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A Perspective on the Houston Economy

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Trade, Manufacturing Put Mexico Back on Track in 2004

The 2001 recession was led by manufacturing in both the United States and Mexico, and slower recovery in Mexico was largely because of Mexico's greater dependence on industrial production.

A decade after the Tequila Crisis of December 1994, the Mexican economy presents a macroeconomic landscape that has been fundamentally improved. An independent central bank brings new transparency and accountability to the conduct of monetary policy, with a stated objective of targeting inflation. The fiscal deficit has been held under 2 percent of gross domestic product (GDP) every year since the 1994–95 crisis. The exchange rate floats successfully, with accumulated foreign exchange reserves reaching nearly \$65 billion in December. Markets for government debt attract investors at low rates, and government securities now have a duration of up to 20 years.

The success of Mexican macroeconomic policy can be seen in the course of recent history. Together with the North American Free Trade

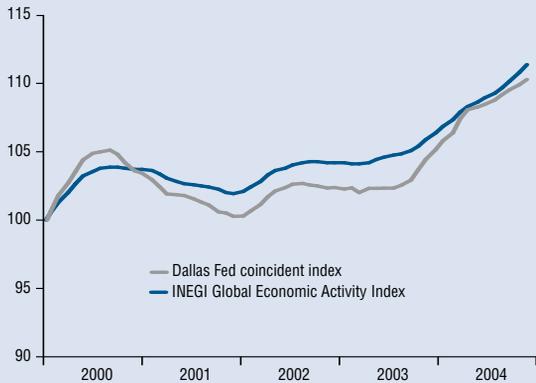
Agreement and the opening of Mexican markets to trade, it contributed to the rapid recuperation of the Mexican economy after 1994–95. And it was essential in limiting the 2001 Mexican downturn to a mild recession, a landmark in a country where every downturn of the prior 30 years had been accompanied by a financial crisis.

Macro stability has also brought into focus the growing synchronization of the U.S. and Mexican economies, primarily the product of strengthening trade ties between the two countries. The 2001 recession was led by manufacturing in both the United States and Mexico, and slower recovery in Mexico was largely because of Mexico's greater dependence on industrial production.

In 2004, however, Mexico finally caught up with the United States, as both countries saw GDP grow at a 4.4 percent annual rate. It was the best year for both countries in this round of expansion. This article examines Mexico's economic performance in 2004 and discusses its economic and political outlook.

Figure 1
Mexican Economy Growing Since Summer 2003

Index, January 2000 = 100



SOURCES: Instituto Nacional de Estadística Geografía e Informática; Federal Reserve Bank of Dallas.

Mexico Takes Off

Economic activity in Mexico intensified in the summer of 2003. Figure 1 shows two economy-wide measures of Mexican economic activity: a coincident economic indicator produced by the Federal Reserve Bank of Dallas and an index of global economic activity produced by Mexico's chief statistical agency. The two indicators point to growth in 2004 of 5.6 and 5.2 percent, respectively, while the expansion in GDP was 4.4 percent.¹

The most strongly growing sectors last year were industrial activity; transportation, warehousing and communications; wholesale and retail trade; and financial services. Within the industrial sector, growth was strongest in construction, manufacturing, and electric, gas, and water utilities. Together these sectors accounted for nearly 80 percent of Mexico's overall growth in 2004.

Consumption and Investment

There are numerous parallels between recent economic events in the United States and Mexico, including a downturn in domestic investment as a key feature of the 2001 recession.

Also, both economies were buffered by strong consumption throughout the downturn and recovery.

Although fixed investment fell 9 percent in 2001 (Figure 2), the decline was much less severe than the 34 percent drop in 1995. Investment began to recover again in mid-2003 and strengthened in

2004; in the third quarter, it reached its best quarterly performance since 2000, at an 8.5 percent annual rate.

Because the 2001 recession was not driven by financial crises, a stable peso and low rates of inflation allowed domestic consumption to support the Mexican economy during the downturn. In 2004, private consumption averaged 8.4 percent annual growth through the first three quarters, with durables, nondurables and services all sharing in these increases. As job growth improves in 2005, growing employment and income seem likely to keep consumption strong.

Inflation in Mexico reached a 30-year low of 4 percent in 2003, but rebounded in 2004 to 5.2 percent. The reasons for higher prices range from global pressures on commodities prices to mad cow disease to a weaker peso. As a result of rising prices, the Banco de México tightened mone-

tary policy nine times in 2004, pushing short-term interest rates from 6 percent to 9 percent in an effort to maintain inflation within the targeted rates of 3 percent and 4.5 percent.

External Sector

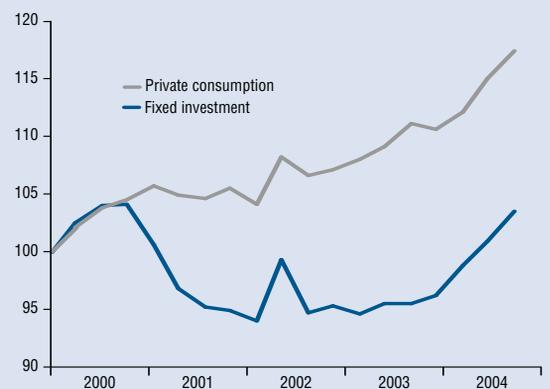
Mexican trade reached \$385.8 billion in 2004, up from \$335.3 billion a year earlier. Mexico's No. 1 trading partner continues to be the United States by far, representing 72 percent of total trade. Asia follows with 13 percent and Europe with 8 percent. U.S.–Mexico trade seems to be back on track, rising at annual rates of 13.5 percent since January 2004.

Trade has been supported by sustained increases in the real exchange rate, a roughly 25 percent devaluation since March 2002. The peso was among the few currencies in the world to depreciate against the dollar in 2004, as the dollar fell by 5.4 percent in 2004 against a broadly weighted index of foreign currencies.²

The maquiladora industry was the largest generator of foreign exchange for Mexico, earning \$19.1 billion. This was followed by remittances from

Figure 2
Consumption Fueled the Economy

Real Index, 2000:Q1 = 100*

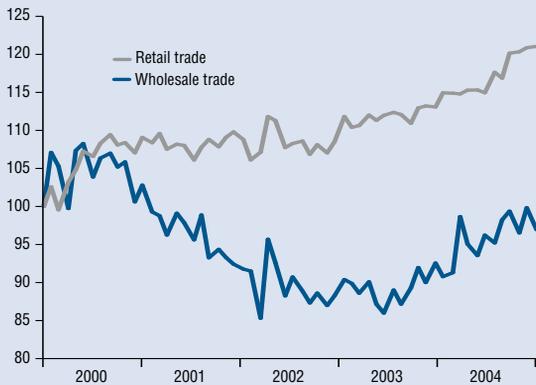


* Seasonally adjusted.

SOURCE: Instituto Nacional de Estadística Geografía e Informática.

Figure 3
Retail and Wholesale Trade Improve

Index, January 2000 = 100*



* Seasonally adjusted.

SOURCE: Instituto Nacional de Estadística Geografía e Informática.

Mexicans working abroad at \$16.6 billion, oil at \$15.6 billion and tourism at \$5 billion. Maquiladora earnings passed oil in 1998 to become No. 1, and 2004 marked the first year remittances passed oil to assume the No. 2 position.³ Mexico's international reserves stood at historic highs near \$65 billion at the end of 2004.

Sectoral Gains

As consumption, investment and trade improved in 2004, they drove improvement in predictable sectors—retail and wholesale trade, construction and especially manufacturing.

Retail trade increased by 7 percent in 2004, and wholesale trade increased by 5 percent. Retail gains were widespread, shared by auto dealers, furniture and home appliance stores, clothing and shoe stores, and department stores. In wholesale trade, the strongest sectors were oil and energy, construction materials, metallic manufacturing materials and general inputs to manufacturing (Figure 3).

Mexico's construction sector grew 12.5 percent during 2004, continuing an upward trend that began in July 2003. Gen-

eral building for housing, schools, offices and hospitals accounted for 44.4 percent of construction in December; transportation projects for 21.3 percent; and oil and petrochemical projects for 10.5 percent. The remaining 23.8 percent was divided among water and sewage, electricity, telecommunications and other projects.

Construction activity was concentrated in the Federal District (22.2 percent), Nuevo León (9.4) and Tabasco (6.1). The states of Campeche, Jalisco, Veracruz, Baja California, Tamaulipas, Sonora, México and Chihuahua were all in the 3 to 4 percent range. Together these states accounted for well over two-thirds of December construction.

Manufacturing and the Maquiladoras

Much of the credit for jump-starting the Mexican economy goes to the revival of U.S. manufacturing. The industrial linkages between the two countries are deep, and trade has become the chief vehicle to transmit economic developments between countries. Today, 91 percent of Mexican exports go to the United States, and 82 percent of Mexico's exports are industrial products. Similarly, 62 percent of Mexican

imports are from the United States, and 91 percent of Mexico's imports are industrial goods. The maquiladora plays a big role in these numbers; goods to be assembled are exported by the United States, and assembled final products return to the United States as domestic imports.⁴

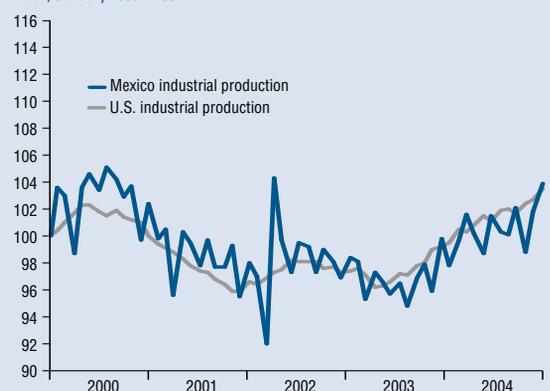
The revival of U.S. manufacturing began in the summer of 2003, attributable to a resumption of U.S. investment and strong export growth that accompanied global expansion and a weaker dollar. Mexican manufacturing responded on virtually the same schedule (Figure 4).

Like the U.S. decline in manufacturing, the industrial recession was long and deep in Mexico. The decline began in late 2000. Mexican manufacturing employment fell by more than 500,000, or 12 percent, in 2001. Losses continued with a 2.1 percent decline in 2002 before stabilizing in 2003. The turnaround in jobs began last year, adding back more than 60,000 Mexican factory jobs.

The good news from Mexican manufacturing is that for the 2001–04 period, labor productivity grew at a 4.2 percent annual rate (Figure 5). Real

Figure 4
Manufacturing Sector Rebounds

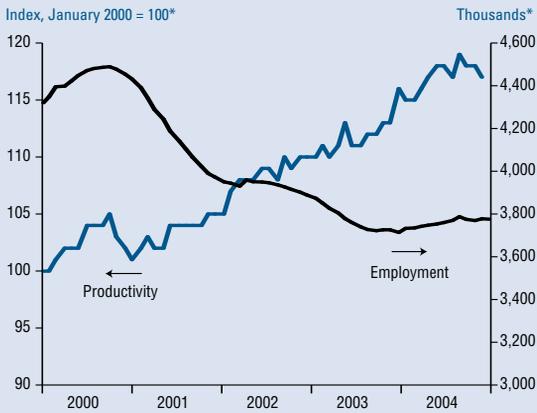
Index, January 2000 = 100*



*Seasonally adjusted.

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

Figure 5
Manufacturing Productivity Rises



* Seasonally adjusted.

SOURCE: Instituto Nacional de Estadística Geografía e Informática.

wages matched a decade-long trend by increasing at a 2.4 percent annual rate.

The maquiladora industry is a vital component of Mexico's industrial sector, big enough to have its own implications for the Mexican economy. It generates half of Mexico's exports, accounts for \$19 billion in foreign exchange and provides 30 percent of Mexico's manufacturing employment. As with the rest of Mexican manufacturing, the 2001 recession was difficult for the maquiladoras. From the industry peak in October 2000 to the trough in July 2003, the industry lost 290,000 jobs, a 21 percent decline. Recent research points to the U.S. business cycle as the chief culprit in this downturn, although many low-wage jobs in sectors like apparel, toys and leather are unlikely to return.⁵

Maquiladora payroll employment has been increasing since late last summer, again matching closely trends in the U.S. industrial sector. During 2004, maquiladoras added back 75,000 jobs, or 26 percent of those lost to the downturn. Among the sectors leading this upward trend are electronics, transportation, services, textiles

and chemicals. Along the Texas–Mexico border, Ciudad Juárez has added 9,600 jobs; Reynosa, 9,000; and Nuevo Laredo, 3,100. Altogether, the six major border cities between Texas and Mexico added more than 21,000 maquiladora jobs, contributing 28 percent of the nationwide

maquiladora job gains in 2004.⁶

Reforms and Politics

If Mexico's macroeconomic picture has improved greatly over the past decade, there is ample room for continued gains from reform. According to most estimates, Mexico's current 4 percent growth is bumping against the ceiling of its potential growth rate. To grow faster—to improve the potential growth rate to 6 percent or higher—changes are needed in Mexico's basic institutional fabric. More specifically, the Organization for Economic Cooperation and Development recently published a list of what it regards as the main challenges for Mexico to reach 6 percent growth:

- Remain committed to macroeconomic stability.
- Put public revenue and expenditure on a more solid and predictable footing.
- Ensure that resources for education and training are used more effectively.
- Raise and improve the stock of infrastructure capital.

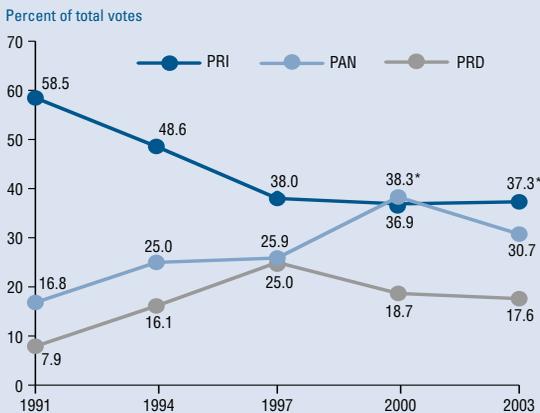
- Pursue labor market reforms.
- Ease regulatory measures and other impediments, including failings of the judicial system and high perceived levels of corruption.⁷

The past year brought little or no progress in advancing a series of widely proposed structural reforms to the Mexican economy. The need for the reforms is recognized, but the political will is lacking. Tax reform is high on virtually every agenda because Mexico's tax system in 2002 yielded revenues equal to only 18.8 percent of GDP, compared with 26.9 percent in the United States and 34.2 percent in Canada. Further, oil continues to deliver close to one-third of public sector revenue, an unreliable source given the volatility of oil prices. The additional revenues must be committed to basic infrastructure and education.

Energy reform is needed to bring down high electricity prices and infuse much-needed capital into oil and natural gas exploration and production. Mexico's labor market ranks among the world's most rigid, imposing high nonwage costs on employers. And Mexico ranks low on most measures of governmental effectiveness, regulatory quality, rule of law and control of corruption.

Not only are reforms needed, but also the timing of such reforms is crucial for Mexico's future economic growth.⁸ The Fox administration has been unable to move reforms forward without a majority in Congress. Figure 6 shows the division of votes among Mexico's three major parties in recent years. Last year was the final opportunity to move reforms forward before the next

Figure 6
Mexican Electoral Results, 1991–2003



* Includes alliance with Green Ecological Party of Mexico.

SOURCE: Instituto Federal Electoral.

presidential election in 2006 because political parties have now turned their focus inward to select candidates.

The 2003 midterm elections may point to the return of the Institutional Revolutionary Party (PRI) after a six-year break in its 70 years of rule. Or the Party of the Democratic Revolution (PRD) could ride the popularity of Mexico City's mayor into the Mexican White House, becoming the first socialist party to rule the country. Or perhaps the National Action Party (PAN), which now rules the country, can score another victory. Given the current division of voting sentiment among the public, it is a battle that promises to leave deep political scars.

It is virtually certain Mexico will operate without significant fiscal, labor or energy reforms through 2006. The opportunity to pass such reforms in the next administration will depend on the 2006 electoral outcome, as well as on the intensity of the political conflict that follows the election itself.

Economic Outlook

Private analysts currently are predicting only slightly

slower growth of Mexican GDP in 2005—in the range of 3.5 to 4 percent. This outlook is based largely on the strong growth prospects for the United States, where GDP is expected to hit 4 percent. At the same time, these same analysts regard the growing U.S. fiscal and trade

deficit as a risk to U.S. expansion, and in turn to Mexico. Also, an unanticipated acceleration of inflation could put both countries' economies at risk. Growing political uncertainty as the 2006 election approaches could also begin to slow growth, if consumers, businesses or foreign investors hold back on spending to await the outcome of the elections.

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Notes

- ¹ For more information behind the methodology of the Mexican index of coincident economic indicators, see "Business Cycle Coordination Along the Texas–Mexico Border," by Keith R. Phillips and Jesus Cañas, Federal Reserve Bank of Dallas, Working Paper no. 0502, July 2004, available at www.dallasfed.org.
- ² According to the Federal Reserve Bank of Atlanta trade-weighted dollar index, available at www.frbatlanta.org/econ_rd/dol_index/di_index.cfm.
- ³ For more information on remittances, see "Workers' Remittances to Mexico," by Roberto Coronado, Federal Reserve Bank of Dallas, El Paso Branch

Business Frontier, Issue 1, 2004, available at www.dallasfed.org.

⁴ "U.S.–Mexico Trade: Are We Still Connected?" by Jesus Cañas and Roberto Coronado, Federal Reserve Bank of Dallas, El Paso Branch *Business Frontier*, Issue 3, 2004, available at www.dallasfed.org.

⁵ "Maquiladora Downturn: Structural Change or Cyclical Factors?" by Jesus Cañas, Roberto Coronado and Robert W. Gilmer, Federal Reserve Bank of Dallas, El Paso Branch *Business Frontier*, Issue 2, 2004, available at www.dallasfed.org.

⁶ Texas–Mexico border cities are Ciudad Juárez, Reynosa, Matamoros, Nuevo Laredo, Piedras Negras and Ciudad Acuña.

⁷ *Economic Survey of Mexico, 2003*, Policy Brief, Organization for Economic Cooperation and Development, Nov. 24, 2003.

⁸ Chile and Mexico, like other countries in Latin America, experienced severe economic crises in the early 1980s, but each underwent a different recovery path. In 1980, Mexico's per capita income was almost double that of Chile; however, after two decades, Chile has erased this gap and returned to its output trend. Mexico, on the other hand, has not yet recovered, and its output continues about 30 percent below its trend. A recent study by the Federal Reserve Bank of Minneapolis and the Central Bank of Chile attributes such differences to early privatization, banking and corporate law reforms taken by the Chilean government. See "A Decade Lost and Found: Mexico and Chile in the 1980s," by Raphael Bergoeing, Patrick J. Kehoe, Timothy J. Kehoe and Raimundo Soto, Federal Reserve Bank of Minneapolis, Staff Report no. 292, September 2001.

All indicators point to continued strength in the Houston economy. The Houston Purchasing Managers Index remained over 60 for the 12th consecutive month, with sales, production and employment all registering nice gains. A value over 50 indicates expansion in the local economy. Labor markets continue to strengthen, with 12-month growth in employment now at 1.7 percent, and the unemployment rate fell from 6.1 percent to 5.5 percent during the same period.

Retail Sales and Autos

Retail sales are mixed in Houston. At opposite ends of the spectrum, discount and upscale stores reported solid results in January and February, while department stores barely met plan. Furniture stores and small independent retailers were operating below expectations. Overall sales are probably up marginally.

New car and truck sales in Houston started the year out right, with January sales up 7 percent over January 2004. It was the second consecutive month of 12-month increases—the first time this has happened since late 2001.

Real Estate

Existing home sales continued to set records in January, with new highs for the month for properties sold, value of transactions and median sales price. Sales are expected to slow in 2005 due to higher interest rates and a growing oversupply of apartments. More jobs and expanding income should keep the market healthy,

however, and shift the focus from starter homes to more upscale properties.

Absorption and occupancy are growing again for Houston office space, although rents are still falling. The central business district and Galleria are leading the improvement. Retail absorption is healthy, with rents and occupancy flat. Industrial occupancy rose during the past year, but flattened out in the fourth quarter.

Oil Services and Machinery

The domestic rig count moved up by more than 20 rigs in recent weeks, with much of the improvement in Texas. Oil service respondents were not bashful about using the “boom” word, comparing current conditions to 1978. They were quick to add, however, that they were anxious to avoid the hangover experienced at that last party.

Capacity is becoming an issue. Some customers are contracting upfront for rigs and services for multiple jobs to ensure availability. People are the main constraint, however, because of shortages of drilling crews and workers with key skills. Prices and margins are such that service companies are now sharing fully in the high commodity prices producers have enjoyed for some time.

Refining

Refiners have begun their spring turnarounds. A refinery

fire and a series of operating problems have kept Gulf Coast refineries at capacity utilization near 90 percent. Refiner margins have moderated from high levels in recent weeks because product prices have not kept up with rising crude price. Inventories of heating oil improved counterseasonally, and gasoline inventories were in excellent shape for February.

Chemicals

Virtually every segment of the petrochemical industry is doing extremely well based on revenue, pricing and profits. Strong product demand is the chief factor giving strength to the industry. Several years of poor demand resulted in reduced capacity for a number of products, and current strong demand is outstripping remaining capacity.

Chlor-alkali, olefins, plastics and aromatics are all projecting record profits in 2005. Among the aromatics, benzene is expected to see a return to record prices in coming weeks as the turnaround season continues for refineries. Propylene prices are up due to strong demand, with some signs of prebuying by customers to avoid future price hikes. Polyethylene prices fell back by 2 cents per pound as feedstock prices slipped, and demand eased, especially export-related demand.



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