Mexico’s Economic Outlook:
Challenges and Opportunities

Remarks by

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I would like to thank the Center for Hemispheric Policy of the University of Miami for the invitation to speak at this conference addressing the growth and trade prospects for Latin America.

In my talk, I will focus on the short- and medium-term outlook for the Mexican economy. My central message will be the following: The deep recession suffered by Mexico during the past two years was mainly due to external factors, but its impact was somewhat mitigated by the soundness of the country's macroeconomic fundamentals. Although the world and Mexico have recently started to show signs of an economic recovery, sustainable growth will require prudent economic management.

To elaborate on these issues, I will divide my presentation into three parts. First, I will analyze how the global financial crisis affected Mexico and how this recession was different from previous ones. Second, I will discuss the economic outlook for Mexico in the international context. Finally, I will comment on some policy challenges for the global economy and Mexico.

The impact of the global crisis in Mexico

During the last two years, Mexico experienced a harsh economic downturn. Official data suggest that the economic contraction started during the second quarter of 2008 and probably ended in the same quarter of 2009. During this five-quarter period, per-capita GDP plummeted by approximately 10%, a fall similar to the one observed in the first half of 1995. In modern history, the depth of the recent recession has been clearly surpassed only during the Great Depression, when the country's per-capita GDP collapsed 26% between 1928 and 1932. The loss of per-capita income and employment in the recent recessionary period has significantly damaged the wellbeing of many Mexicans.

By far, the most distinct feature of this modern contraction relative to others in the post-war period was that it comprised two adverse external shocks that fed back into each other and led to a dangerous deterioration of economic and financial conditions. As was the case for other emerging economies, Mexico was affected by the global crisis through the financial sector in the form of substantial market volatility and a generalized fall in asset prices. However, the Mexican economy was most deeply disturbed through the real sector, as seen in the contraction of international flows of goods and services, especially to and from the United States, Mexico's main trading partner.

As we know, the widespread increase in risk aversion triggered by the problems derived from the previous lending boom in the housing and real estate sectors of the United States caused substantial financial turbulence worldwide. In particular, the Lehman Brothers collapse in September 2008 sparked major volatility which started falling only seven months later. Massive monetary injections in several countries and an official bailout program for troubled financial institutions in the United States allowed international financial markets a gradual return to normal conditions. To cushion the effects of the financial blow, Mexican authorities implemented several actions, especially geared to providing liquidity in the foreign exchange and credit markets. Given the relative resilience of the Mexican financial system, most measures were relatively modest and designed as temporary, and thus have already ended or will soon end.[1]

Moreover, the real economic disturbance, which in April 2009 was aggravated by the eruption of swine flu epidemics, had a deeper and more lasting effect on Mexico. Its manifestation included a contraction of tourism in Mexican destinations and the worsening of an already declining trend in worker remittances from abroad. However, the most important driving force of the

[1] For a review of the measures taken by Mexico during the crisis, see Manuel Sanchez, "Impacto de la Crisis Internacional en México, Respuesta de Política y Perspectivas" speech at the Reserve Bank of El Salvador, November 2009: http://www.bcr.gob.sv/uploaded/content/category/2106364632.pdf.

economic slump was the sharp fall in the demand for Mexico's exports, especially manufacturing goods oriented to the United States, which during the last ten years accounted for over 80% of the country's total non-oil exports. According to the national income accounts, Mexico's total exports of goods and services in the second quarter of 2009 were 24% lower than those at their peak level six quarters earlier.

It is worth noting that this last recession in Mexico exhibited substantial differences from previous ones. Past crises were typically linked to major macroeconomic and financial disequilibria, in the form of high fiscal deficits, large current account imbalances and fragile financial intermediaries. Given a predetermined exchange rate system, these weaknesses eventually led to a speculative attack on the currency. The sequence of events was a significant burst in inflation and interest rates, a sudden drop in investment and output, major job losses, and a dramatic fall in real wages. Restoration of macroeconomic equilibrium usually required the implementation of tight fiscal and monetary policies.

In contrast, the recent recession occurred in the presence of sound macroeconomic fundamentals, including a solvent fiscal position, a floating exchange rate system, and an independent central bank committed to price stability. In addition, the construction of a strong regulatory and supervisory framework together with openness to foreign investment yielded a solid banking system. The development of long-term loan products at fixed nominal interest rates offered by banks reduced the vulnerability of consumers and firms to sudden changes in financial conditions. These elements proved valuable in ameliorating the effects of the external shock on domestic spending.

Of particular note, exports of goods and services fell dramatically whereas they had either remained relatively stable or boomed in previous recessions. However, private consumption was more resilient than it was in the mid-1990s crisis, and the fall in private investment was lower than that in the 1982 and

1995 recessions. Additionally, public expenditures grew at higher rates than in any previous contraction, thus exerting some countercyclical effect on output.

The main lesson to be drawn from Mexico's experience with crises is that there are no substitutes for good and well-coordinated economic policies. Prudent macroeconomic measures together with a well-capitalized financial system and flexible exchange rates are suitable elements to preserve the confidence of market participants and facilitate an orderly adjustment to external disturbances.

Mexico´s economic outlook

Let me now turn to the economic outlook for Mexico. Given this country's openness to foreign trade and investment, its prospects naturally depend on the expected evolution of the world economy and, in particular, that of the United States. So allow me to first briefly comment on the international scenario.

Most forecasters share the view that the global economy will perform better in 2010 and 2011 than in the previous two years. On the one hand, GDP and international trade are expected to increase, in clear contrast with their corresponding contractions in 2009. A characteristic feature of this outlook is that recovery will exhibit a more gradual pace than in previous expansions. For example, the IMF forecasts that global GDP will grow 3.9% in 2010 and 4.4% on average from 2011 to 2014. The latter figure is half a percentage point lower than that observed in the 2004-2007 period. Additionally, emerging market economies are expected to continue to grow faster than developed countries. For the U. S. economy, the IMF estimates 2.7% growth in 2010 and 2.4% in

2011. At the same time, world inflation is estimated to remain fairly subdued in the near future.[2]

Prospects for better world economic performance are based on different factors, among which recent data stand out. Since the second quarter of 2009, the global economy has shown increasingly clearer signs of a rebound. While growth has been widespread, the recovery has been more vigorous in specific emerging economies, especially China, India and Brazil. In the case of Latin America, during the second half of 2009 the region experienced a mild recuperation supported by an increase in government spending, lower interest rates, and an improvement in external demand.

In the United States, favorable developments included a 5.7% annualized quarterly increase in GDP in the fourth quarter of 2009, the fastest pace in six years and the second consecutive quarter of growth after four quarters of decline. Moreover, during the fourth quarter, liquidation of inventories by firms slowed and their investment in equipment and software started to show signs of recovery. Similarly, real estate indicators continued an upturn observed in the previous quarter.

Given substantial excess capacity, global inflationary pressures have remained relatively contained. In the advanced economies, inflation turned positive during the last quarter of 2009 after being negative for several months. In the United States, inflation ticked up recently mainly as a result of higher energy prices. In developing countries, although consumer inflation also took a downward path, it has generally remained positive, with some exceptions such as China and Chile. In general, the monetary stance in most countries is expected to continue to be accommodative for some time, although some central banks have already started their tightening cycles.

[2] For the IMF forecasts, see IMF, *World Economic Outlook, October 2009* :http://www.imf.org/external/pubs/ft/weo/2009/02/index.htm) and *World Economic Outlook Update*, January 2010: http://www.imf.org/external/pubs/ft/weo/2010/update/01/index.htm.

In the financial system, the risk of a widespread collapse of international markets has significantly narrowed. While initially the main source of improvement was constituted by the measures implemented by the authorities in various countries, the more recent upturn in the financial system seems to reflect a positive feedback loop between the growth prospects of the real economy and financial conditions.

However, certain factors suggest that the economic recovery in the United States will be sluggish. One is that consumers and firms will likely continue deleveraging their financial positions, which may imply higher saving rates than pre-crisis levels. Another is that banks will continue cleansing their balance sheets and seeking to replenish capital before resuming lending. Finally, although some recent housing-sector indicators such as construction orders and sales point toward further progress, full adjustment of inventories may still take time. These elements may, in turn, contribute to an explanation of why employment has been responding somewhat more slowly than in previous expansions.

Furthermore, low interest rates in the United States and in other advanced countries, together with the expectation that they will remain low for an extended period as well as a weak dollar, have led to the proliferation of the "carry trade." This type of trade consists in investors seeking higher returns in risky assets by borrowing cheaply in the money markets of advanced countries, seizing opportunities from a lax monetary stance. These transactions have resulted in a notable increase of capital flows into emerging market economies, a trend which implies a possible source of future financial instability. In particular, as the Fed and other major central banks begin to tighten their monetary policies and the dollar starts to appreciate, risky positions in a number of assets should begin to unwind, affecting the financial markets and reversing capital flows into developing countries. In this event, volatility could return to international financial markets and the U. S. economy could grow less than anticipated.

How will Mexico fare in the future? The consensus forecast is for a gradual economic recovery, proceeding hand in hand with the improvement of the world economy. Specifically, the Bank of Mexico estimates that, after a contraction of a little less than 7% in 2009, the Mexican economy will grow between 3.2% and 4.2% in 2010 and 2011.[3] The main engine of growth will be the continued greater dynamism of the U. S. economy, particularly its industrial sector. As is well known, the correlation between the industrial outputs of these two countries exceeds 0.9, reflecting the high share of manufacturing exports going to the United States out of Mexico's total exports.

As is the case for other counties, the Mexican economy has already begun to show signs of resurgence. After five consecutive quarters of contraction, third-quarter GDP posted a 2.9% seasonally adjusted, non-annualized change. Additionally, some economic indicators for the fourth quarter of last year also support the view that growth has continued. For example, last November, the Economic Activity Indicator (IGAE) showed a monthly seasonally adjusted rise of 1.5%, which corresponds to a third consecutive month of positive change.

Perhaps the most encouraging factor is the reversal of the external-sector troubles which, as I mentioned, were the main source of the economic slump. In particular, annual dollar growth rates of non-oil and auto-industry exports have recently followed a rising trend, reaching more than 15% and 31%, respectively, in December 2009.

Although domestic demand indicators still show a mixed picture, with reviving consumption and stagnant investment, these variables may respond with a lag to the external impetus. This hypothesis seems to be confirmed by the positive recent trend of leading indicators such as the Purchasing Managers' and Consumer Confidence Indexes, and the reduction in the unemployment rate by the end of last year. Notwithstanding the latest return of business to market

[3] Banco de México, *Informe sobre la Inflación Octubre – Diciembre 2009 y Programa Monetario para 2010,* January 2010: http://www.banxico.org.mx/publicaciones-y-discursos/publicaciones/informes-periodicos/trimestral-inflacion/%7B2303131F-F72D-1284-E524-1E506B0E7DD2%7D.pdf.

financing, the revival of bank lending, especially consumer credit, will probably take time.

Economic policy challenges

The sustained growth scenario I have just described depends on the appropriate management of crucial challenges faced by advanced economies, which are related to the timely reversal of the extraordinary monetary and fiscal actions that were undertaken to counter the global crisis. The resulting expansionary stance is reflected in the unprecedented enlargement of the major central banks' balance sheets and the high fiscal deficits in many developed countries. Adequate exit strategies need to be planned and properly implemented.[4]

These policies are widely expected to be maintained until growth consolidates and gains more momentum. There is concern that if the various stimulus measures are retired too early or too rapidly, this withdrawal might adversely affect consumers and firms that are still too leveraged. In addition, many financial institutions may still be too fragile to handle liquidity or solvency problems on their own. In fact, in accordance with this preoccupation, the U.S. government announced last November a new package of fiscal stimulus to support growth and employment.

Unfortunately, maintenance of these measures over the medium term is clearly unsustainable. High fiscal deficits may exert upward pressure on interest rates, crowding out private spending and hampering economic activity. This may also

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[4] For a discussion of possible principles guiding exit strategies, see IMF, *Global Economic Prospects and Principles for Policy Exit*, Meetings of G-20 Finance Ministers and Central Bank Governors, November 6–7, 2009: http://www.imf.org/external/np/g20/pdf/110709.pdf.

limit the access of emerging economies to international capital markets. On the other hand, if maintained for too long, highly expansionary monetary policies may cause deterioration of inflation expectations, fueling inflation and weakening the recovery. On both fiscal and monetary counts, the key issue ahead is when and how to retire stimulus without letting these risks materialize.

Finally, Mexico has important tasks ahead. One relates to the improvement of the fiscal and monetary framework to continue supporting growth prospects. In response to the foreseen decline of oil-related fiscal revenues, at the end of last year, the Mexican Congress approved a fiscal reform that included certain higher tax rates. Additionally, some public-sector prices at the federal and local levels will be revised upward in 2010, particularly those such as for gasoline and gas that were frozen during 2009 to support the economy. Notwithstanding some possible short-term undesirable effects on economic activity,[5] these adjustments may be justified as a means to maintain the long-term sustainability of public finances, ameliorating Mexico's "country risk" perception. Additionally, a strong fiscal position contributes to the anchoring of inflation expectations and the lowering of both short- and long-term interest rates.

Since April 1994, the Bank of Mexico has, as its Constitutional mandate, the main objective of "preserving the purchasing power of the currency," which means price stability. To fulfill its obligation, since 2001, the central bank has conducted its monetary policy under an inflation-targeting regime and established as its medium-term objective a 3% annual inflation rate.

Price stability is a highly commendable objective as it represents a necessary condition for sustainable economic growth. As you know, inflation is one of the

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[5] For an estimation of the possible effects of the fiscal package on the real economic activity, see Banco de México, *Addendum al Informe sobre la Inflación Julio – Septiembre 2009,* December 2009: http://www.banxico.org.mx/publicaciones-y-discursos/publicaciones/informes-periodicos/trimestral-inflacion/%7BF64F6DE0-189A-503A-167B-646FADD668FA%7D.pdf.

worst maladies that can affect any economic system, and Mexico has suffered its catastrophic consequences during long periods in the past. Inflation acts as one of the most regressive taxes, wiping out the financial wealth of the poor. It introduces a wide range of inefficiencies in the form of diversion of economic resources from their most productive uses. Its associated uncertainty shortens the planning horizons for savings, investment and job creation. In short, inflation dramatically lowers the possibilities for growth and poverty alleviation. So particularly for us, it is essential to fight against inflation.[6]

After many years of severe price instability, during the past decade inflation in Mexico has been reduced to relatively low levels. In 2009, to accommodate the shock of the global crisis, the Bank of Mexico reduced its policy interest rate by 375 basis points. As the effects of previous currency depreciation subsided and economic slack remained substantial, annual inflation came down to 3.6% by year-end.

For 2010, the increases in taxes and public-sector prices will likely have a direct, once-and-for-all impact on inflation that is expected to dissipate early in 2011. It is not advisable for any central bank to try to offset these kinds of effects, as this would require an overly restrictive monetary policy in order to exert downward pressure on other prices. In fact, the likely outcome of such an attempt could be a negligible effect on inflation and downward pressure on economic activity. However, the central bank should be ready to act when these kinds of price adjustments appear to affect the medium-term dynamics of inflation or lead to a deterioration of inflation expectations.

Therefore, in 2010 the Bank of Mexico will remain vigilant to prevent likely transitory pressures on inflation from becoming widespread or from raising inflation expectations, so that its inflation target of 3% may be reached by 2011. If the Mexican central bank determines that the behavior of these variables is

[6] For an exposition of the benefits of price stability, see Ben Bernanke, "The Benefits of Price Stability" speech at the Center for Economic Studies, Princeton University, February 24 2006: http://www.federalreserve.gov/newsevents/speech/bernanke20060224a.htm.

inconsistent with its inflation target, it will not hesitate to adjust its policy interest rate to induce inflation and inflation expectations towards the 3% target.

A second type of challenge is the need to implement structural reforms in order to increase the potential growth rate of the economy. These include changes to make the use of labor and investment more attractive, enhance total factor productivity, and take advantage of worldwide technological progress. In the pursuit of this agenda, there is no panacea and a wide range of transformations is desirable. These include a fiscal reform that efficiently broadens the tax base and focuses public expenditure to the better provision of public goods, such as public security, protection of property rights and physical infrastructure, as well as the liberalization of barriers to entrepreneurial activities, which take the form of red tape and limitations or prohibitions to production, investment, and market flexibility and competition.

Concluding remarks

The recent deep recession had its origin abroad, but its impact was somewhat mitigated by the sound macroeconomic fundamentals prevalent in the country. Fortunately, the global economy has begun to recover, a trend which is already benefiting Mexico. The sustainability of economic growth will depend on the appropriate management of crucial challenges in advanced economies related to removing the extraordinary measures undertaken to handle the crisis. Mexico will need to continue strengthening its framework for macroeconomic and financial stability, as well as pursue structural reforms that would increase its potential economic growth. With these changes, Mexico will be able to improve its prospects for higher living standards and achieve substantial poverty reduction.