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MEXICO

RECENT MACROECONOMIC PERFORMANCE

The first months of 2003 were characterised by volatility in the financial sphere, with lacklustre economic growth associated with weak demand in the United States. Nevertheless, as the year went by, the picture changed. Mexico's financial variables registered a marked improvement: interest rates (28-day CETEs, or treasury bills) reached 4.45% in August 2003, its lowest level ever. The peso/US$ exchange rate stood at 10.25 in May, after trading at 10.58 in January. Moreover, longer-term interest rates also declined and the Mexican stockmarket saw the beginning of a rally.

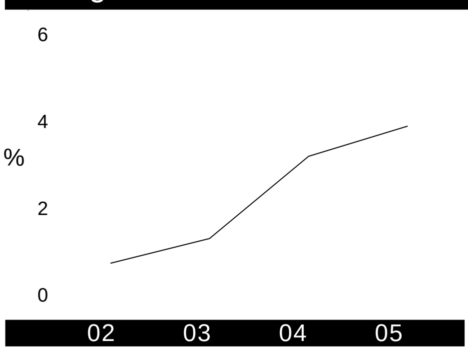
This change of fortune reflected an improvement in expectations about US recovery, but more fundamental causes were also at play. A sound macroeconomic position allowed Mexico to benefit from the expansion in world liquidity. On the fiscal front, the deficit measured by the PSBR (2.54% of GDP) was smaller than anticipated. Public debt was financed predominantly from the internal market: as a proportion of the total, foreign public debt went from 41.6% in 2001 to 39.3% in 2003. Since the beginning of NAFTA Mexico's trade balance has been highly endogenous; this high correlation between exports (2.9% growth during 2003) and imports (1.4%) led to a current account deficit of US$9.5 billion or 1.5% of GDP, the smallest since 1996. Thus, although FDI inflows (US$10.7 billion) were below previous years, they were enough to cover the current account deficit. This position was further reinforced by high oil prices and foreign remittances from Mexican workers (legal and illegal) in the United States worth US$13.3 billion.

This implies a significant supply of dollars and a dilemma. The Mexican government has—via the state-owned oil monopoly—dollar-denominated revenues directed mostly to reserve accumulation. Thus, the US$5.1 billion increase in international reserves during the first five months of 2003 (they stood at US$59.03 billion in December) led the central bank to devise a mechanism to auction in the open market half of all reserves accumulated. While all fundamentals pointed to a strengthening of the peso *vis-à-vis* the US dollar, by the end of 2003 the peso/US$ exchange rate had depreciated 9% in nominal terms.

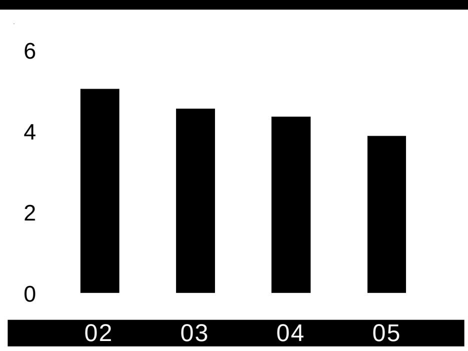
A GROWTH PUZZLE

In spite of the improvement in macroeconomic conditions, growth has been modest. Mexico's economy grew 1.3% in 2003, below the forecast in the 2003 PEO report (2.1%) and lagging behind the United States for the third year in a row. This situation has sparked controversy as to whether the 'NAFTA channel' (that is, the productive link between the United States and Mexico) is still in place. These doubts are associated with two interrelated arguments: increasing Chinese competition in the US market

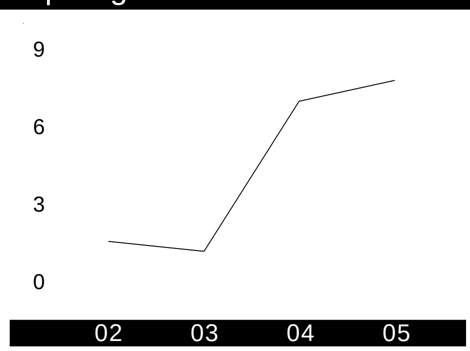
GDP growth



CPI inflation



Export growth



is displacing Mexican producers, and Mexico's falling competitiveness.

Mexico's competitiveness problems are real, and their association with the need to accelerate the pace of structural reform is welcomed.

Nevertheless, the 'NAFTA channel' is still working. The lag in Mexico's recovery is partially explained by the fact that US industrial output took longer to react, and this segment of the US economy is the main 'driver' of Mexico's export demand. In fact, the stage of recovery has been marked by a remarkable similarity in industrial output in the two countries that now extends to the behaviour of industrial employment and thus leads to strong cyclical gains in terms of labour productivity. Output per employee in Mexico's manufactures rose 2.7% in 2003.

Moreover, sector-specific effects have been quite important. Mexico's share in total US imports fell from 11.6% in 2002 to 11% in 2003. Three industrial segments account for around 70% of that decline.

The apparel industry is in structural decline, as it requires low wage levels to remain competitive. The exodus of apparel maquiladoras from Mexico's northern border to the south has now been followed by the relocation of plants abroad: of the 882 maquiladora plants lost by Mexico between December 2000 and November 2003, 56% belonged to the apparel industry.

The 3.7% decline in motor vehicle exports to the United States is due to the modest performance of the companies operating in Mexico and to the fact that light vehicles, a major export item, has been affected by changing preferences among US consumers. That said, electric and electronic equipment is the critical sector, because it is a very dynamic sector and not only Mexico and China, but virtually all of the Pacific Rim economies are participating in it.

THE 2004 OUTLOOK

Consistent with the idea that the 'NAFTA channel' is still in operation, Mexican exports have reacted to a stronger US industrial recovery. In spite of modest auto exports, figures for September–December 2003 show total exports up 6.1% and industrial output growth of 2.4% on a year-on-year basis in December. Nonetheless, employment will take longer to recover due to structural change affecting low-wage sectors (such as apparel), and permanent productivity gains in some dynamic activities, such as electrical and electronic equipment. Therefore, the same forces behind the current 'jobless recovery' in the United States are at play in these segments and suggest that job creation will be limited. Along with investment, employment is thus the variable to watch: in 2003, the number of workers with social security benefits (a proxy for the formal labour market) fell 0.03%. For 2004, our forecast is a 2.4% change, consistent with our expectation of 3.2% GDP growth.

What are the other drivers behind growth in 2004? We expect private consumption growth of 2.6%, as the outlook for employment is partially compensated by the expansion of banking credit already underway in 2003. Durable goods and residential construction are thus likely to show a better relative performance than non-durable goods. Regarding investment, the modest 0.6% annual growth rate expected for 2004 reflects a slight improvement over 2003 (1.8%), as the levels of capacity utilisation in some industries start to rise. That said, the sector-specific rates of investment will be far from uniform, consistent with an uneven recovery of product lines. In the case of motor vehicles, for example, investments are already under way to change production platforms, although this will not be reflected in growing exports until the end of the year.

Macroeconomic conditions will remain very similar to those prevailing in 2003; no major changes in public finances are expected although oil prices above the original budget will provide additional manoeuvring room. A current account deficit of 1.6% of GDP will be mostly the result of a higher rate of growth. Additional effort will be required in terms of inflation, and therefore CPI inflation in 2004 is likely to be slightly above the central bank's target (4.1%). This factor, along with the assumption of a Fed movement at some point of the year, suggests modest increases in interest rates by the end of the year. Finally, 2004 might also feature some periods of short-term volatility associated with exchange-rate movements. Such behaviour is not consistent with fundamentals, but the 2003 experience suggests reactions in Mexico's foreign exchange markets are sensitive to uncertainties regarding adjustments in the international currency market, and expectations about the structural reforms under discussion. Regarding the latter, no specific assumption is made and therefore figures for 2004 can be seen as an inertial scenario. Should the reform agenda show advances, better results could be expected due to improved market confidence and higher rates of investment.

Manufacturing: year-on-year change, %

Both manufacturing output and employment in Mexico replicate the behaviour of their US counterparts, with employment lagging behind the recovery of output as a consequence of cyclical gains in productivity.