



Houston Business

A Perspective on the Houston Economy

Mexico Imports U.S. Recession but Shows Financial Strength

So far, recovery and stronger growth in Mexico seem to be simply a matter of waiting for U.S. economic expansion to get under way. The potential for crisis seems remote.

The National Bureau of Economic Research tells us that after a decade-long expansion, the U.S. economy peaked and fell into recession beginning March 2001. Mexico has similarly slipped into recession: Its index of coincident economic activity peaked in August and September 2000; a global index of economic activity in Mexico peaked in October 2000; gross domestic product fell 1.6 percent between fourth quarter 2000 and fourth quarter 2001; and employment declined by 382,000 jobs over the same four quarters. The recession is a U.S. import, with the U.S. manufacturing downturn having particularly serious implications for Mexican industrial production, especially the important maquiladora operations centered in the north.

However, good news comes with the bad. Mexico shows no signs of slipping into a financial crisis such as those that accompanied the country's other four economic downturns during the past 30 years. In place of a peso crisis, this downturn has so far been marked by a strong peso, declining inflation and falling interest rates. This article examines the sources of Mexico's recession and the broader improvements in Mexico's financial health that have limited the downturn's damage to that of a garden-variety recession.

MEXICAN EXPORTS

Mexico's decision to join the North American Free Trade Agreement was essentially a commitment to integrate its economy into the larger North American economy, which the United States dominates by producing five times the output of Canada and Mexico combined. As a regional economy, Mexico would compare with the largest U.S. states; its total gross product fits in at the top of the list between New York and California.

Table 1

Major Sources of Mexico's Dollar Earnings

(Billions of dollars, January through September each year)

	1999	2000	2001
Tourism	5.5	6.2	6.5
Family remittances	4.3	4.8	6.6
Oil	6.6	12.5	10.2
Manufactured goods	88.9	106.0	105.8
Less maquila imports	52.6	61.3	63.2

SOURCE: Banco de México.

If asked to assess the health of Mexico, a regional economist might first ask what it exports. Exports are important because they pay for imports and because they support inherently local activity in food stores or laundries, for example. Table 1 lists Mexico's major sources of dollar earnings in the current account for the first three quarters of 2001 and compares them with previous years. Recent events in the United States have negatively affected all four areas.

Tourism. Tourist visits to Mexico are a combination of border crossings and visits to the interior. Trips across the border dominate in numbers, but higher spending in the interior (\$549 per interior visit vs. \$25 on the border) means overall revenue divides about equally between the two. Eighty-five percent of all visitors are from the United States, meaning the slowdown in U.S. consumer spending has had an immediate impact in Mexico. The effects of Sept. 11, including the cutback in traffic across the border, were felt immediately in border cities, and numerous tourism-related layoffs have taken place in resorts along the Pacific Coast.

Family Remittances. These are funds sent home by an estimated 23 million Mexican citizens working in the United States, legally or illegally. About 1.3 million Mexican homes receive this money, and it makes up about 2 percent of Mexican income. Some of the money received is saved for a new home, a major goal of many immigrants, but most is for immediate consumption. The deteriorating U.S. labor market, particularly since Sept. 11, has slowed the flow of funds. The Inter-American Development Bank polled 1,000 immigrants in November and found that 7 percent had lost jobs since Sept. 11 and 56 percent were sending less money home.

Oil. Even world oil markets are affected by U.S. recession, as the United States has been the chief engine of world growth for the past decade.

Mexico produced 1.8 million barrels per day in 2001 and has exported just over half of its production in recent years. Volatility in world oil prices imparts instability to both the Mexican federal budget and the balance of payments. Pemex, as national oil company and sole domestic producer, turns all profit over to the government. In 1996, for example, crude oil contributed 28.8 percent of the federal budget, but with the 1999 plunge in prices, Pemex crude contributed only 14.5 percent. Last year, as the price of Mexican crude fell to \$18.53 per barrel from \$24.36 in 2000, a series of budget cuts became necessary. This year, the federal budget assumes \$15.50 per barrel and includes a production cut of 100,000 barrels per day to support the OPEC price target.

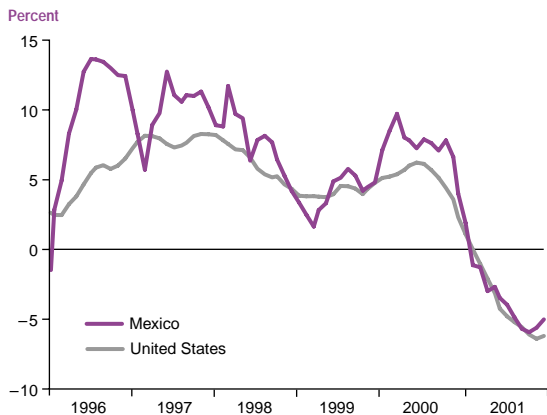
Manufactured Goods. In the 1980s, oil was the dominant export from Mexico, and oil revenues crowded out other activity. In the 1990s, manufacturing pushed oil aside and took the dominant position. The maquiladora export platform was a major source of this growth. Parts are designed and produced abroad but assembled in Mexico. Table 1 shows that, allowing for the import and re-export of foreign-made parts, the dollar earnings from manufacturing in 2001 were at least six times that of oil. More than 95 percent of Mexico's non-oil exports are now manufactured goods.

The growing role of manufacturing is a product of the increasing integration of Mexico into the U.S. economy. Certainly, the major market for these goods is the United States, which bought 87 percent of Mexican manufactured exports in 2001. The worst-hit part of the U.S. economy in the current recession has been manufacturing. Figure 1 overlays the growth rate of manufacturing output in the United States and Mexico since 1996, showing that the timing and depth of the decline in 2000–01 are strikingly similar in both countries.

FINANCIAL STABILITY

The regional economist has only part of the story, however. Mexico is a sovereign nation with its own financial system and monetary and fiscal policy. Since 1975, economic reverses in Mexico have been associated with serious financial setbacks. In 1975–76, Mexico experimented with a series of left-leaning policies that included state control of investment in strategic industries and large increases in social spending. State deficits, largely financed abroad,

Figure 1
Mexican and U.S. Manufacturing Production:
12-Month Growth Rate



SOURCES: Banco de México and Federal Reserve.

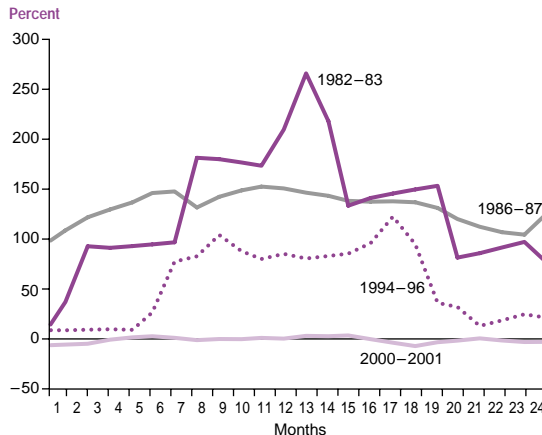
ballooned out of control, and the peso was devalued for the first time since 1954.

Problems arose again in the 1980s, when Mexico spent oil revenues from newly discovered fields and borrowed heavily abroad against future revenues. As oil prices fell, first in 1982–83 and then again in 1985–86, Mexico found itself again unable to handle domestic spending deficits and foreign debt, provoking two rounds of crisis. In 1994–95, a planned devaluation spun out of control, and a shortage of foreign reserves, combined with the short-term structure of debt held abroad, forced Mexico to float the peso. Recession in each case was accompanied by devaluation, soaring inflation and spiraling interest rates. A common element in each crisis was a bankrupt banking system—the heart of the Mexican financial system.

This time, things have been different. Figure 2 shows the 12-month change in the value of the dollar relative to the peso. Measured over 24-month periods of financial crisis in 1982–83, 1986–87 and 1994–96, the dollar doubled and tripled in value against the peso. The bottom line on the chart, however, represents the most recent 24 months, showing stability in the exchange rate. Similar charts depicting past bouts of inflation and soaring interest rates also show stability or improvement in recent months.

Peso Exchange Rate. In 2001, the dollar continued to gain in value against nearly all world currencies; the Mexican peso was one of only three currencies to gain against the dollar. Peso strength stems from U.S. interest rate cuts, financial discipline by both the Mexican central

Figure 2
Change in the Dollar–Peso Exchange Rate:
12-Month Change in Times of Crisis



SOURCES: Adapted from a September 2001 presentation on the Banco de México web site (www.banxico.org.mx). Data from Banco de México.

bank and the federal government, a war chest of over \$40 billion in foreign exchange reserves and a surge in direct foreign investment in 2001. There were few signs of contagion in Mexico from economic crises in Turkey and Argentina, and Mexico may have actually found itself acting as a safe haven for funds fleeing problems in South America.

Inflation. Inflation fell steadily throughout 2001, with 12-month changes in consumer inflation dropping from 8.1 percent in January to 4.4 percent in December. The December figure was the lowest recorded over any 12 months in the 40 years Mexico has kept price statistics. Inflation is the Bank of Mexico's chief policy target, but no doubt recessions at home and abroad have made it easier to achieve and exceed monetary goals.

Interest Rates. Interest rates also declined steadily throughout 2001. Nominal rates on 28-day bills fell from 17.9 percent in January to 6.3 percent by December, while real rates fell from 9.8 percent to 0.9 percent. Why such a sharp fall? The United States was cutting rates throughout the year, the recession limited demand for credit and Mexico enjoyed larger capital inflows in 2001 than in 2000.

These favorable statistics are the result of long-term structural changes as well as recent policy decisions. High on the list of improvements made in the past two years is the banking system, which scored substantial gains whether measured by asset quality, profitability or capital adequacy. Foreign control of the banking system

(Continued on back page)

Layoffs at Continental Airlines, the proposed Compaq merger and the Enron bankruptcy have combined to hurt consumer and business confidence in Houston. Add serious emerging problems in the oil patch, and the near-term outlook for Houston has turned increasingly negative. Job growth in the fourth quarter declined at a 1.4 percent annual rate.

OIL AND NATURAL GAS

OPEC announced a production cut of 1.5 million barrels per day in early January, coordinated with a cut of another half million from non-OPEC producers. This was sufficient to push crude prices back up to near \$20 per barrel, where the price has stayed. Despite stability in the price of crude, downward pressure has continued to mount with warm weather and weak global industrial demand. U.S. inventories are 33 percent above year-earlier levels.

Warm weather has also limited demand for natural gas and left inventories 76 percent higher than last year at this time. As the chance of a late winter storm passes, gas will leave storage because companies don't want to hold it over the summer. A near-term collapse of gas prices becomes increasingly possible as warm winter weather continues.

OIL SERVICES AND MACHINERY

U.S. drilling activity showed signs of bottoming out at near 850 working rigs in January, then quickly dropped another 38 rigs in two weeks as warm weather increased pessimism about natural gas prices. A collapse in gas prices would quickly take another 100–150 rigs out of service. Producers, watching oil and gas inventories, have turned cautious in recent weeks, canceling or postponing near-term projects both at home and abroad.

REAL ESTATE

With the completion of four new office buildings, downtown office space was already facing the possibility of being overbuilt. Enron's implosion, the Chevron/Texaco merger and the new buildings are likely to take effective down-

town occupancy rates from 93 percent to the upper 70 percent range by the end of next year. Rents seem likely to fall several dollars per square foot.

A strong apartment market lost momentum in the fourth quarter. Occupancy remains strong, but absorption slowed by 60 percent from the same period a year earlier. Class A absorption came to a standstill.

Mexico *(Continued)*

has reached 75 percent of assets, but this new foreign capital has reversed the shrinkage of bank assets and kick-started lending, which has begun to grow again in just the past few quarters.

Government spending and budget deficits also remain under control. Federal spending was cut three times in 2001 as oil prices fell. The forecast for 2002 revenues was cut again by \$2.2 billion in December as the oil price outlook weakened. For 2002, the current administration had hoped to broadly reform federal taxes, broadening the value-added tax. Instead, it received from Congress a package of miscellaneous taxes to fill the budget gap. Still, the 2002 federal deficit outlook is only 0.65 percent of GDP, small enough to keep international investors content.

Finally, Mexico has assembled international reserves of \$42 billion, substantially higher than the \$12 billion it held as the 1994–95 crisis unfolded. Plus, the government has been able to extend the yield curve in recent years, selling public debt with maturities of three, five and 10 years. Only 27 percent of government debt (\$23 billion) has a maturity of less than one year, and only 6.5 percent of all debt is held abroad.

So far, recovery and stronger growth in Mexico seem to be simply a matter of waiting for U.S. economic expansion to get under way. The potential for crisis seems remote. The consensus outlook for Mexico in 2002 is for GDP growth under 2 percent and, as the recovery takes hold, modest difficulty in maintaining current low interest rates and inflation.

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