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Despite its economic crisis, or perhaps because of it, Mexico has been moving ahead with structural reform throughout 1995.

The Mexican Economy in 1995: A Post-Devaluation Assessment

Not long ago, Mexico was in the world spotlight for being a model economic reformer, one to be emulated, in fact, by developing countries. As this decade began, Mexico was intensifying efforts to correct its finances, privatize businesses in critical sectors and liberalize trade. Foreign investors responded to these actions with large capital flows: total foreign investment in Mexico surpassed \$33 billion in 1993, up from less than \$3 billion in 1988. Portfolio investment, nonexistent before 1989, made up the largest share with 86.8 percent of total foreign investment.

The North American Free Trade Agreement (NAFTA), implemented in 1994, was expected to further stimulate total foreign investment in Mexico, while enhancing trade flows among Canada, the United States, and Mexico. NAFTA, however, took effect as sociopolitical strife surfaced in Mexico. First came an armed uprising in Chiapas and, was followed by the assassination of a presidential candidate and an assortment of kidnappings. These events, which coincided with Mexico's 1994 presidential election, depressed overall capital inflows into Mexico. In 1994, capital flows into Mexico reached \$16.2 billion, roughly half the 1993

level. However, this drop was directly attributable to a contraction in portfolio investment, which totaled only \$8.2 billion in 1994, down from almost \$29 billion in 1993. Foreign direct investment, on the other hand, reached its highest level ever in 1994, at almost \$8 billion, representing an increase of 81.2 percent relative to 1993. In fact, among developing countries in recent years, Mexico has been second only to China in the levels of foreign direct investment received.

In 1995, Mexico is in the world spotlight once again, but this time it was the December 1994 peso devaluation that placed it there. This event surprised the world financial community and now has made Mexico the focus of discussion about what went wrong with what appeared to be a sound economy. The sections below describe the economic fundamentals that characterized Mexico in 1994 and assess the economy's post-devaluation performance.

Mexico's Economic Fundamentals in 1994

The economic reforms Mexico has followed over the past decade have comprised tight fiscal and monetary policies, privatization, trade liberalization

and deregulation. Another key component of the reforms was the anti-inflation program of direct price controls (the so-called Pact), which was started in 1987 and extended through successive renewals until 1994. The centerpiece of the Pact was the control of the peso/dollar exchange rate, which served as the nominal anchor for the reduction of inflation.

The results of these reforms have been largely positive. Mexico's inflation declined to 7.1 percent in 1994, down from almost 160 percent in 1987. Real gross domestic product (GDP), which exhibited essentially zero (0.2 percent) average growth during 1983–88, recovered to average annual rates of 3.1 percent during 1989–94. High and persistent fiscal deficits in the 1980s were turned into significant fiscal surpluses during 1991–93 with only a slight deficit (0.3 percent of GDP) in 1994. The external public debt, which in 1986 equaled 61.8 percent of GDP, was lowered to 20.5 percent of GDP in 1994. By 1994, Mexico appeared to have transformed what in 1982 had been a state-dominated, closed economy that mainly exported oil into a private-sector-led, open economy with a diversified export base.

Table 1 contrasts the Mexican economy's main indicators in 1982 with those of 1994. These indicators point to the economy's radically improved situation in 1994 over 1982, in performance as well as structure. Economic indicators before the December 1994 peso devaluation

Table 1
Main Economic Indicators, 1982 and 1994

	1982	1994
Inflation (CPI, end-of-period, %)	98.9	7.1
Real GDP (%)	-0.6	3.5
Fiscal Balance (% of GDP)	-16.2	-0.3
Privatization	None	80% divestment of public enterprises
Trade Opening	None	GATT, NAFTA
Main Export (% of Merchandise Exports)	Oil 77.6	Manufactures 87.8
Current Account Balance (Billions of U.S. dollars)	-5.9	-28.8

point to the basic soundness of the Mexican economy in the fundamentals, except for the acute deficit in the current account, which toward the end of 1994 became unfinanceable.

In essence, then, the crisis that followed December's devaluation was one of liquidity. Mexico at the end of 1994 faced a high deficit in its external accounts combined with high levels of short-term, dollar-indexed debt (*tesobonos*), yet capital flows in Mexico had dropped to levels that were insufficient to finance its obligations. November and December, especially, were months of pronounced capital outflow in Mexico. This outflow caused international reserves to suffer a drastic drop: they amounted to \$6 billion in December, down from nearly \$25 billion the previous year.

The Mexican Economy in 1995

January–September

The December 1994 peso devaluation and the financial crisis that followed resulted in Mexico's current austerity economic program. The program is aimed at containing inflation after a devaluation shock of more than 50 percent. The economy's performance so far shows a deep recession with high inflation, but the imbalance in the external accounts has been reversed.

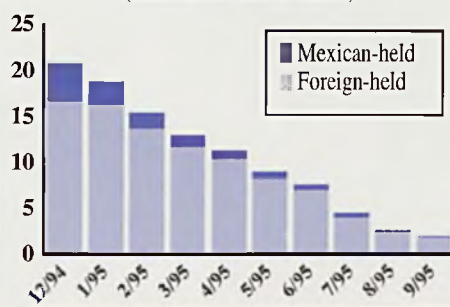
The worst point in Mexico's financial crisis during the January–September period came in early March, when the exchange rate dropped to its lowest level since the devaluation, to 7.45 pesos/dollar, and interest rates soared. At that time, two benchmark interest rates, the 28-day *cetes* rate and the average interbank interest rate (*TIIP*) reached nearly 83 percent and 110 percent, respectively. Interest rates began to drop in May and remained on a downward trend through September. During that month, 28-day *cetes* averaged 33.5 percent, while the *TIIP* rate averaged 35.5 percent. What helped bring interest rates down was the virtual elimination of the late 1994–early 1995 liquidity problem that stemmed, in large part, from the overload of *tesobono* debt. Thanks to the \$50 billion loan package received mainly from the United States and the International Monetary Fund, Mexico has been able to retire most of this

debt. From a \$20.8 billion level at the end of 1994, total tesobono debt was reduced to less than \$2 billion by September (*see Graph 1*). The exchange rate, meanwhile, stabilized after March, reaching levels of 6.2 pesos/dollar in August and 6.3 pesos/dollar in September.

The impact of the austerity program on growth has been substantial. The available figures show a contraction in real GDP of 5.8 percent in the first semester, after negative rates of 0.6 percent in the first quarter and 10.5 percent in the second quarter. The recession in Mexico has translated into a rising unemployment rate, which increased to 7.3 percent in September, up from 3.2 percent in December. Since the devaluation, some 1.5 million workers have lost their jobs, bringing the total number of unemployed in Mexico in September above the 2.5 million mark. The one bright spot in Mexico's employment landscape, however, is the maquiladora industry. In the first seven months of 1995, maquiladoras recorded job growth of 9.5 percent relative to the year-earlier period. Since maquiladora companies have dollar-denominated budgets but pay costs in pesos, they essentially received a boost this year through the higher value of the dollar relative to the peso.

On the inflation front, the consumer price index (CPI) saw its highest monthly level in April, when it rose 8 percent, reflecting increases in the minimum wage and the value-added tax that took effect that month. The

Graph 1
Tesobonos
(Billions of U.S. Dollars)



CPI slowed in succeeding months, dropping to rates of 1.7 and 2.1 percent in August and September, respectively. During January–September, Mexico's annual inflation rate stood at 43.5 percent.

As would be expected, the lower value of the peso relative to the dollar has helped boost Mexican exports, while imports have been depressed. In February, Mexico recorded its first surplus in the trade accounts since 1990, and has continued recording positive balances ever since (*see Graph 2*). During January–September, Mexico's trade balance equaled \$5.4 billion. Merchandise exports over these nine months grew 33.2 percent relative to the year-earlier period, while total merchandise imports declined 7.7 percent. However, imports of intermediate goods, the category of imports most in demand by export-oriented industries, recorded positive growth of 3.7 percent. The current account recorded a deficit of \$1.7 billion in the first quarter of the year, followed by a surplus of \$460 million in the second quarter. The first-semester current-account balance,

then, is equal to a deficit of \$620 million—a significant reduction from the almost \$29 billion deficit recorded in 1994.

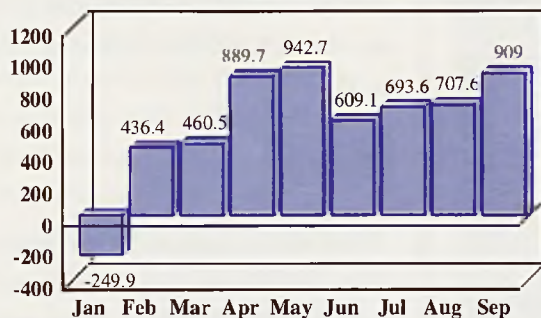
October–November

As Mexico entered fourth-quarter 1995, several emerging factors were making markets nervous. There was general concern over the economic program's results for inflation and growth in 1995 and uncertainty about new objectives for 1996. Also, there were questions about Mexico's ability to meet payments on certain loans that were coming due and about the government's resolve to stick to tight fiscal and monetary policies in the face of the country's dismal growth. These concerns, in turn, fed expectations of higher inflation, which in October reached an annual rate of 45.7 percent. Moreover, in late October, peace talks with Chiapas rebel leaders were temporarily halted because of the arrest of a rebel leader who was later released.

The most severe impact of these developments on the exchange rate came on October 26, when it dropped to 7.235 pesos/dollar. On October 30, however, Mexican authorities announced a new package of economic measures under a program called the Alliance for Economic Recovery. The program's 1996 objectives call for 3-percent economic growth and 20-percent inflation, plus 10-percent increases in the minimum wage in both December and April, a variety of

Graph 2**Mexico's 1995 Trade Balance**

(Millions of U.S. Dollars)



fiscal incentives to promote investment and job creation and gradual increases in electricity and gasoline prices amounting to a 29-percent price increase over 13 months. This announcement had a positive effect on the markets, as the exchange rate strengthened to a rate of 6.94 pesos/dollar on October 30.

However, what began as nervousness in October by early November turned into panic that sent markets into a tailspin. On November 8, the exchange rate dropped to 7.85 pesos/dollar, breaking the March 9 low of 7.45. The November market volatility resulted from several rumors, including the possibility of a military coup, impending resignations of certain cabinet members and the reported death of powerful labor leader Fidel Velasquez. Although the authorities have publicly and vehemently denied these rumors, the markets remain vulnerable as the December 20 anniversary of the devaluation approaches.

Not surprisingly, interest rates moved upward in October and November. The TIIP rate, an average of interbank interest rates, averaged 46.1 percent in October—10 percentage points higher than in September. Then, on November 9, this benchmark rate reached almost 60 percent. On that day, as the exchange rate slipped below 8 pesos/dollar amid heavy speculation, Mexico's central bank was forced to intervene in the

markets with about \$170 million in reserves to prevent a freefall of the currency. The central bank's action managed to bring the currency up to 7.55 pesos/dollar on that day. International reserves stood at around \$14.1 billion on November 10, down from \$15 billion a week earlier.

Conclusion

Central bank authorities in Mexico estimate 50-percent inflation and expect the economy to contract as much as 6 percent in 1995. Despite this economic crisis, or perhaps because of it, Mexico has moved ahead with structural reform throughout 1995. For instance, in February, new rules for greater foreign participation in the banking sector were announced. Also, the government has stepped up its efforts to privatize telecommunications, ports, airports, railroads and even some petrochemicals. These actions have had a positive effect in attracting foreign direct investment. For example, in October, the authorities announced that some \$12 billion in foreign direct investment projects had been committed for the next five years, mostly in sectors where greater deregulation is taking place.

Indeed, the available figures show a positive foreign direct investment record in Mexico for the year: almost \$1 billion in the first quarter and \$1.6 billion in the second quarter. This, if anything, is a sign that long-term investors perceive the current crisis in Mexico as a temporary setback and are concentrating on Mexico's economic discipline and commitment to deeper structural reforms, both of which point to the complete restoration of sound fundamentals and to a consolidation of the economy's long-term growth potential.

— Lucinda Vargas
Economist

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