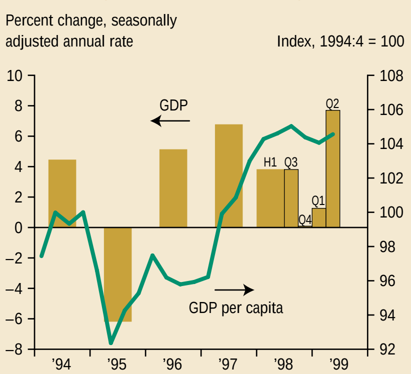
Can Mexico Weather Its Next Election Cycle?

OVER THE LAST 25 years, Mexico has suffered a financial crisis toward the end of three of its four presidential terms. Because problems during election years have become so common in Mexico, people are naturally anxious about the potential for a crisis during next year's Mexican presidential election—despite government claims that things will be different this time. The question for Mexico—and, of course, for Texas businesses that depend on trade with Mexico—is how will the country fare during its next election cycle?

I first review Mexico's economic performance since the 1994–95 peso crisis. Second, I examine vulnerability indicators for Mexico and compare Mexico's economic situation 10 months before its next presidential election with the same period before previous elections. Next, I assess factors that could contribute to a crisis in the coming year, given the political and economic changes in Mexico over the last five years. I conclude with an assessment of the potential for economic turbulence in Mexico through its elections in July 2000.

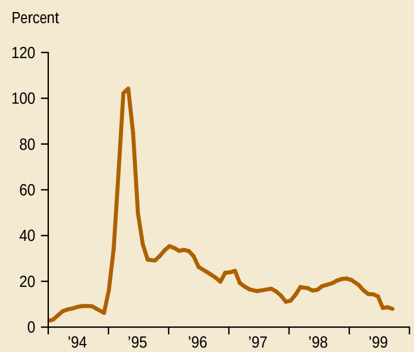
The bottom line of the analysis is that developments in Mexico since 1995, especially the adoption of a flexible exchange rate and better debt management, make economic turbulence in 2000 less likely than in the past.

Chart 1
Economy Shows Strength



SOURCES: Mexican statistics; author's calculations.

Chart 2
Inflation Down



NOTE: Seasonally adjusted annual rate, rolling three-month average.

SOURCES: Mexican statistics; author's calculations.

Recent Economic Performance

Overall, the Mexican economy has done remarkably well during the last four years. As shown by the bars in Chart 1, real GDP growth averaged more than 5 percent from 1996 to 1998. Real GDP per capita, shown by the line, now exceeds its level before the peso crisis by about 4 percent.

Although last year's Russian crisis stalled the economy in fourth quarter 1998, growth resumed in the first quarter of this year and showed strength in the second quarter, growing by nearly 8 percent at a seasonally adjusted annual rate.

As shown in Chart 2, during the peso crisis in early 1995 inflation rose above 100 percent at a seasonally adjusted annual rate but declined to less than 15 percent in 1997. Inflation moved up to nearly 19 percent for 1998 as a whole, largely because of a sharp peso depreciation. In response to the weak peso and inflation pressures during 1998, the Bank of Mexico pursued a tight monetary policy and has since reversed the trend of higher inflation. Since January, inflation has been under 16 percent.

Short-term domestic interest rates, shown in Chart 3, had been falling since 1995 but jumped to over 40 percent in 1998 after the Russian crisis. Similarly, the peso depreciated nearly 15 percent against the dollar in the aftermath of Russian financial turbulence. Domestic interest rates started falling, and the peso strengthened in fourth quarter 1998, although those trends were temporarily reversed when the Brazilian crisis struck in January of this year.

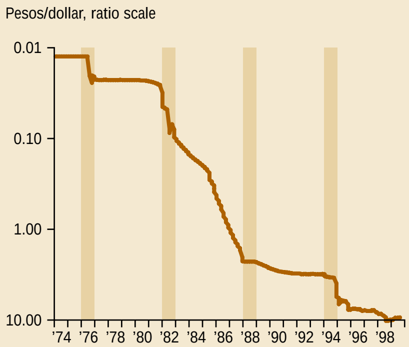
Despite predictions of a lingering period of volatility, the Brazilian crisis resulted in only a relatively minor setback on Mexico's path to recovery. Although real GDP growth stalled in fourth quarter 1998, it has shown signs of a moderate recovery in the first half of 1999. The fallout from Brazil's devaluation was limited in part by Mexico's willingness to raise interest rates quickly to avoid a sharp fall in the peso and consequent inflationary pressure and in part by precautionary adjustments investors had made during the Russian turbulence six months earlier.

Chart 3
Interest Rate and Exchange Rate

* 28-day Treasury bill rate.

SOURCE: Mexican statistics.

Chart 4
Nominal Exchange Rate



NOTE: Bars indicate election years.
SOURCE: Mexican statistics.

As Brazil has stabilized, Mexico has benefited from renewed capital inflow. Mexico is expected to continue to recover, but questions loom about the country's vulnerability to economic turbulence during its 2000 election year.

The Pattern of Mexico's Election-Year Crises

Major devaluations and financial crises have followed most Mexican elections since 1976, as shown in Chart 4. In three of the last four elections—1976, 1982 and 1994—a major devaluation and economic crisis occurred around an election. The 1988 election was an exception, as Mexico had not fully recovered from its 1982 election-year crisis. In addition, the peso had depreciated earlier under high inflation and midterm turbulence following oil price declines and the 1985 earthquake.

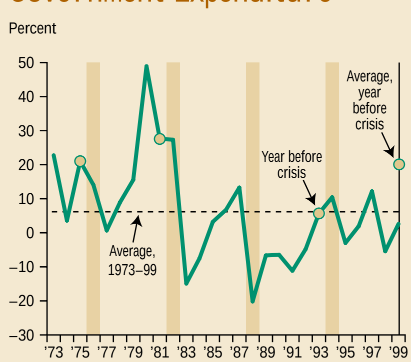
Why do financial crises occur in election years? A confluence of forces makes the economy vulnerable to crisis. Incumbent governments in Mexico, like those in many other countries, have the incentive to keep the economy growing in an election year to attract as many votes as possible. The more rapid the growth, the better voters feel and the more likely they are to vote for the incumbent party. Consequently, going into an election year, the government tries to sustain or increase fiscal spending. Monetary policy is kept loose and the pace of lending to the public and private sectors is maintained.

These actions cause inflationary pressures and—given a highly managed nominal exchange rate, which Mexico has had for much of its history—lead to appreciation of the real exchange rate. An overvalued real exchange rate reflects a drop in international competitiveness, resulting in reduced exports and increased imports. This, in turn, generates a widening current account deficit and increases speculation of an impending devaluation, which drains international currency reserves as capital flees the country. Eventually, under mounting pressures, a balance-of-payments crisis erupts and the currency is devalued.

Vulnerability Indicators

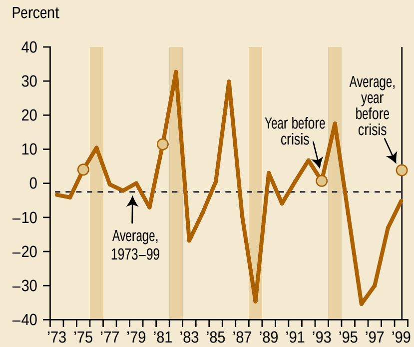
To assess whether Mexico will fall into another election-year crisis, I examine major vulnerability indicators and compare their current behavior with that during past election cycles. Vulnerability indicators attempt to measure an economy's susceptibility to crisis. I examine the following indicators: the growth in real government expenditure, an indicator of fiscal imbalance; the growth in domestic credit relative to GDP, an indicator of monetary stimulus and inflation pressures; real exchange-rate appreciation, a measure of how internationally competitive the country is; and, finally, the current account balance, an indicator of how reliant the country is on foreign capital inflows to fund imports of goods and services. In general, countries with high growth in government expenditure, rapid expansion of domestic credit relative to GDP, overvalued real exchange rates and large current account deficits are susceptible to financial crises.

Chart 5
Growth in Real Government Expenditure



NOTE: Bars indicate election years.
SOURCES: Mexican statistics; author's calculations.

Chart 6
Growth in Domestic Credit/GDP



NOTE: Bars indicate election years.
SOURCES: Mexican statistics; author's calculations.

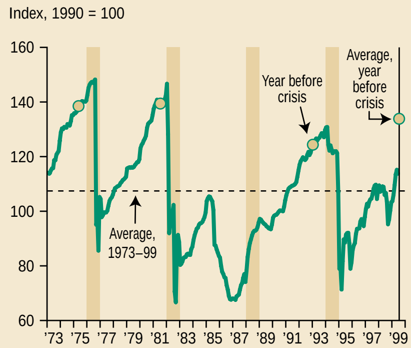
Chart 5 shows the growth of real government expenditure, which is fiscal spending deflated by the price level. The dashed horizontal line indicates the average value of real government expenditure over the sample period. The circles on the plotted line mark the year before a balance-of-payments crisis. The average value of the growth of real government expenditure the year before crisis is shown with a circle on the right axis. As mentioned earlier, 1988 is not classified as an election-year crisis because a major devaluation did not occur.

In the years prior to elections, fiscal spending accelerates. On average, the growth in real fiscal spending was 18 percent before crises. In contrast, real fiscal spending for 1999 is projected to increase by only about 3 percent from 1998 levels.

The increase in fiscal spending prior to crises was usually accompanied by an acceleration in domestic credit relative to GDP, a measure of monetary stimulus and price pressures (*Chart 6*). Monetary expansion was especially evident in 1982 and to a lesser degree in 1976 and 1994. On average, as shown on the right axis, the year before crisis domestic credit relative to GDP grew by

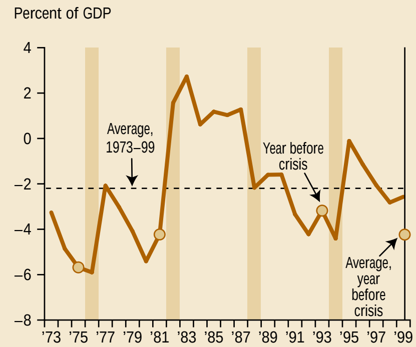
In the year prior to crisis, the real exchange rate was about 26 percent higher than its long-run average.

Chart 7
Real Exchange Rate



NOTE: Bars indicate election years.
SOURCES: Mexican statistics; author's calculations.

Chart 8
Current Account Balance



NOTE: Bars indicate election years.
SOURCES: Mexican statistics; author's calculations.

about 5 percent, while so far this year it has fallen 5 percent.

The accumulated price pressures before crises, stemming from fiscal and monetary expansion, along with a highly managed nominal exchange rate, generally led to an appreciating real, or inflation-adjusted, exchange rate (*Chart 7*). The real exchange rate appreciates when domestic prices increase faster than foreign prices and cause the country to become less competitive internationally. In the year prior to crisis, the real exchange rate was about 26 percent higher than its long-run average. Notice that in 1988, the only election year that didn't suffer a crisis, the rate was below its long-run average. Currently, the rate is only about 7 percent above its long-run average.

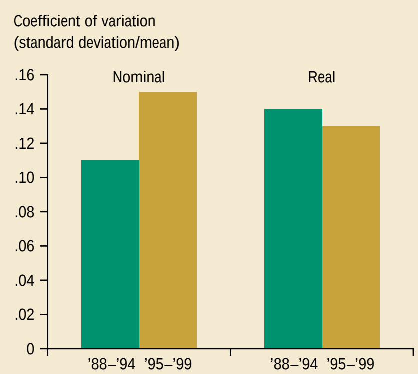
Reflecting all these vulnerabilities, international trade and funding imbalances generally deteriorate in the run-up to balance-of-payments crises. As shown in Chart 8, the average current account deficit before crises was about 4.5 percent of GDP. The deficit is now about 2.5 percent, slightly below its long-run average but much better than during past periods leading up to crisis.

Crisis Assessment

Mexico's current situation appears better than in past pre-election years, but there is a wide variation across election years. Moreover, history shows that these indicators can worsen over the ensuing 10 months. Since the 1994–95 election-year crisis, however, several key factors have changed, suggesting that turbulence is less likely now than in the past. These factors include a floating exchange rate, which can limit real exchange rate overvaluation; a weak banking sector, which is unlikely to be a source of rapid credit expansion; greater political competition, which may restrain fiscal spending; and better debt management.

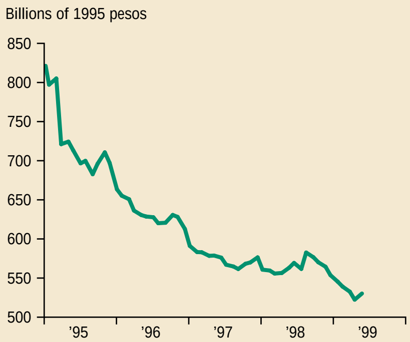
Since Mexico floated its exchange rate in December 1994, the nominal exchange rate has become more volatile, as one would expect under a floating regime (*Chart 9*). At the same time, the volatility of the real exchange rate has declined. Increased flexibility in the nominal exchange rate has acted as a shock absorber to external turbulence, permitting adjustments to changing

Chart 9
Exchange Rate Volatility
(Bilateral against U.S. dollars)



SOURCE: Mexican statistics.

Chart 10
Real Bank Lending
Remains Weak
(Commercial banks)



SOURCE: Mexican statistics.

pressures rather than allowing them to build up. Consequently, the real exchange rate has become less overvalued and less volatile, which has decreased the likelihood of a large discrete devaluation. Much the same happened during Mexico's period of exchange-rate flexibility in the years before its 1988 election and was probably an important factor in averting a major devaluation that year.

Bank credit expansion was a source of vulnerability in past crises, particularly in 1994. Historically, the banking sector has amplified the boom-and-bust cycle by extending easy credit to marginal borrowers when asset prices are high and then withdrawing that credit when asset prices fall. In 1994, before the peso crisis struck, expansionary bank lending fueled unsustainable spending.

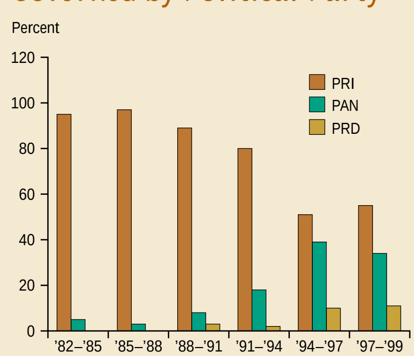
Recently, however, the banking sector is less a factor in excessive growth simply because it has never recovered from the peso crisis. Large corporations still have access to international capital markets, but individuals and small businesses are credit constrained. The level of real bank loans outstanding has continued to fall since the peso crisis (*Chart 10*), while the level of nonperforming loans as a share of total loans is still relatively high, at about 15 percent.

Over the last 14 years the political dynamics in Mexico have changed dramatically, with mixed implications for the coming year. As Chart 11 shows, Mexico has moved from a one-party system, in which the PRI dominated the government, to a multiparty system with less concentrated power. As a result, the 2000 elections could give the PAN, the conservative and second most popular party, the best chance it has ever had to win the presidency. The PRD, the most liberal of the top three parties, has little chance of winning the election by itself and is unlikely to join a coalition with the PAN.

As a result of greater political competition, the PRI has become more aggressive in producing a candidate who can win election. In a major change from its tradition of allowing the president to handpick his successor, the PRI held a primary on November 7, in which the candidate was chosen by popular election. This has produced a candidate who has had to appeal to a larger electorate than in the past. The economic implication is that increased political rivalry between parties may generate pressures for more election-year spending. However, because power is now shared in the Congress, there are more checks in the system, which may limit excessive spending.

Another factor bolstering Mexico's stability is the shift away from reliance on volatile portfolio capital inflows, which is investment in the stock and money markets, to more stable foreign direct investment, which is property, plants and equipment. As Chart 12 indicates, portfolio investment is much more volatile than direct investment. Foreign direct investment has grown relative to portfolio investment since 1997, and consequently, its importance for funding the current account deficit has grown as well. In the most recent

Chart 11
Share of Municipalities
Governed by Political Party



SOURCE: Mexican statistics.

Bank credit expansion was a source of vulnerability in past crises, particularly in 1994.

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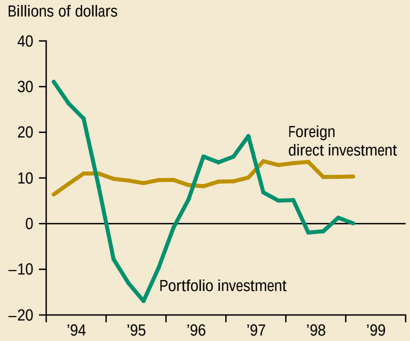
Chart 12
Foreign Direct and Portfolio Investment



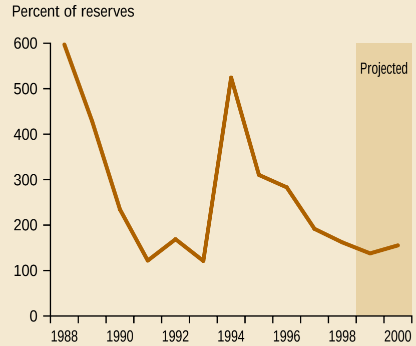
NOTE: Four-quarter moving sum.
SOURCES: Mexican statistics; author's calculations.

four quarters, foreign direct investment corresponded to 75 percent of the current account financing needs, substantially better than in previous years before an election.

Chart 13 shows external debt service as a share of international reserves, which is a gauge of the ability to make foreign debt payments should international capital markets dry up. Mexico's external debt service as a share of reserves has fallen markedly since 1994, to just over 160 percent in 1998. If current levels of debt and reserves are maintained, debt service through the year 2000 is projected to remain below 155 percent of reserves—relatively low by developing-country standards.

The external debt service projection reflects the new financial package Mexico announced on June 15. Mexico will receive a $4.1 billion standby agreement from the International Monetary Fund (IMF), which essentially rolls over the remainder of Mexico's 1995 IMF loan until 2001. In addition, loans of $5.2 billion from the World Bank and $3.5 billion from the Inter-American Development Bank will allow Mexico to ease pressures on public-sector funding. These loans, in addition to a $4 billion credit line from the U.S Export-Import Bank, will cover nearly 80 percent of the public sector's expected external debt service in 2000. The $6.8 billion swap line associated with the North American Framework Agreement is a potential source of assistance should Mexico fall into crisis.

Chart 13
External Debt Service Is Manageable



NOTE: Includes private and public sector amortization and interest and *Tesobono* (Mexican treasury) debt.
SOURCES: Mexican statistics; author's calculations.

Conclusion

Mexico has repeatedly suffered balance-of-payments crises around election years. Part of the reason was the political incentive to stimulate the economy to garner votes for the incumbent government. Excessive spending in combination with a rigid exchange rate regime and lax supervision and regulation of the banking sector created unsustainable economic imbalances that eventually led to balance-of-payments crises.

While the potential for economic turbulence still exists in this coming election year, several factors have changed, reducing the chance of a crisis similar to those in the past. In particular, the exchange rate is much more flexible, which decreases the likelihood of an overvaluation and a large discrete devaluation; the banking sector is not a source of excessive spending; and foreign debt is more manageable. Overall, Mexico is better positioned this year, compared with previous election cycles, to weather most storms on the horizon.

—David M. Gould

Gould, former senior economist and policy advisor in the Research Department at the Federal Reserve Bank of Dallas, is now a senior economist at the Institute of International Finance in Washington, D.C.