OnTheRecord

A Conversation with **William C. Gruben and Erwan Quintin**

The Mexican Economy at a Crossroads

The installation of Felipe Calderón as Mexico's new president provides an occasion for Dallas Fed economists William C. Gruben and Erwan Quintin, both specialists on the Latin American region, to discuss Mexico's progress toward economic stability as well as its remaining hurdles to growth.

Q: Why has the Mexican economy been so stable in the face of recent political turmoil?

Gruben: The first thing to recall is the protracted period of Mexican history when presidential transitions were accompanied by fiscal misbehavior, which created worries for the investment community. Investors would understandably be highly uncertain about the exchange rate, so Mexico would get boom-and-bust cycles every six years.

One of the most important developments in the last 50 years is that Ernesto Zedillo, Mexico's president from 1994 to 2000, didn't engage in this type of behavior as his "sexenio," or six-year term, came to a close. Although Calderón inherits a stable, growing economy, he faces the challenges of an ineffective educational system, a legal structure in need of repair and excessive government interference in the private sector.

Q: What have been the fruits of this good fiscal behavior?

Quintin: I like to say that Mexico has been able to grow a yield curve in recent years. The Mexican government was unable to sell any debt with over a year to maturity in the aftermath of the mid-1990s Tequila Crisis, but the situation has changed tremendously in the past five years.

Investors, both domestic and international, are now much more willing to entrust the government with their money. In 2004, Mexico issued its first 20-year bonds. And the government just started issuing 30-year, fixed-rate, peso-denominated bonds.

Q: Even against this backdrop of greater stability, Mexico's economic growth is nowhere near its full potential. Why is that?

Quintin: Yes, macroeconomic stability creates an environment where it's easier to lend and invest, but this alone isn't sufficient to achieve strong economic growth. Several factors still impede the ability to do business.

Erwan Quintin

One obstacle is the Mexican financial sector. Despite recent improvements, it remains one of the world's smallest. The ratio of loans to GDP is still quite low, relatively speaking. One key problem is that property rights aren't enforced. So banks aren't certain of repayment or their ability to collect on collateral in case of default.

That hampers the efficiency of the financial system, whose job is to facilitate investment and help allocate resources to their most productive uses. Insufficient financial intermediation results in an economy that doesn't invest as much and isn't as productive as it would otherwise be.

Q: This seems to tie in to the notoriously stormy history of the Mexican banking sector.

Gruben: Mexico's banks have had their fair share of troubles. First, the banking sector was nationalized in the 1980s. Then, when the banks were privatized in the 1990s, many of those who took the reins were stock-market types, which is to say they were prepared to take on more risk than traditional bank managers. This resulted in banks making loans they shouldn't have, which, of course, played out to Mexico's detriment in the Tequila Crisis.

Q: So where does that leave the banking sector today?

Quintin: It's in much better shape than it was 10 years ago. Supervision has greatly improved. The ratio of nonperforming loans to outstanding bank credit is a small fraction of what it used to be. Bank lending is now growing at a healthy rate, albeit from a very low base.

Q: What are other symptoms of economic inefficiency in Mexico?

Quintin: One is Mexico's informal sector—the untaxed and unregulated portion of economic activity. By some estimates, it accounts for as much as a third of Mexico's $1.07 trillion economy.

A large informal economy is a natural response to a burdensome regulatory environment, especially when bank financing, one advantage formal producers presumably enjoy, remains scarce. The flip side is that the

William C. Gruben

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country pays a high price in the form of a smaller tax base—fiscal resources being less than they otherwise would be.

The allocation of resources is unlikely to be efficient when a significant share of production is carried out in an environment where there aren't sufficient legal means of contract enforcement. The result is an excessive amount of low-scale production and self-employment.

Q: It would seem that now more than ever there is a need for strong leadership.

Gruben: The good news is that the current generation of politicians appears more open to cooperation than ever before. This carries tremendous implications for Mexico's overall economy.

And regardless of political affiliation, there's a commitment to ensuring macroeconomic stability, especially the continued independence of Mexico's central bank. If you can imagine, Mexico's central bank was recently easing when the Federal Reserve was tightening. That would have been unheard of 15 years ago.

Q: Step outside Mexico for a moment to the broader economic landscape of Latin America. How does the Mexican economy differ from its neighbors to the south?

Gruben: The larger Latin American countries trade to a much lesser extent than Mexico does—that is, the share of their economies tied to their export sector is much smaller. Of course, trade is of particular importance to Mexico because of its proximity to the United States.

This makes Mexico much more vulnerable to the U.S. business cycle; hence the adage, "When the United States gets a cough, Mexico gets pneumonia." With the U.S. industrial sector showing signs of slowing, short-term risks mount that any shock to U.S. manufacturing will be pushed southward.

Quintin: One other thing that bears mentioning is that Mexico is one of the biggest customers for U.S. exports. As with Canada, our trade relationship with Mexico is very much a two-way street.

While it's true that there's concern about a possible slowdown in U.S. manufacturing, something new has cropped up in the Mexican economy to act as an offset. The improving health of the Mexican financial sector has unleashed quite a bit of pent-up demand in many areas, including housing. This pickup in domestic-driven growth is promising. It suggests the Mexican economy may not take as big a hit as it did in 2000 if the U.S. manufacturing sector were to once again slow significantly.

Q: What about China? What has Mexico done to adapt and recapture its competitive position on the global stage?

Gruben: It's important to note that countries whose export profiles most closely resemble China's will encounter the most direct, face-to-face competition. Of the seven most populous Latin American countries, the one with an export profile most like China's is Mexico.

At the risk of oversimplifying, it's useful to note that the value of Mexico's manufacturing exports as a percent of total exports is nearly 80 percent—far above that of any other Latin American economy. It's easy to say that Mexico will have to move toward specializing in production that benefits from Mexico's proximity to the U.S., but that's already happening.

There are various products Mexico can still produce efficiently enough to compete with Chinese manufacturers. Think of the fast-changing apparel sector, where it's perhaps more convenient to produce higher value-added garments in Mexico than in China.

Quintin: Chinese competition has hurt some Mexican manufacturers, who have essentially had to reinvent themselves to survive. Today, we see many of the new plants that have cropped up on the border concentrating on products that can effectively compete with China—particularly those with high transportation costs and high-skill content.

Q: What's your prognosis for the Mexican economy?

Gruben: The most important issue to address is the need for structural reform in the legal and education systems. The good news is there are signs of progress, especially the apparent formation of bipartisan coalitions in Mexico. One promising development is a recent comment made by the new finance minister, Agustín Carstens, about tax dodging by Mexico's large corporations. Carstens said it was rational for these corporations to dodge taxes but that it wasn't rational for the finance ministry to let them do it. I don't know when I've seen any cabinet level minister anywhere say anything more succinctly.

Quintin: Mexico had a very good year and should continue to grow at a decent pace over the next few quarters. The main risk to this outlook remains the possibility of a marked slowdown in U.S. manufacturing. On the upside, the stage could be set for a long-overdue investment boom in Mexico if the new administration manages to implement significant reforms.