthy financial environment.

In addition, banks were highly exposed to currency risks because many of their liabilities were denominated in U.S. dollars. The collapse of the peso in December 1994, together with jumps in interest rates and inflation, put tremendous stress on bank balance sheets, eventually leading to a full-blown banking crisis.

Experience is a harsh tutor, and Mexico learned the lessons taught by the earlier financial system collapse.[5]

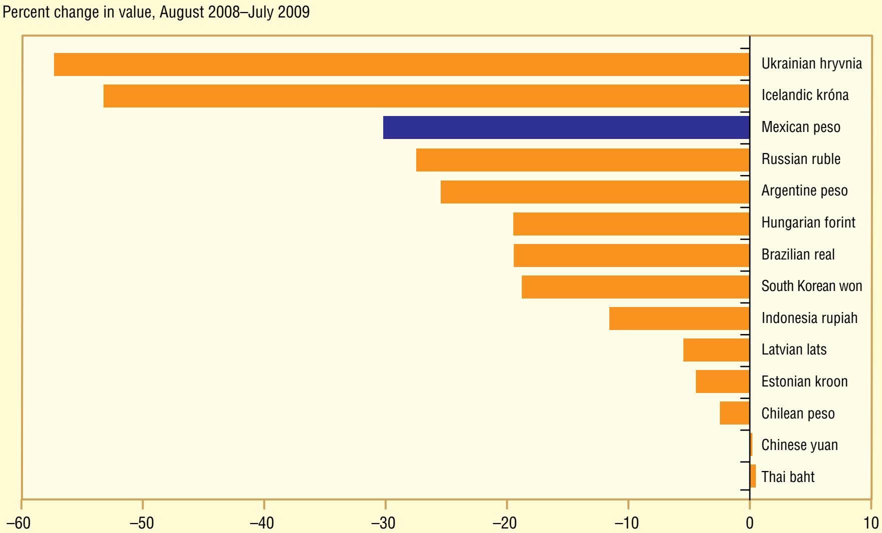
Banks have lowered their exposure to currency movements by reducing their dollar borrowing. They also measure risk much more effectively than in the mid-1990s and are considered well-capitalized under international accounting standards. Furthermore, financial system authorities have spent a great deal of time and energy modernizing supervision. Transparency has greatly improved as financial authorities have implemented regulations and accounting practices consistent with, and in many cases more stringent than, international standards.[6]

Prospects for Improvement

When is Mexico likely to emerge from this deep recession?

For the most part, Mexico's troubles

Chart 5
Investors Dump Emerging-Market Currencies in Quest for Liquidity



NOTE: Base currency is U.S. dollars.
SOURCES: The central banks; *Financial Times.*

result from the global slump. Therefore, improvement should materialize when the global economy—and the U.S. in particular—begins to recover.

Most forecasters expect the world economy to shrink 1 to 2 percent this year, bringing about the first global recession since World War II.[7] Next year should bring positive, if small, numbers for world output growth. The U.S. economy is expected to contract 2 to 3 percent this year and grow at a slow pace next year.

The short-term outlook is worse for Mexico than the U.S. Because of its heavy reliance on exports and the country-specific shocks it's experiencing, the Mexican economy is expected to retreat 6 percent or more this year. Growth should turn positive by the end of 2009 but remain weak.

While Mexico awaits a turnaround in global economic activity, policymakers are trying to mitigate the effects of the contraction without compromising their dedication to policy discipline.

Mexico was slow to use monetary policy to respond to the deteriorating conditions because the weakening peso threatened price stability. Once the peso stabilized and inflation began to wane, the central bank aggressively lowered the overnight interest rate. The rate is down 375 basis points since January, leaving it at 4.5 percent.

Mexico responded more quickly with fiscal policy, passing a stimulus package at the end of 2008. However, the government's fiscal challenges greatly constrain its ability to spend during downturns.[8] Mexico depends heavily on oil prices for revenue because its large informal economy limits its ability to raise taxes. Consequently, the eventual size of the stimulus package is likely to be rather small. After maintaining a near-balanced budget over the previous few years, Mexico's Congress approved a budget deficit of 1.8 percent of GDP for 2009.

Despite Mexico's *año horrible*, the country's remarkable efforts to reduce its financial vulnerability have enhanced its ability to deal with large economic shocks. Mexico's economy has been bloodied but has avoided collapse, thanks to prudent policymaking and a much improved financial system.

At the same time, Mexico has yet to address many areas of vulnerability. The nation's economic activity remains highly dependent on external forces. Mexico still rises and falls with the U.S. Rumors of decoupling, it seems, have been greatly exaggerated.

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Notes

[1] See "Labor Markets in Turbulent Times: Some Evidence from Mexico," by Sangeeta Pratap and Erwan Quintin, Federal Reserve Bank of Dallas *Southwest Economy*, no. 5, 2008.

[2] See "Las Remesas Familiares en 2008," Banco de México, Jan. 27, 2009.

[3] The many steps taken by Mexico to reduce its financial exposure are discussed in detail in "Mexico's Financial Vulnerability: Then and Now," by José Joaquín López and Erwan Quintin, Federal Reserve Bank of Dallas *Economic Letter*, vol. 1, no. 6, June 2006.

[4] Generally, "toxic assets" refers to financial products that are difficult to value and almost impossible to sell. More specifically, in the recent financial system volatility, toxic assets in the U.S. have included subprime mortgage-backed securities, among other products.

[5] For more information about the evolution of Mexico's financial system, see "Financial Globalization: Manna or Menace? The Case of Mexican Banking," by Robert V. Bubel and Edward C. Skelton, Federal Reserve Bank of Dallas *Southwest Economy*, no. 1, 2002.

[6] The modernization of Mexico's banking system is discussed in more detail in "Mexico Emerges from 10-Year Credit Slump," by Robert V. Bubel and Edward C. Skelton, Federal Reserve Bank of Dallas *Southwest Economy*, no. 3, 2005.

[7] Output growth projections can be found, for instance, in the International Monetary Fund's *World Economic Outlook Update*, July 2009, available for download at www.imf.org/external/pubs/ft/weo/2009/update/02/index.htm.

[8] For a discussion of Mexico's fiscal difficulties, see "Raising Taxes in Mexico," by Erwan Quintin, Federal Reserve Bank of Dallas *Southwest Economy*, no. 1, 2001.