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Mexico's Economic Revival

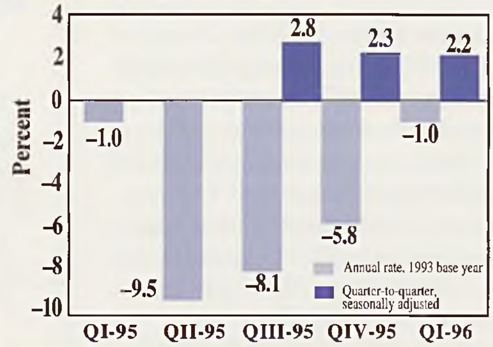
"Mexican economic indicators showed the beginnings of a recovery—in essence, a revival—as early as the start of 1995's second half."

Mexico experienced one of its worst recessions in 60 years in 1995. Real gross domestic product (GDP) contracted by more than 6 percent, while inflation reached almost 52 percent. Although Mexico's economy is still suffering, some key indicators are pointing to an economic revival, if not quite yet to a full-fledged recovery. In fact, economic indicators show Mexico coming out of this recession much sooner than in similar episodes in the past. This article first describes Mexico's economic performance in 1995 and the first half of 1996. It then discusses the outlook for the Mexican economy in the remainder of 1996 and provides the most recent results of the Mexican Leading Economic Index, a measure developed by the Federal Reserve Bank of Dallas and the Center for International Business Cycle Research at Columbia University.

Key Macroeconomic Indicators

Mexico's quarterly real GDP recorded negative annual growth rates throughout 1995 and into the first quarter of this year (*Chart 1*). However, these annual-growth declines have been successively smaller since the third quarter of 1995. Moreover, when GDP is measured on a quarter-to-quarter, seasonally adjusted basis, it shows growth of more than 7 percent between the third quarter of 1995 and the first quarter of 1996. This evidence suggests that Mexico's recession touched bottom in the first half of 1995. Stated differently, the Mexican economy began a recovery as of the second half of 1995.

Chart 1 Quarterly Real GDP



Although the December 1994 peso devaluation led to Mexico's steepest GDP decline in its modern history, perhaps more remarkable is the speed with which Mexico is coming out of this recession relative to the 1982–83 devaluation and recession episode. Comparing the performance of industrial production in the two recession periods illustrates this point. As shown in Chart 2, despite nearly the same decline in industrial production, last year's recession bottomed-out in only seven months, whereas it took 13 months to reach that point during the 1982 crisis. Moreover, while it took more than three years to return to pre-crisis output levels after the 1982 crisis, if the current trend continues, it will probably take less than two years to do so this time.[1]

The performance of the following list of other indicators provides further evidence of Mexico's improving economic conditions:

[1] Thanks go to David Gould, senior economist at the Federal Reserve Bank of Dallas, for developing the analysis on industrial production.

• **Inflation.** Mexico's pursuit of tight fiscal and monetary policies since the beginning of 1995 has produced important results in controlling inflation. Monthly increases in the consumer price index (CPI) have been coming down since the April 1995 peak rate of 8 percent. In fact, since May of this year, monthly rates have been under 2 percent (*Chart 3*). Thus, inflation moved from an annualized rate of almost 100 percent in April 1995 down to a 17-percent rate in July 1996.

• **Interest Rates**. Both the 28-day *cetes* rate and the average interbank interest rate (TIIP) have declined substantially since last year, when *cetes* hit a peak of 82.65 percent and the TIIP peaked at almost 110 percent in mid-March. These rates had subsided to 30.2 percent (*cetes*) and 32.2 percent (TIIP) by the last week of July 1996 (*Chart 4*). Despite this important reduction, however, interest rates remain high, especially in light of the fact that the devaluation basically slashed Mexicans' purchasing power in half. In recognition of the obvious difficulties this situation poses for debtors, Mexican authorities have launched various debtor-relief programs, especially in the area of mortgages.

• **The Exchange Rate.** While the exchange rate exhibited some volatility during the first quarter of 1995, it remained stable from April through September, only to turn volatile again during the last quarter[2] (*Chart 5*). This year, the exchange rate has remained stable, moving from a monthly average of 7.48 pesos/dollar in January to 7.61 pesos/dollar in July. Moreover,

[2] For more detail on the exchange rate and on Mexico's overall economic performance in 1995, see *Business Frontier*, Volume 2, Number 4.

Chart 2

Industrial Production

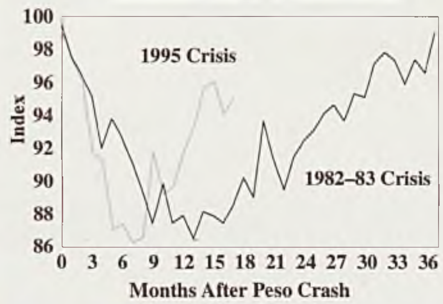


Chart 3

Inflation

(Monthly CPI)

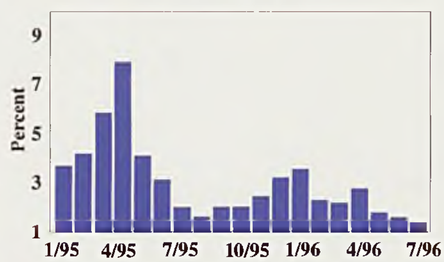


Chart 4

Interest Rates

(Monthly Averages)

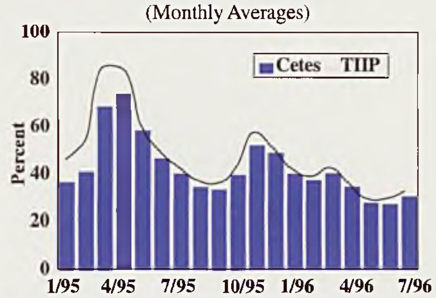
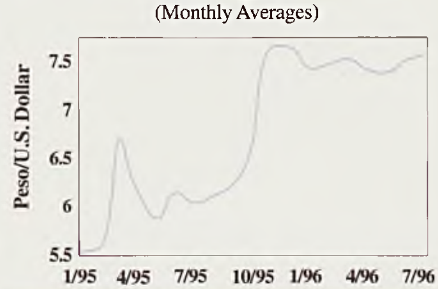


Chart 5

Exchange Rate

(Monthly Averages)



because of improved expectations about the economy over the course of the year, the peso futures market at the end of June showed a rate of 8.5 pesos/dollar for contracts closing in December 1996, an improvement over the 9.75 pesos/dollar rate registered by the futures market for such contracts in early March.

• **Open Unemployment.** After peaking at 7.6 percent in August 1995, Mexico's open unemployment rate had come down to 5.6 percent by June 1996. Though open unemployment reflects a very narrow measure of urban joblessness in Mexico, since it does not count as unemployed those individuals who worked at least an hour in a given week, it's nonetheless important that this variable is on a downward trend. Still, unemployment remains high and above the 1994 pre-crisis rate of 3.7 percent.

• **Employment**. Formal employment in Mexico, measured by the number of workers incorporated by employers into the social insurance system (IMSS), recorded losses for 10 consecutive months from December 1994 through September 1995. However, between the last quarter of 1995 and the first quarter of this year, formal employment increased by more than 440,000 workers.

Also, not all regions in Mexico have suffered net job losses since the beginning of the crisis. Baja California and Chihuahua, for example, have been adding jobs since last year, principally because of these states' important base of maquiladora investment, which boomed in 1995.[3] Between April 1995 and April 1996, Baja

[3] For more detail on the performance of the maquiladora industry in 1995, see *Southwest Economy*, Federal Reserve Bank of Dallas, Issue 5, 1995, pp. 9–10, and *Business Frontier*, Volume 2, Number 3, p. 7.

California's net job gain was 36,000; Chihuahua's was 12,400 jobs.

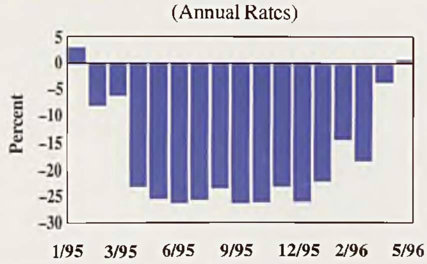
• **Retail Sales**. As expected, Mexico's depressed demand dealt a heavy blow to retail sales in 1995 and into this year. As shown in Chart 6, retail sales suffered profound contractions last year that continued through April 1996. In that month, however, the smallest decline in 14 months was recorded (-3.4 percent), with growth turning slightly positive in May (0.7 percent). Behind this improvement in sales is a revival in consumer demand, which grew 1.3 percent in the first quarter of 1996 relative to the year-earlier period, after negative annual-growth rates last year of almost 8 percent and 7 percent in the third and fourth quarters, respectively.

• **The Banking Sector.** The Mexican banking system has been under severe strain since the beginning of the crisis. The post-devaluation situation of high interest rates, in combination with a contraction in aggregate demand, placed a dangerous specter of massive loan default over the system. To deal with this, last year the government introduced a recapitalization program (FOBAPROA), in which 12 banks, representing 94 percent of the banking system's assets, are now included. Still, despite this correction and the relief provided by the various debtor-relief programs mentioned earlier, the ratio of nonperforming loans in Mexico remains high, and was at 12.9 percent in March.[4] An

Chart 6

Retail Sales

(Annual Rates)



important development that has helped bring much-needed investment into Mexico's financial system was the February 1995 introduction of more liberal rules for foreign participation in the financial sector. The box on page 5 lists the foreign financial institutions that have been authorized in Mexico through June 1996.

External-Sector Indicators

On the external-sector front, Mexico has shown considerable progress in the past 18 months. Exports continue to post strong growth, and imports have begun to recover. Foreign direct investment has been rising, despite the crisis, while foreign investment in the Mexican stock market in April was at its highest level in 13 months. Finally, Mexico has been able not only to meet its obligations under the international financial assistance package it received last year, but has also managed to restructure some of this debt into more favorable terms.

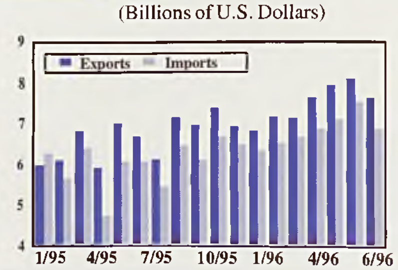
• **Trade Balance**. In contrast to the $18.5 billion trade deficit Mexico recorded in 1994, last year's trade balance reached a surplus of $7.1 billion. Behind this reversal is the peso devaluation, which helped accelerate exports while dampening imports. Merchandise exports grew 30.6 percent last year; imports declined 8.7 percent. Thanks to NAFTA and Mexico's overall commitment to trade-opening policies since 1986, imports were not drastically affected in 1995. Recalling once more Mexico's situation in 1982–83, the response then after a devaluation was a sharp increase in tariff rates, which caused imports in 1983 to shrink by a dramatic 47 percent. The reduction in imports last year, then, stemmed directly from the higher relative price of these goods and the contraction in aggregate demand, rather than from unilateral trade-protection measures, which characterized the 1982–83 episode. Moreover, the overall reduction in imports last year resulted from decreases in both consumer and capital goods imports, since intermediate goods imports, which fed the growing export sector, increased 3.4 percent in 1995.

This year, not only have exports from Mexico continued to grow, imports are now showing an important recovery (*Chart 7*). During January–June, exports increased 18.7 percent relative to the year-earlier period, while imports rose 17.4 percent. Improved aggregate-demand conditions this year have made intermediate goods imports more dynamic (19.1-percent growth) and triggered a resurgence of growth in imports of both consumer goods (9.3 percent) and capital goods (16.7 percent).

Chart 7

Mexico's Trade

(Billions of U.S. Dollars)



[4] This ratio of nonperforming loans excludes assets from intervened banks as well as assets that banks have sold to FOBAPROA. If these assets are included, the level of nonperforming loans for the entire system is about 18 percent. Moreover, this ratio is still understated, since Mexican accounting standards only count as nonperforming the part of a loan that is in arrears rather than the full amount of the loan, as is done under U.S. accounting principles (U.S. GAAP). Starting in 1997, however, Mexican banks will have to report their nonperforming ratios using the U.S. method.

• **Foreign Investment**. After reaching a historical high of $11 billion in 1994, foreign direct investment in 1995 continued to grow and totaled $7 billion. During the first four months of this year, foreign direct investment reached $1.3 billion, a 6.8-percent increase relative to the same period a year earlier.[5] Hence, despite the economic crisis, foreign investors are still finding Mexico economically viable for medium- and long-term projects. Furthermore, foreign investment in the Mexican stock market has shown an important recovery, reaching a level of $31.9 billion in April 1996, after dipping to a low of $18.9 billion in February 1995.

• **International Financial Assistance**. Mexico's liquidity crisis in early 1995 prompted the international community to come through with a $48.9 billion financial assistance package for the country. The funds pledged came from the financial authorities of the United States ($20 billion under the Exchange Stabilization Fund), the International Monetary Fund ($17.8 billion), the Bank of Canada ($1.1 billion) and the Bank for International Settlements ($10 billion). This package was negotiated mainly to deal with an overload of short-term, dollar-indexed debt —*tesobonos*— that at the end of 1994 amounted to some $29 billion. Indeed, by February 1996, this debt had been totally cancelled and replaced with longer term, lower cost obligations available under the package.

In all, Mexico has used only some $26 billion of the support package, and as of June 1996, it had not missed any interest payments or required principal repayments. Of the $20 billion pledged by the U.S.'s Exchange Stabilization Fund (ESF), Mexico used $13.5 billion, $10.5 billion of which remains outstanding. On June 18, however, Mexico announced that it was planning a prepayment of $4.7 billion to the ESF by the end of summer. Moreover, in a new announcement at the end of July, the intended prepayment amount was raised to $7 billion, which would leave a $3.5 billion outstanding balance with the United States. The prepayment will be made possible through a bond sale to private investors that will provide Mexico with more favorable debt terms. The bonds will have an initial cost of 8.12 percent with a maturity of almost 8 years, an improvement over the 9.89-percent interest and 3.5-year maturity of the funds owed to the United States. Mexico is also planning to repay $1 billion to the International Monetary Fund, from which it has borrowed some $13 billion.

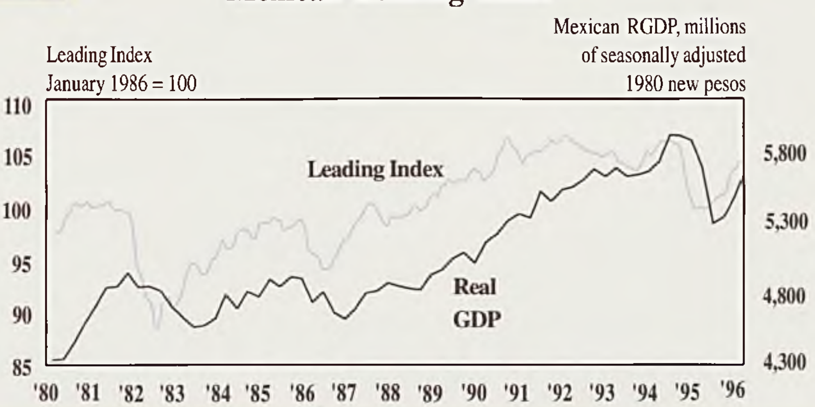
This development is but the latest sign of international financial investors' restored confidence in Mexico. For example, Mexico regained access to international capital markets only five months after the December 1994 peso devaluation. Once again, this contrasts with the 1982–83 situation, since after the 1982 devaluation, it was almost seven years before Mexico was able to tap these markets again.

1996 Outlook

The Mexican Leading Index, a composite of leading economic indicators for Mexico,[6] is a useful tool for gauging the duration of any given period of expansion or recession in Mexico. Over the past year, movements in both the Mexican Leading Index and real GDP have strongly signaled that Mexico began an economic recovery in July 1995 that has continued into this year (*Chart 8*). Changes in the leading index through April indicate that the recovery should continue at least until October.

Overall for 1996, Mexican authorities expect GDP to grow 3 percent and inflation to reach 20.5 percent. As shown in Table 1, private-sector forecasts have

Chart 8 **Mexican Leading Index**



[5] In 1995, the Ministry of Trade and Industrial Promotion in Mexico (SECOFI) and Banco de México revised their methodologies for calculating foreign direct investment statistics. The 1994–1996 foreign direct investment figures shown here reflect the revised numbers based on the new methodology.

[6] A complete description of the Mexican Leading Index and its components is contained in the following article by Keith Phillips, Lucinda Vargas and Victor Zarnowitz: "New Tools for Analyzing the Mexican Economy: Indexes of Coincident and Leading Economic Indicators," *Economic Review*, Federal Reserve Bank of Dallas, Second Quarter 1996, pp. 2–15.

Foreign Financial Institutions in Mexico

In February 1995, Mexico liberalized rules for foreign investment in the financial system. For example, foreigners can now hold up to 49 percent of the shares of financial institutions, up from the previous limit of 30 percent. Also, foreign investors may acquire a controlling share of existing institutions with 51 percent or more of shares and may establish a new subsidiary with only 51 percent of the capital, rather than the previously-stipulated 99 percent. The list below, which identifies the foreign financial institutions authorized in Mexico in 1995 and the first half of 1996, attests to the fact that foreign investors have responded favorably to these changes.

FINANCIAL GROUPS
- Associates
- Caterpillar Financial Services Group
- Chemical
- Citibank
- Ford Credit International
- GE Capital Corp.
- ING Baring
- JP Morgan
- Santander

COMMERCIAL BANKS
- ABN AMRO Bank
- American Express Bank
- Bank of America
- Bank of Boston
- Bank of Tokyo
- BNP
- Chase Manhattan
- Chemical
- Citibank
- Dresdner Bank
- First Chicago
- Fuji Bank
- ING Baring
- JP Morgan
- NationsBank
- Republic National Bank of New York
- Santander
- Société Générale

BROKERAGES
- Bankers Trust
- Bear Stearns
- Chemical
- Citibank
- Deutshe Bank
- Goldman, Sachs
- Indosuez
- ING Baring
- James Capel
- JP Morgan
- Lehman Brothers
- Merrill Lynch
- Morgan Stanley
- Santander
- Swiss Bank

LEASING COMPANIES
- Associates
- ATI
- Bank of America
- The Capita Corp.
- Caterpillar Financial Services Group
- Citibank
- Ford Credit International
- GE Capital Corp.
- John Deere Capital Corp.
- Mercedes-Benz Credit Corp.

INSURANCE AND BONDING COMPANIES
- Aluanz of America
- American Bankers Insurance
- American Skandia Life Assurance Corp.
- Colonial Penn
- Combined Insurance Company of America
- Federal Insurance Corporation of Indianapolis
- Gerling America Insurance Company of New York
- ING Baring
- Pioneer Financial Services Inc.
- Reliance National Insurance Co.
- Tokyo Marine
- Transocean Holding Corporation of New York
- Windsor Insurance Company of Indiana
- Zurich

LIMITED-SCOPE FINANCIAL INSTITUTIONS
- Associates
- Caterpillar Financial Services Group
- Ford Credit International
- FTI
- GE Capital Corp.
- General Motors Acceptance Corp.

FACTORING COMPANIES
- Associates
- Caterpillar Financial Services Group
- Ford Credit International
- GE Capital Corp.

REPRESENTATION OFFICES IN MEXICO
- American Reinsurance Co.
- Employers Reinsurance International A/S
- Korea Foreign Insurance Co.
- MAPFRE
- The Mercantile and General Life Reassurance Company of Canada
- Mercantile and General Reinsurance Company of Canada
- Sumitomo Marine & Fire Insurance Company Ltd.
- Yasuda Fire and Marine Insurance Company Ltd.
- Zurich

FOREIGN PRESENCE IN EXISTING MEXICAN BANKS

In terms of the presence of foreign financial institutions through an acquired controlling interest in existing Mexican banks, the following relationships have developed in the past 18 months: Banco Bilbao Vizcaya–Probursa; Bank of Nova Scotia–Inverlat; and Bank of Montreal–Bancomer. Also, the purchase of Banca Cremi and Banco de Oriente by Banco Bilbao Vizcaya was recently approved. With these developments, foreign banks now control 14 percent of the Mexican banking system.

Sources: *Banco de México; U.S. Embassy in Mexico, Treasury representative; U.S. Treasury Department.*

Table 1

1996 Mexican Economic Outlook

	Official	Private Sector*			
		March	April	May	June
Real GDP (%) *Annual Rate*	3.0	2.2	2.6	3.0	3.2
Inflation (%) *December to December*	20.5	29.7	28.9	28.3	27.5

*/Average forecast of the following forecasting companies: Grupo Financiero GBM-Atlántico; Centro de Análisis e Investigación Económica (CAIE); CIEMEX-WEFA; Grupo de Economistas y Asociados (GEA); Macro Asesoría Económica; and Bursamétrica Management.

differed from these official targets. In March, for example, the private sector was more pessimistic than the government and forecast 1996 growth of slightly more than 2 percent and inflation of almost 30 percent. Since then, however, private-sector analysts have become more optimistic about the economy. By May, they were forecasting growth equal to the government's prediction of 3 percent and inflation of near 28 percent. The following month reflected even more private-sector optimism, especially for GDP, which was forecast to grow at a 3.2-percent rate. Obviously, expectations for the economy's 1996 overall performance have been improving as a result of continued and more solid signs of a recovery.

Conclusion

The Mexican economy in this decade has seen some of its brightest and darkest moments. Market-oriented reforms which were introduced in the 1980s, were aggressively pursued in the 1990s, such that, by 1994, the Mexican economy was characterized by a balanced budget, single-digit inflation and real per-capita-income growth. The December 1994 peso devaluation brought a reversal of fortune, and in 1995, the country dipped into one of its worst recessions since the 1930s. As daunting as this fact seems, however, the speed with which the economy is coming out of this recession is no less impressive. Mexican economic indicators showed the beginnings of a recovery—in essence, a revival—as early as the start of 1995's second half. This year, other signs of an economic upturn are emerging, turning the incipient recovery of last year into a more solid one. However, more generalized conditions of economic well-being have to be present in Mexico before the country achieves a full-fledged recovery.

Mexico was able to turn the corner much faster in this crisis than in the past because of its strict adherence to sound fiscal and monetary policies and its steadfast commitment to structural reforms such as privatization. NAFTA played a role, as well, since it helped lock-in free market reforms. Finally, the financial assistance package Mexico received in early 1995, aside from helping Mexico solve its short-term liquidity crisis, signaled the international community's confidence that Mexico was "worth the risk," a risk that, 18 months later, is paying off quite well.

—Lucinda Vargas
Economist

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