

MEXICO

2002: A CHALLENGING YEAR

During 2002, the Mexican economy grew 0.9 per cent, half the figure we were predicting a year ago. With the benefit of hindsight, two factors account for this discrepancy.

- The internal market proved to be more vulnerable to the slowdown in external demand. Employment offers a good example. Given that manufacturing jobs are intimately linked to export activities, formal job losses in this sector were 252,000 and 248,000 in 2001 and 2002 respectively. The key difference in performance, however, is in internally-driven commerce and services. While in 2001 job creation in these activities (212,000) almost wholly compensated for the decline in manufacturing, their contribution in 2002 (135,000 new jobs) was insufficient. Thus, the economy-wide payroll was affected due to both fewer jobs and lower real wage increases. As a result, internal demand stalled—while in the first half of 2002 retail sales rose 0.6 per cent on an annual basis, a contraction of 0.5 per cent was registered in the second half of the year.
- Although external demand has recovered, the pace of the recovery has been irregular. By third-quarter 2002, exports of traditional manufacturing and maquiladora plants were growing by 1.6 per cent and 7.1 per cent on an annual basis respectively. Nevertheless, this performance lost momentum. In fourth-quarter 2002, annual export

growth was 1.5 per cent for traditional manufacturing and 2.8 per cent for maquiladora products.

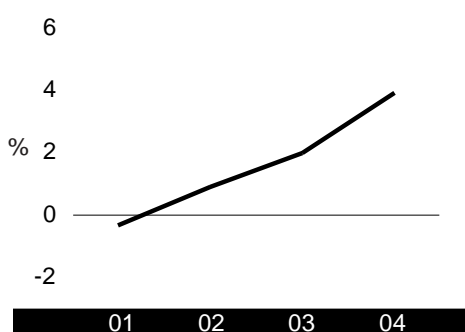
We believe that these patterns reflect a high sensitivity to demand in the United States rather than a displacement of Mexican exporters in that market. In this respect, Mexican industrialists have voiced concerns about Chinese competition in the United States. Our research suggests that the story is much more interesting.

Broadly speaking, an assessment of Mexican and Chinese competition in the US market should consider three product categories: those in which China dominates (toys, shoes and some lines of apparel and furniture), those in which an intense competition between these two countries is effectively taking place (notably electronic products and equipment), and those in which Mexico dominates. The latter includes the auto industry, where a logic of regional integration in North America under the auspices of the NAFTA seems to be the determining factor. In this respect, competition under the second category above could also reflect the same logic of spatial reorganisation of production, but within the Asia region and favouring China instead. We believe that some of the gains of China in the US market could reflect losses from other countries in the region that reflect the relocation of production facilities to mainland China. Under such conditions, trade due to intra-regional relocation of production would lead to high levels of intra-regional foreign direct investment (FDI) and would explain why, in spite of

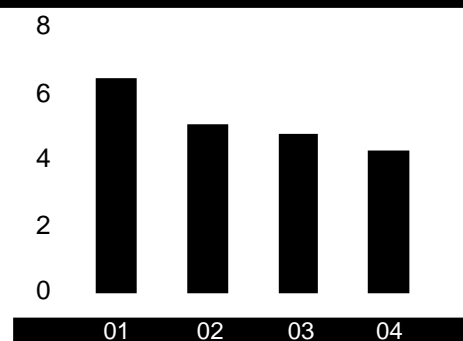
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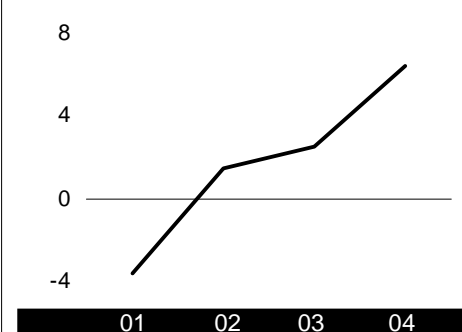
GDP growth



CPI inflation



Export growth



China's massive FDI inflows, the cumulative amount originating in the United States is still below that directed towards Mexico.

That said, Mexico faced a difficult productive situation in 2002. Nevertheless, macroeconomic stability prevailed due to a combination of structural and policy management factors.

- 56 per cent of total imports in Mexico are associated with export activities. In the absence of internal sources of growth, fewer exports translate into fewer imports. This explains the 19.7 per cent fall in the size of the trade deficit in 2002. Moreover, categories likely to reflect security concerns in the United States performed satisfactorily—the surplus in the tourism balance increased 3.6 per cent on an annual basis, while remittances from Mexicans abroad increased by 10.3 per cent. Thus, the current account deficit (2.2 per cent of GDP) was easily financed—FDI inflows alone represented 97 per cent of the deficit—and led to strong reserve accumulation (US\$7.1 billion).
- The fiscal deficit was in line with the narrow target of 0.6 per cent of GDP and reinforced a trend towards reducing exposure to conditions in international financial markets. The ratio of international reserves to gross foreign debt stood at 61 per cent at end-2002.

Therefore, the stability of variables such as country risk should not come as a surprise. The case of the currency market was nonetheless remarkable: 2002 saw the appearance of a very strong correlation between the peso–US

dollar and the US dollar–Euro exchange rates that has yet to find a theoretical justification. More importantly, the depreciation of the peso against the US dollar has been associated with concerns about the ability of the central bank to control inflation. Although so far there is no evidence of pass-through, annual inflation in 2002 (5.7 per cent) was well above the central bank's 4.5 per cent inflation target.

2003: ECONOMIC OUTLOOK

The conditions at the end of 2002 describe quite well the situation in the first months of 2003. Demand from the United States—particularly in the key auto sector—lead us to expect a weak and very gradual recovery in Mexico's main external market. Owing to the dynamics of adjustment in the external balance, February 2003 saw Mexico's first monthly trade surplus (US\$65 million) since June 1997. High oil prices contributed to this result, but oil represents only 9 per cent of total exports and therefore can hardly compensate for weak foreign demand for manufactures.

What about internal sources of growth? The dilemma here is compounded by the government's commitment to macroeconomic stability. Fiscal consolidation is bound to remain the main objective of fiscal policy. We therefore anticipate a fiscal deficit of 0.7 per cent of GDP. That said, the main change has to do with monetary policy. The expectations of most analysts have gradually converged to the upper limit of the central bank's inflation target (3 per cent from December to December plus/minus a range of tolerance of 1 per cent). Thus, our own

forecast is for inflation of 4.1 per cent. This is the consequence of the implementation of major policy initiatives at the beginning of 2003, which include a reinforcement of the central bank's intervention mechanisms aimed at increasing the responsiveness of interest rates to quantitative signals of monetary restriction, and a reduction in the rate of accumulation of foreign reserves (US\$51 billion at the beginning of April 2003) which will increase the availability of US dollars in the currency market.

The announcement of these measures has weakened the correlation between the peso–US dollar and US dollar–Euro exchange rates. However, an improvement in liquidity conditions worldwide at the end of the first half of 2003 suggests that this situation is consistent with lower local interest rates. Therefore, we anticipate an average exchange rate of 10.4 pesos to the US dollar in 2003 and a 28-day Treasury-bill rate of 6.7 per cent in 2003 compared to an annual average of 7.1 per cent in 2002.

Continued macroeconomic stability implies that the mildly restrictive policy mix will not allow the internal market to compensate for the slack in foreign demand. Therefore, we forecast economic growth of 2 per cent in 2003.

The high degree of uncertainty surrounding the international economy, and the US economy in particular, raises concerns about a scenario which is highly dependent on economic recovery in Mexico's northern neighbour. Mexico's options rather than being related to countercyclical macroeconomic management, lie in the promotion of changes in fiscal policy, energy and labour market reform.

The major direct impact of this type of initiative would be reflected in economic efficiency and productivity in the medium term. Their approval would also stimulate investment in the short term. Advances in this area will depend on Mexico's ability to achieve consensus across the whole political spectrum in a year in which the whole lower chamber of Congress will be renewed.

FDI from the United States, 1994–2002 (cumulative, US\$ million)

Cumulative FDI flows from the United States to Mexico were US\$36 billion compared to US\$9.2 billion to China in 1994–2002.

