

How Much Will the Global Financial Storm Hurt Mexico?

The credibility earned by prudent policymaking over the past decade should help Mexico weather the current financial storm without devastating effects on real economic activity.

By Erwan Quintin and Edward Skelton

Once inward-looking and crisis-prone, Mexico has transformed itself into a nation that thrives on foreign investment and trade and displays a steadfast commitment to monetary and fiscal discipline.

Largely as a result of this transformation, Mexico has been crisis-free since 1995. The country has now weathered two potentially turbulent presidential transitions without experiencing significant financial difficulties—a remarkable achievement, given its economic history.

Now, this newfound resiliency is being put to its biggest test yet as Mexico confronts the consequences of a global shock of a magnitude not seen in decades. Financial turmoil around the world is reducing the availability of credit, hurting consumer confidence and spending, and depressing external demand, especially from the ailing U.S. manufacturing sector. Mexico's prospects for economic growth have been notably downgraded.

Two decades ago, these shocks almost surely would have pushed Mexico into financial chaos. Fortunately, the country's recent transformation makes such a collapse a remote possibility. The credibility earned by prudent policymaking over the past decade should help Mexico weather the current financial storm without devastating effects on real economic activity.

Mexico's Transformation

Between the mid-1970s and the mid-1990s, sharp devaluations in the peso's exchange rate against the dollar invariably occurred around presidential transitions. In several cases, these currency collapses were accompanied by debt defaults and banking crises, which took massive tolls on the economy.

The 1982 crisis prompted Mexico to begin opening its economy to foreign trade

and investment. These reforms, however, proved insufficient to insure against another crisis. Political uncertainty surrounding the 1994 presidential contest and doubts about the nation's commitment to macroeconomic discipline fed speculative attacks against the peso. In December 1994, authorities were forced to announce yet another drastic devaluation, throwing the recently privatized banking sector into turmoil. In 1995, Mexico experienced its largest fall in GDP since the 1930s.¹

The 1995 Tequila Crisis became a turning point in Mexico's economic history. The nation no longer tries to defend a fixed dollar-peso exchange rate, a policy that frequently led to disaster during turbulent times. Since 1995, Mexico has managed to keep budget deficits within a reasonable range and has staunchly targeted inflation with remarkable results (*Chart 1*).

Investors have grown increasingly confident in the country's commitment to macroeconomic discipline, allowing Mexico to greatly improve its public debt manage-

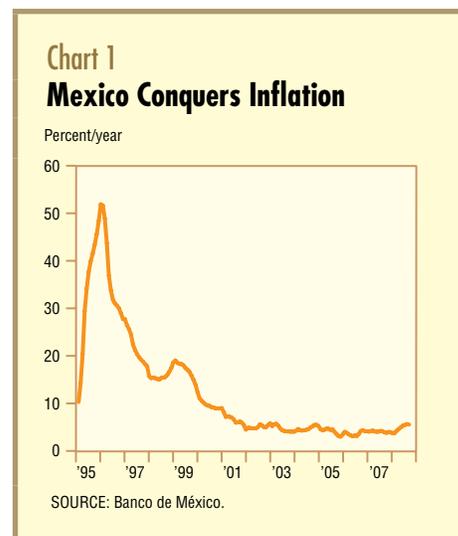


Chart 2 Central Bank Supports Peso



SOURCE: Banco de México.

ment. The government ran into trouble a decade ago in part because most of its debt was in foreign hands, dollar-denominated and short-term.

The external share of total public debt has fallen from a high of 85 percent before the Tequila Crisis to 40 percent today. In 1995, Mexico's longest bond had a maturity of one year. Today, the nation issues 30-year, peso-denominated bonds.

This deep change in the composition of debt became possible because of disciplined policymaking and has greatly bolstered Mexico's ability to deal with short-term fluctuations in interest rates or exchange rates.²

Not Crisis-Proof

Through September 2008, the volatility in developed countries' financial markets wasn't seen as a threat to Mexico's financial stability. The situation began to change in early October as international investors' quest for liquidity and safety led them to reduce their exposure to emerging markets.

The peso reached a six-year high against the dollar in early August but then began to falter. On Oct. 8, this weakening intensified as the peso dropped by 13.8 percent on the day (*Chart 2*).

The fall was exacerbated when several large Mexican companies started selling pesos to cover speculative bets on the exchange rate (see box titled "Playing with Derivatives Burns Mexican Companies"). Mexico hadn't experienced such a currency depreciation since the Tequila Crisis.

The premium Mexico must pay on its debt relative to comparable U.S. instruments also spiked in October and reached

its highest level in over 10 years (*Chart 3*).

There have also been some signs of stress within Mexico's financial system. The cost of short-term funding has risen over the past three months. Some corporations are reporting difficulties rolling over their commercial paper. Moreover, corporate bond rates have been under pressure recently as mutual fund managers scramble to sell some of their holdings to meet clients' redemptions.

Still, as a result of the steps taken since the Tequila Crisis, Mexico continues to be viewed as a relatively safe haven, and the spread on Mexican bonds remains lower than that of the rest of Latin America and of global emerging markets.

Fast Foreign Exchange Response

In an effort to moderate volatility, the Banco de México has intervened in the foreign exchange market in two ways. First, the central bank has orchestrated four separate extraordinary offerings of U.S. dollars (*Chart 2*). Second, the central bank has re-instituted daily dollar sales.³

Through these two facilities, more than US\$13 billion of Mexico's international reserves have been spent to ease peso volatility. As of Dec. 5, US\$84 billion in international reserves remained for any necessary future interventions. Should that large cushion not suffice, the Federal Reserve has established a US\$30 billion line of credit with

the Banco de México, authorized through April 30, 2009, to support dollar liquidity.

Foreign exchange market interventions are a temporary fix. The hope is that, in the long run, Mexico's disciplined policymaking, sound macroeconomic conditions and solid financial fundamentals will assuage investor concerns about the peso.

Government Helps Debt Markets Too

Mexican authorities have also taken a number of preemptive measures to support liquidity in debt markets.

The Banco de México announced a new measure allowing commercial banks to use their required reserves as collateral for short-term funding through guaranteed loans. Banks can also access short-term funding through repurchase agreements with the central bank in exchange for a wide range of government and corporate debt instruments.

As for nonbank financial institutions, the Secretaría de Economía has set up a guarantee fund of 2.5 billion pesos to improve their access to liquidity. It bears mentioning that, to date, no institution has taken advantage of these liquidity measures.

For its part, the Hacienda (Finance Ministry) announced a 50 billion peso loan guarantee program designed to help companies roll over short-term debt or commercial paper. The loan guarantees will be provided via development banks

Chart 3 Country Premium Rises (Emerging Markets Bond Index yield spreads over U.S. interest rates)



SOURCES: CTRB J.P. Morgan Chase Bond Indexes; Bloomberg.

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Nafin and Bancomext. Companies using the guarantees—which are for a maximum of 500 million pesos per issuance and for a maximum term of six months—are required to provide collateral.

Although there have been anecdotal reports of liquidity shortfalls in Mexico's mortgage market, data indicate that this market hasn't yet been significantly affected by the credit crisis. Mortgages originated rose modestly year-over-year through October.

Nevertheless, Mexico's housing development bank Sociedad Hipotecaria Federal will preemptively offer over 40 billion pesos to shield the country's 985 billion peso mortgage industry from the external crisis. This includes 20 billion pesos in credit lines, guarantees for mortgage finance companies, and more than 20 billion pesos for mortgage finance companies to fund individual mortgages and bridge loans to homebuilders.

Finally, the Banco de México, the Comisión Nacional Bancaria y de Valores and the Hacienda introduced a series of measures aimed at alleviating pressures in the local bond market.

The initiatives include a reduction of 10-, 20-, and 30-year government bond issuances for the remainder of 2008 in favor of treasury bills; credit lines of up to US\$5 billion to the government from multilateral lenders through 2009; a reduction of the

size of the weekly auction of debt securities issued by deposit insurance agency IPAB; and the establishment of a program that will enable the Banco de México to repurchase IPAB securities.

These measures are all designed to improve liquidity and short-term funding and alleviate pressure in the local fixed income market. Once liquidity conditions improve, government authorities will return to standard borrowing practices.

Mexico's Outlook

Mexico is much better equipped to deal with adverse economic shocks today than at any point in its recent history. Nevertheless, the global financial crisis will impact the economy in several key respects.

Domestic credit contraction and increased uncertainty about future growth will dampen domestic spending for the short term. Mexican consumers are reporting that their situation has worsened compared with 12 months ago and that they expect it to deteriorate further in the next few months. The fraction of households reporting plans to make a large purchase over the next 12 months has collapsed. In September, retail sales showed their weakest growth in over five years.

Another damper on consumer spending comes from a weak U.S. economy, which means less growth in remittances to Mexico over the next few quarters.

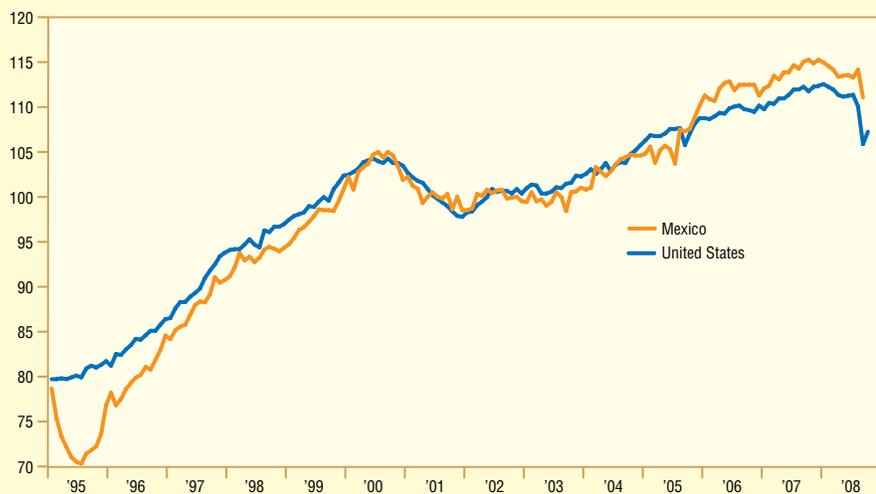
The global slowdown is taking a toll on external demand as well. Mexico depends on the U.S. manufacturing sector for about 80 percent of its exports, and the two nations' industrial sectors are closely synchronized (*Chart 4*). In light of this dependence, the latest data hint that the worst is yet to come for Mexico's industrial sector.

A drastic contraction of U.S. manufacturing is under way. History suggests this will cause Mexico's manufacturing output to weaken. Losses are particularly severe in the U.S. auto sector—a leading destination for Mexican exports—which hurts Mexico's short-term prospects.

These headwinds have caused analysts and government agencies to revise down projections for economic performance over the next two years. As of November, real growth was expected to be below 2 percent this year. For 2009, private analysts surveyed monthly by the central bank of Mexico expect growth to be below 0.5 percent, less than one quarter the rate they expected as recently as two months ago (*Chart 5*).

Chart 4
Together, for Better or Worse
(Industrial production index, seasonally adjusted)

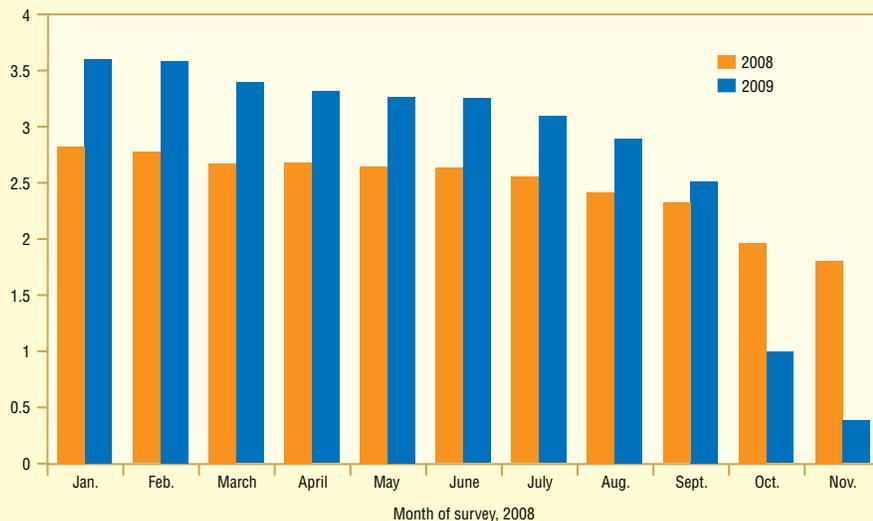
Index, 2002 = 100



SOURCES: Instituto Nacional de Estadística, Geografía e Informática; Federal Reserve Board.

Chart 5 Growth Expectations Have Plummeted in 2008 (Private growth forecasts by vintage)

Expected annual growth in real GDP (percent)



SOURCE: Banco de México.

Real growth fell to its weakest rate in five years during the third quarter. The industrial sector is already contracting. So far, the service sector is showing sufficient resiliency to keep the economy growing. Growth could weaken further once the

crisis' toll on consumer spending becomes more pronounced.

The full impact of the global turmoil on Mexico will depend on how quickly the world financial system can return to normal and on the depth and length of the U.S.

manufacturing contraction—factors that are eminently difficult to predict. However, for the time being, the biggest external shock in decades is causing analysts to forecast only a slowdown in growth rather than utter collapse, demonstrating how far Mexico has come over the past two decades.

If anything, the adverse global environment is making the need for additional structural reforms even more urgent. Mexico has managed to greatly reduce its vulnerability to homegrown shocks. Better functioning domestic markets will provide the best possible form of insurance against external shocks.

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Notes

¹ The economic slowdowns in Mexico arising from past financial crises, along with the impact on the labor market, are studied in "Labor Markets in Turbulent Times: Some Evidence from Mexico" by Sangeeta Pratap and Erwan Quintin, Federal Reserve Bank of Dallas *Southwest Economy*, no. 5, 2008.

² For more details on Mexico's recent economic history, see "Mexico's Financial Vulnerability: Then and Now," by José Joaquín López and Erwan Quintin, Federal Reserve Bank of Dallas *Economic Letter*, no. 6, 2006.

³ Policymakers had originally implemented daily dollar sales of US\$40 million in 2003 to curtail the growth in foreign reserves. However, the peso's strength and a decline in international reserves led to the suspension of dollar sales in July 2008. The current auction facility offers up to US\$400 million a day. For more information on the new auction facility, see Banco de México Circular 47/2008, published Oct. 8, 2008, <http://www.banxico.org.mx/tipo/disposiciones/bancos/47-2008.html>.

Playing with Derivatives Burns Mexican Companies

The Comisión Nacional Bancaria y de Valores is investigating Mexican corporations' use of financial derivatives after losses on these contracts caused the country's third largest supermarket chain, Controladora Comercial Mexicana, to declare bankruptcy.

In its bankruptcy filing, Comercial Mexicana cited more than US\$2 billion in liabilities, some tied to a \$1.4 billion loss in peso derivatives. Other nonfinancial firms—hotel and resort company Grupo Posadas; steel, paper and consumer product conglomerate Alfa; tortilla maker Gruma; and glass producer Vitro—also disclosed large trading losses tied to financial derivatives.

These firms all took unexpected and unusual currency risks having little direct relationship with their core businesses. Because they had bet that the peso would be stable or rise, they were caught exposed when the peso began to weaken. As these bets began to go bad, the companies had to buy dollars to cover their exposure, which aggravated peso weakness in an already illiquid global market.

In addition, concerns about companies' exposure to derivatives have compounded existing fears for Mexico's corporate sector, whose core operations had already begun to be adversely impacted by the U.S. downturn and financial crisis.

It should be pointed out that the list of Mexican corporations threatened by speculative positions on currency derivatives isn't expected to grow further. Mexican companies with large dollar-denominated debt are generally exporters to the U.S., which provides them with a natural hedge against exchange-rate volatility. Exporters also tend to have long-term debt and, therefore, are less exposed to short-term currency fluctuations.