

**Mexican Economy facing the international crisis**

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## **I. Introduction**

The world economy goes through a deeply adverse juncture, probably the most dramatic since the Great Depression of the 1930s. Its immediate origin dates back to 2007. Then, the increasing difficulties in the US mortgage market -in the context of its far from adequate financial regulation, the over indebtedness of its private sector and the mounting disequilibria of the US fiscal and foreign trade performance– triggered a financial crisis with deep and long lasting effects in the world economy. In fact, due to the collapse of the subprime mortgage market, the economic outlook, not only in the USA but also in most industrialized nations has been drastically shocked by the bankruptcy of until recently very prestigious and solid financial institutions and major manufacturing companies, the acute contraction of the credit and the stock markets, and the instability and volatility of the exchange market and the inauguration of a deep recession in the US economy.

The financial collapse adversely affects the economic activity of industrial clusters as well as of small and medium sized enterprises. It has acutely reduced foreign trade, slowed down investment projects and cut by now millions of jobs in the OECD. In fact, in 2008 the US formally entered a period of economic recession. Actually, unemployment has reached its highest levels in more than a decade with close to 5 million jobs being lost so far. In February open unemployment climbed close to 8%, its highest level since 1992, and several points above its register just twelve months before.

All countries – both industrialized and developing ones – are suffering the effects of the financial crisis. Already in the last quarter of 2008, most advanced economies show a slowdown or a reduction in their production and employment levels. The emerging economies, in general, record an abrupt deceleration of their productive activity and employment, with some of them actually registering a decline in them (Banxico, 2009). International financial organizations and think tanks agree that the adverse international economic environment will persist in 2009. The most optimistic ones suggest that a slight gradual recovery will begin in the second half of 2010. In any case, at the time of writing this article (March 2009), the projections of the IMF and the OECD coincide in estimating that the world economy will have no growth or actually contract in 2009. Such projections are subject to considerable uncertainty and will no

doubt be revised. An important element in this regard is the extent to which policies adopted in the industrialized nations –especially in the US- will or will not be able to correct the financial situation and avoid the world economy’s fall on an prolonged recessionary spiral.

To a certain extent, the crisis is having somewhat different degrees of impact in the various regions of the world. Asia is certainly one of the most affected areas. Latin America experiences a significant economic deceleration; somewhat deeper in countries where their previous expansion had been specially favored by the improvement of their terms of trade. The consensus is that the Mexican economy will be among the most affected ones because of its close relation with the US. In fact, in 2008 Mexican economy had already suffered a deceleration in its activity pace. In the last quarter of 2008, real GDP declined 1.8% relative to its level twelve months before. Moreover; average remuneration fell in real terms (Banxico 2009) and consumers’ confidence fell to its lowest level ever. From October 2008 to February 2009, the number of formal workers i.e. those affiliated to the Mexican Institute of Social Security (IMSS), went down from 14.6 to 13.8 million people. The rate of unemployment increased over and above 5%, its highest level in more than a decade (INEGI, 2009). In December, manufacturing’s output and employment were 6.6% and 4.7% below their levels twelve months before. On the other side, by the end of March, the Mexican stock exchange index was almost half its most recent maximum (registered in October 2007). The exchange rate had gone up above 15 pesos per US dollar; that is a depreciation of more than 40% relative to August 2008.

Recent forecasts by the Ministry of Finance indicate that in 2009, the Mexican economy will fall 2.8% in real terms. Non-governmental sources estimate a sharper fall of GDP, for example JP Morgan predicts a contraction of 4%. The decline of employment is estimated to be between 150.000 and 800.000 jobs. In any case, the consensus is that the number of jobs and their quality will acutely deteriorate. Given the uncertainty surrounding the depth and length of the world financial crisis and of the efficacy of the policy measures implemented worldwide it may be idle to concentrate this paper to contrast the validity of the official forecasts for the Mexican economy’s growth or employment performance in 2009. It seems more relevant to focus our present analysis on the following issues: What are the main strengths and limitations of

the Mexican economy and how will they affect and be affected by the current crisis? How and by which means are the main effects of the international crisis passed on to Mexico's domestic economy? What is the policy response of the government? Is it appropriate? How and when will the Mexican economy begin to enter a long-term path of high expansion? The purpose of this paper is to deal with those questions.

## **II. Strengths and vulnerabilities after the structural reforms**

To understand the strengths and vulnerabilities of the Mexican economy it is necessary to recall that its current productive and financial structure is -to a great extent- the result of the intense process of liberal reforms undertaken since the middle 1980s to leave behind its traditional pattern based on import substitution and the direct intervention of the state in the allocation of resources. The aim of this reform process was to turn the exports and the private investment into the main generator of the economy expansion. Those reforms, deepened by subsequent governments, transformed Mexico into one of the mid-sized economies most open to foreign trade and capital flows, with a markedly reduced intervention of the public sector in the economic sphere.

The liberal reforms had three objectives. The first and most urgent one was to cut down inflation and to slash the fiscal deficit; two key macroeconomic variables that had been strongly destabilized in the aftermath of the debt crisis and the collapse of the international oil market in the early 1980s. Price and fiscal stabilization was achieved through the reduction of public expenditure and the implementation of a heterodox program: the Pact for Economic Solidarity. This Pact was a deal between the business sector, the labor sector and the government and comprised the control of the exchange rate, the minimum nominal wage and the prices of some basic goods.

Besides fighting back inflation and cutting down the fiscal deficit, the reforms aimed to radically transform the structure of the Mexican economy. On one side, national markets were drastically opened to foreign competition, and the import protection system based on permits, controls and multiple custom duties was eliminated. On the other side, the intervention of the public sector in the economic sphere was dramatically reduced. The following pages present a detailed description of the essential aspects of these reforms.

**Trade liberalization and foreign investment deregulation.** A key piece in the removal of protectionism was Mexico's acceptance of international agreements committed to free trade. Among the most important ones were the adherence to the General Agreement on Tariffs and Trade (GATT) in 1986 and, the signature of the North American Free Trade Agreement (NAFTA) with Canada and the USA. NAFTA began to operate on January 1<sup>st</sup> 1994, with the purpose to virtually eliminate all tariff and non-tariff barriers to intra-regional trade and investment in less than fifteen years. Since then, Mexico has signed other trade agreements with, among others, Bolivia, Chile, Colombia, Venezuela and the European Union. In addition, it is important to stress the adscription of Mexico to the OECD and the World Trade Organization.

It's worth pointing out that long before signing NAFTA, Mexico had already begun to dismantle in a unilateral way its trade protection system. Since the mid-1980s, gradually at first but gained momentum soon after, Mexico eliminated the requirement of previous permits for imports, and cut down the number and dispersion of tariffs, and canceled the scheme of official import prices that was applied on certain goods.. In fact, towards the end of 1988 –years before NAFTA- Mexico was already one of the mid-sized economies most open to foreign competition (Ten Kate y De Mateo, 1989). Just before the beginning of NAFTA, only 20% of imports were subject to previous permit requirements, the highest import tariff was 25% and the average one was 11,5% (Tornel and Esquivel, 1997).

After NAFTA, only few areas, considered as non strategic ones – like corn, cars, and the transport equipment – kept some trade protection. On the other hand, the Trade Agreement includes in its additional elements, the commitment to liberalize FDI and to incorporate certain environmental and labor criteria in trade provisions. For Mexico, NAFTA had three objectives. The first one was to reduce the inflationary pressures through greater foreign competition. The second one consisted of inserting the economy into a trajectory of high long-term growth driven by exports, mainly to the US. The third one was to guarantee, through an institutional agreement with Canada and the US, the irreversibility of the liberal macroeconomic reforms put in place since the mid 1980s

The liberalization of foreign investment moved forward in a slower, but still steady, way, than trade opening. Through a series of modifications to the law of foreign investment (in place since 1973), the barriers and controls over the participation of foreign capital in most productive activities in Mexico were removed. One important move in this direction was the *Law to Promote Mexican Investment and to Regulate Foreign Investment* of 1989. This law, much more in line with the opening of the economy, removed the maximum legal limits to the presence of foreign capital in most productive activities.

In December 1993, a New Law of Foreign Investment was enacted in accordance with NAFTA. It allowed major participation of foreign investment in numerous activities (their aggregate output was equivalent to 81% of total GDP). Among the areas liberalized were cable TV, maritime services and ground transportation of passengers. Restrictions in the secondary petrochemical industry, the autopart industry and the assembly of buses and trucks were removed. Except for basic petrochemical, (whose coverage was substantially reduced) and the production of armament and explosives, the manufacturing industry was fully opened to foreign investment, even allowing for majority control. The last significant step in opening up, adopted during 1994 crisis, was the rescue of the commercial banking system by allowing entry of foreign investment without any caps.

**Reduction of the public sector's intervention in the economy.** The cancellation of trade protection and the liberalization of foreign direct investment resulted in a sharp decrease in the range of controls and forms of public sector intervention in the economy. This effort was accompanied by a process of privatization of public entities and the elimination of industrial policy. On the first point, the privatization sought to give greater scope for action to the private sector while reducing the fiscal deficit since, with few exceptions, public enterprises generated losses (Ros, 1991).

The sale of public companies underwent two phases. The first, in the mid-1980s, focused on selling around 200 middle-sized or small-sized companies, which, in general, do not have privileged positions in their markets. The second, between 1989 and 1996, included the sale of large firms with strong market power. In total, it involved

the transfer to the private sector of more than 1,000 of the 1,155 public enterprises that existed in 1982. Since then, there have been a few more privatizations, of rail companies, port administration and other services. Reopening the discussion on energy reform in 2008 may alter this picture, but there is still a strong restriction on private sector participation in basic petrochemicals, while the secondary petrochemical industry allows up to 100% of private investment, local or foreign.

The second way to limit the state's intervention in the economy was by dismantling traditional industrial policies. Thus, the scheme of subsidies and promotion to specific sectors was replaced by one based on, so-called, horizontal policies. These, instead of being tailored to specific and selected branches of productive activity, are applied to all sectors, though perhaps focusing on small and medium sized firms. This new policy aims at strengthening competitiveness but with no subsidies or trade protection. It focuses on facilitating administrative procedures and strengthening the general framework of respect for property rights. Thus, the new policy eliminated all forms of direct selective intervention, subsidies, permits and licenses, as well as any performance requirements on say exports or the ability to generate foreign exchange. Indeed, in accordance with the stipulations of the GATT / WTO, most trade subsidies or tax incentives disappeared. Only some tax return facilities on temporary imports for re-export purposes were kept in place. This policy has remained virtually unchanged, since the 1990s up until today.

### **III. The results of the liberal reforms**

**Inflation and public finance.** The economic reforms put in place in Mexico to change its pattern of development have been an absolute success in reducing the fiscal deficit and in cutting back inflation. Indeed, by slashing public spending -particularly in infrastructure investment- rather than by rising tax revenues, the government has practically eliminated the fiscal deficit. In this process, it shrunk the public sector's external debt. In fact, by the end of 2008, total outstanding external debt was 56 billion dollars, 40% lower than ten years before. As a proportion of GDP it amounted to 6.1%, fifteen points below its 1998 ratio.

Fiscal correction was so firm that, excluding contingent liabilities associated with pensions of the social security system, the public deficit has remained below 2% of GDP for a number of years and recently it has systematically recorded a surplus. In addition, in March 30<sup>th</sup>, 2006 Congress passed the Law for Fiscal Responsibility. This law establishes the obligation to avoid running a deficit in public finances. In 2008 the Law was modified to allow the exclusion of investment spending from the fiscal balance calculations. The new law imposes a significant restriction to a countercyclical policy by the public sector, the law allows, in exceptional macroeconomic conditions, a margin to the fiscal restriction up to a deficit equivalent to 1% of GDP.

This process, however, did not correct two main flaws of Mexico's fiscal structure. The first is the low tax burden. Indeed, total tax revenues are equivalent to less than 14% of GDP. In fact, Mexico is perhaps the country in the OCDE with the lowest tax burden and, perhaps more worrying its tax burden is lower than that of other medium sized economies in Latin America. The second one is the fiscal revenues' excessive dependence on oil. Actually, oil income represents close to 40% of total tax revenue. These massive resources, however, are subject to the effect of the fluctuations of the international oil market. Additionally, they may suffer a significant reduction in the long term, given the loss of oil reserves. Both elements -the low tax burden and its dependence on oil income- limit the capacity of the government to execute a significant anti-cyclical fiscal policy or for that matter to push a strong drive for development.

As for annual inflation, after reaching a three-digit level in the mid 80s, it has since then shown a downward trend and since 2000, it remains below 10%. A key element to achieve such result has been the monetary that -until recently- allowed a persistent appreciation of the real exchange rate of the peso against the dollar

**Export-led growth.** The neo-liberal reforms helped to generate an export boom, particularly of manufactures, and a sharp increase in foreign direct investment. NAFTA played an important role behind this boom. Indeed, since the treaty was signed in 1993 until 2006 –the most recent year for which information is available- manufacturing exports grew on average at more than 10% per year. Though lower than China's, it was still one of the highest in the world. In fact, during this period, exports doubled as a

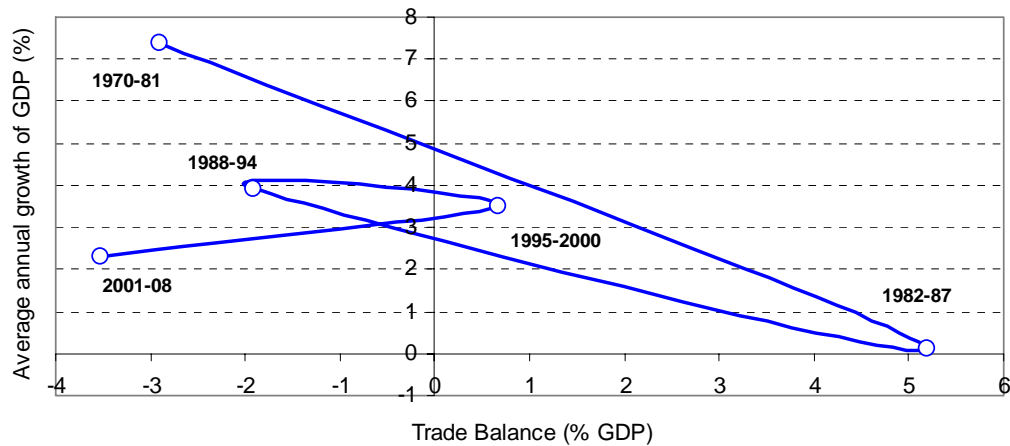
share of GDP, reaching 35%. If you add imports, international trade rose to an average, of 60% of GDP, that is, more than double its level of ten years before.

However, such export expansion was concentrated in a few industries, mainly autoparts, engines, cars, computers and miscellaneous electronic equipment. This export dynamism generated a trade surplus with the US, but has been accompanied by a significant trade deficit with the rest of the world. In other words, the export boom has been accompanied by an even more remarkable expansion of imports. Such increased import penetration has been a major obstacle for Mexico's exports to pull the rest of the domestic economy into a path of high and sustained growth.

One reason behind the import surge was, undoubtedly, the trade liberalization reform ending decades of protectionism and giving easy and legal access to products manufactured abroad. Another factor behind it was the persistent tendency to appreciate the real exchange rate. In addition, part of the import boom reflects the break-up of linkages between domestic suppliers and producers, as the former were displaced by cheaper imports.

**The limitations of the neo-liberal model.** Mexico's attempt to adopt an *export-led growth* strategy has simply failed. One way of illustrating this is presented in Figure 1 that relates Mexico's foreign trade and economic growth performance in the last 40 years. During 1970-81, real GDP grew at an average rate of 7%, and registered a trade deficit of 2% of GDP. The next period there shown, 1982-87, corresponds to the years of the international debt crisis, and was marked by economic stagnation and a huge trade surplus (8% of GDP). The following years, 1988-94 when the first batch of liberal reforms (pre-NAFTA) were put in place, showed an economy that grew at an average annual rate of 3.5%, half of its rate of expansion in the 1970s, and generating a small trade deficit.

Figure 1 Trade balance and economic growth, 1970–2008



Source: Own elaborations based on data from INEGI and Banco de Mexico

Mexico’s economic expansion and trade performance, during the first six years of NAFTA (1995-2000) , was affected by the balance of payments crisis of 1995 when GDP fell 6.4%, Currently, in 2001-08 and almost 20 years after Mexico’s economic reforms were initiated, the economy shows an average trade deficit similar to that of the 1970s, but growing on average at 2.2%; per annum, a rate much lower than the one achieved in the 1970s. That is, with a similar inflow of foreign exchange the Mexican economy grows now at a pace significantly lower than its historical average, . Most important, if oil exports are excluded, Mexico’s trade deficit would be four times higher. It must be emphasized that such decline in Mexico’s growth potential has occurred despite having had a favorable external economic environment. Indeed from 2000 to 2007 Mexico benefited from the strong expansion of the world economy, specially the US, an easy and cheap access to capital markets and an improvement in its terms of trade.

Such slow growth is worrying because it implies that the Mexican economy is increasingly unable to generate sufficient jobs to be able to absorb the labor force expansion. According to different estimates, Mexico needs to create between 800.000 and one million jobs per year, a goal that has not been met. This is most worrying given the pressing need to create many more jobs in order to help reduce poverty in a more significant and persistent way. Poverty today affects more than 40% of the Mexican population and in its extreme form it affects a little more than 10% of the population..

Another major limitation of the Mexican economy has been the weak response of fixed investment. In fact, gross fixed investment reached its peak – as a proportion of the GDP- during the oil boom, but it collapsed during the years of the international debt crisis in the 1980s. After the crash of 1986, its recovery was slow and today investment amount to approximately 20% of GDP; lower than in other mid-sized economies and below the 25% threshold identified by the United Nations Conference of Trade and Development (UNCTAD) as the minimum investment ratio needed to attain an annual rates of economic growth of 5% or more.

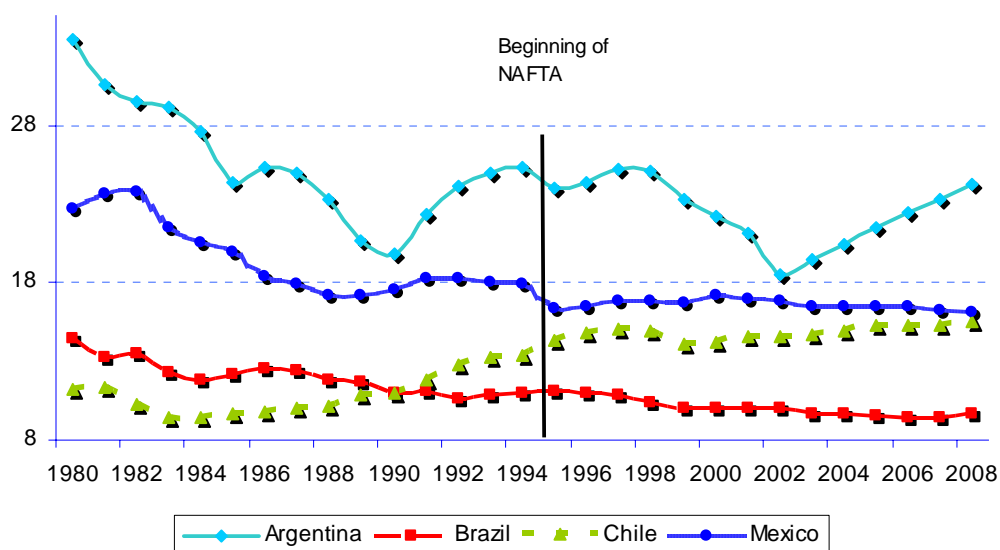
The bleak response of investment to the macroeconomic reforms is explained by several reasons. The first one, but not necessarily the most significant one, is the shortage of credit that most local companies in Mexico suffered after the collapse of the banking system in the mid-1990s. Today, the credit availability for productive activities –except for commerce and housing- is at very low levels as a proportion of GDP. The practical dismantling of development banks that took place with the reforms aggravated this situation.

Another factor behind the lack of a dynamic response of fixed capital formation was the contraction of public investment that was implemented as part of the macroeconomic reforms. This reduction of public investment had an adverse impact on infrastructure, and thus on overall competitiveness; though it did help to size down the fiscal deficit. Similarly, the phase out of industrial policies and of special programs/ incentives led to a decline in private investment in manufacturing activities. These elements, combined with the increased uncertainty inherent to any major change, in the pattern of development, discouraged “animal spirits” and thus tended to reduce fixed capital formation .Finally, the persistent real exchange rate appreciation also had a negative impact on manufacturing investment, relative to non-tradable activities.

Without a sustained and strong investment process, economic growth will be low. Investment brings about an expansion and a modernization of machinery, equipment and infrastructure. Without it domestic producers lose competitiveness in the world markets as well as in the local ones. Given the slow growth of the Mexican economy –despite its impressive export boom- the gap between its GDP per capita and

that of the USA has been widening. As shown in Figure 2 there is simply no sign of catching up. Mexico's economic recovery achieved since 1987 somewhat narrowed this gap. But this progress was reverted in 1995, when Mexico suffered a major financial crisis. Since then, the gap has remained at levels close to 16%; a percentage similar to the one of the 1950s! An important consequence of this income differential is, of course, the increase of Mexican migration to the USA. Indeed, in the last ten to fifteen years, on average between 400.000 and 500.000 Mexicans migrate to the US. If not for such migration, the conditions of the domestic labor market with wide spread informality and scant social protection would be much worse.

Figure 2 Mexico and other Latin American countries: real GDP per capita relative to USA, 1980-2008, (GDP per capita of USA = 100, constant dollars of 2000)



Source: Own elaboration, calculations based on data from The World Bank (2008) and author's estimates for 2008.

#### IV. The effects of the international crisis on the Mexican economy

The previous section examined the main characteristics of the Mexican economy's pattern of development and of international insertion brought about by the macroeconomic reforms. It identified its strengths and weaknesses, stressing its failure to achieve a strong and persistent economic expansion led by non-oil exports, and in the context of a reduced role of the State in the economy. This section identifies the main

channels of transmission of the effects of the international crisis on the Mexican economy. As will be seen, so far the world crisis' impact on the Mexican economy is felt not so much through its banking system but through the balance of payments and demand for exports. In fact due to its shallowness and far from adequate development, Mexico's domestic banking and financial sector has been so far highly insulated from the toxic-asset driven tsunami that has shaken the world since 2008. Such characteristics of Mexico's financial/real economy has marked the policy responses so far put in place by the government in response to the adverse external shocks caused by the world crisis. In particular, the responses have not focused by any means on regulatory aspects of the financial sector, but much more on fiscal and monetary actions that may help to stimulate domestic activity, to stabilize the foreign exchange markets and avoid a spurt of inflation. We also analyze to how extent these external effects –and the influence of the corresponding policy responses- may exacerbate key restrictions of the Mexican economy's structure and that undermine its growth potential in their impact of the crisis.

A first effect that the international crisis is having on the Mexican economy is caused by the reduction of external financing. In fact, the acute credit contraction experienced in the US and in other industrialized economies severely and drastically rations Mexico's access to the world capital markets. To a great extent independently of their overall macroeconomic health, all developing economies are confronting severe reductions in the inflow of private capital. Moreover, financial costs are also increasing reflecting the rising risk spread. This credit crunch hits the public as well as, and perhaps even more, the private sector. In Mexico, this rationing is especially significant for big companies which -in the new growth model- intensely participate in global markets but supported by external funds. Thus a number of big conglomerates in Mexico already face major problems to meet their debt obligations. Actually, their repayment needs are creating periodic, significant pressures on Mexico's foreign exchange market. In this regard, it should be noted that around 55% of Mexico's total external debt accrues to the private sector (Banco de Mexico, 2009).

Another element, linked to the previous one, is that since more than a decade ago a major share of Mexico's commercial banking system is composed of subsidiary branches – by the way extremely profitable- of major foreign banks. The problem is that some of these foreign banks, for example Citigroup, are going through critical

situations bordering bankruptcy in their home countries, and have had to be rescued by the US government. Others like HSBC, Santander –though not in such critical condition- are also having trouble in their balance sheets and are opting to somewhat restrict their credit operations in markets/activities considered to be more risk prone, like for example small and medium manufacturing firms in developing countries. What will be the strategy that the headquarters of these banks imposed on their subsidiaries to face the financial crisis? To what extent the financial intermediation operations of the subsidiaries in Mexico will be pressured to cut their operations in order to transfer more and more funds abroad? The answers to these questions are not clear yet. But, it does seem that foreign subsidiaries are rationing more their lending operations. In March 2009, there was a huge debate –with legal implications- regarding whether Citigroup should be forced to sell Banamex, its subsidiary in Mexico, given that Mexico’s banking law forbids the operation of banks that are partially or totally owned by foreign governments. The official ruling of the General Attorney has so far been to continue to allow the presence of Banamex in Mexico’s banking system even though the US government is now an important share holder of Citigroup.

The gloomy outlook on global capital –and for that matter real- markets and the mounting risk premiums curtail Mexico’s access to foreign funds from other sources distinct than the international financial organizations. To the extent that this situation continues or worsens, it may lead to the postponement or cancellation of investment projects. And, moreover it may lead to major instability in the foreign exchange market provoking uncertainty and volatility in the nominal exchange rate of the peso against the dollar. To avoid this situation, and after the Central Bank’s reserves had declined by more than 20 billion dollars since the beginning of the crisis, Mexico has now guaranteed immediate access to a special credit facility of 30 billion dollars from the Federal Reserve of the US government as well as to another non-conditioned credit line of 47 billion dollars from the IMF. With these additional resources, Mexico’s foreign reserves have practically doubled to reach US \$157 billion dollars at the beginning of April 2009.

The financial crisis is also acting against foreign direct investment and the net short-term capital inflow to Mexico. Regarding the increased uncertainty, the collapse of world economic activity -and in particular of US demand for Mexico’s exports- and

the financial crunch certainly discourage investment in new projects. Neither TNCs' greenfield investments nor mergers/acquisitions have shown any dynamism in Mexico in 2008 and 2009, as in general companies are financially constrained and expect no significant profits from expanding or modernizing their plants and equipment in the country in the current world context. In fact, in 2008, foreign direct investment to Mexico fell 30% on a yearly basis, and a significant decline is also forecasted for 2009. In turn, short-term capital flows suffer sharp fluctuations in response to speculative pressures against the peso and to the search for "safe assets" (flight to quality). In this regard, and to a certain extent a bit paradoxical, Mexican residents are perceiving US Treasury bonds increasingly attractive as safe assets; a perception that is self-fulfilled as speculative pressures tend to force a depreciation of the nominal exchange rate and thus increase the gain in Mexican pesos. In addition, the difficulties to have access to foreign finance has forced some domestic investors to shift back to Mexico part of the funds deposited abroad in order to meet credit or other obligations.

In any case, the fall of exports –due to the reduction in the volume of non-oil exports and the decline in the international price of Mexico's oil mix-, the collapse of FDI and the volatility of short term capital act are major determinants of the economic recession (circa -3% of GDP) and cut-back of employment that Mexico will suffer in 2009. Such contraction is expected notwithstanding the application –as seen further below in this article- of certain countercyclical fiscal and monetary measures by the Mexican government. As mentioned before, the Mexican is perhaps the most adversely affected economy in the region by the US recession as it weakens the demand for Mexican oil and on-oil exports. The industries that are initially more vulnerable are those most oriented to exports, like manufacturing and tourism. Indeed they are already facing severe difficulties. Recent data –February 2009- shows that both sectors are registering significant contractions in their output: at an annualized rate 56% in cars exports and of 10% in tourism. There is consensus in forecasting that their performance will most likely not improve in the rest of the year 2009. Moreover, their deterioration could be more severe if protectionist measures are implemented in the US. In addition, the restructuring of the US auto industry –including the bankruptcy of some major firms- will have an immediate impact in Mexico as car assemblers may close (temporarily or definitively) some of their plants abroad. Such closures, plus the

reduction of exports, are cutting down the demand for the autoparts industry in Mexico, an industry in which *maquiladora plants* prevail with an intensive use of labor.

Parallel to the decline of exports there is also a reduction of imports caused by on the one hand by the contraction of Mexico's real disposable income and on the other hand by the increase in their relative prices brought about by the depreciation of the exchange rate (40% against the US dollar in the last three months). The EIU forecasts indicate that the combined result of the decline in exports and imports will translate in 2009 into a higher trade deficit as a proportion of GDP practically twice as large as the 2% seen in 2008. This increased deficit is, in our view, cause of concern given that it occurs in a context of a substantial fall of real GDP, when previous similar experiences have systematically provoked a reduction in such deficit.

Another element linked to the external crisis and weakening Mexico's disposable income is the reduction of family remittances as a consequence on the one hand of the slash of employment and wages of migrant workers in the US and on the other hand of the fewer number of migrants leaving the country. Such cut back in remittances may create serious economic problems in some towns and communities in Mexico, traditionally heavily dependent on such sources of revenue and with not many options of finding/developing alternative income generating sources of significance in their communities. In 2008, the flow of family remittances to Mexico declined 3.6% compared to 2007, and another reduction is expected for 2009.

A third effect of the crisis involves the multiplier effects that impact the real income of groups initially not-directly affected by the external shock. That is, the first round of contraction of exports and of family remittances generates successive rounds of contraction in other sectors' income and employment that produce for the –now weakened- internal market. The magnitude of the aggregate and final impact on employment of such successive rounds may be equal or even higher than the first round of externally driven effects. An additional and major issue to consider in this process is the impact on tax revenues. As economic activity and trade falls, firms' revenues and profits also fall and formal jobs are eliminated thus reducing taxable income and ultimately fiscal revenues. In fact, the most recent figures -for the last quarter of 2008- show a fall in tax revenues as had not been seen in years for a comparable period.

In the previous pages we identified the major channels through which the international crisis is affecting Mexico. We should emphasize that *pari passu* with the slowdown and contraction of economic activity there is a deterioration of the business' climate, increased uncertainty and, thus, of domestic and foreign investors prospects. This vicious circle of diminished performance and expectations of the Mexican economy has to be short-circuited through public policy. To do so, the government authorities must monitor the above-identified channels of transmission of the effects of the international crisis on the Mexican economy, paying special attention to their impact on the diverse regions and social groups. As argued above, the combined contraction of a collapse of external demand and financial flows with a significant reduction of internal demand may have extremely worrying economic and social impacts on Mexico's various vulnerable groups/communities. These may include, incidentally, numerous members of the middle class, whose employments and revenues were closely tied to the global circuits of trade and finance. Most important, if these social and economic effects are not promptly and significantly –if not totally- alleviated, there is a risk of triggering social instability, particularly in the regions most affected.

It should be obvious that several of the effects of the external crisis will or may increase the structural weaknesses of the Mexican economy in its quest for development, also pointed out in the first part of the paper. Indeed, the external crisis aggravates the balance-of-payments constraint; that is, it tends to stress the insufficiency of the external sector as the engine of growth. Likewise, the crisis painfully evidences the urgent need of a fiscal reform that sets the ground to effectively implement compensatory or countercyclical policies to stimulate the economy. Such policies, even if they are now explicitly in the agenda of the Mexican government's response to the crisis, are constrained by the comparatively low tax revenues and their fragility due to their crucial dependence on oil export revenues. In addition, the previously mentioned federal law for responsible public finances that legally impedes a significant expansion of the fiscal deficit will be ruled out by the politically urgent need to increase public expenditure in major employment-generating activities to prevent a deeper economic and social deterioration. Similarly, the crisis makes it evident key weakness of Mexico's banking system illustrated, most importantly, by the lack of banking finance for productive activities; pointedly of small and medium sized enterprises.

Moreover, some strengths of the Mexican economy are also highlighted in the current juncture. The facts of having left behind the era of massive fiscal deficits of past times, as well as the excessive external indebtedness and persistently high inflation are motives of pride as they extend the room of maneuver for economic policy. They open the possibility to use public spending to deal with the crisis without necessarily generating acute and persistent fiscal imbalances or inflationary pressures. Thus they create possibilities to implement countercyclical policies, adopting a pragmatic attitude in the management of public finances away from the dogma of the permanent zero-deficit as stated in the fiscal responsibility law. Finally, the floating exchange rate regime, along with selective interventions in the foreign exchange market by the Bank of Mexico, have allowed a rapid modification of the exchange rate of the peso vis a vis the US dollar and thus of the relative prices of tradable and non-tradable goods. It has also allowed a prompt response to curb speculative runs. All these reduce the impact of the external shock on the level of domestic economic activity. This is a major difference compared with past situations where a virtually fixed exchange rate led to exacerbate the employment and output impact of external shocks and, ultimately, detonated a balance of payments crisis.

## **V. Mexico's policy measures to respond to the effects of the world crisis**

Initially, the reactions of the Mexican government to the outbreak of the financial crisis in the US tended to minimize the importance of their potential impact on the domestic economy. Such reaction was based on the belief that in the, say, last six years the evolution Mexican economy -as well as that of other semi-industrialized Latin American economies- had de-coupled from that of its northern neighbor. It was thus held that the fiscal and foreign reserves' strength of the Mexican economy -with its so called sound macroeconomic fundamentals- "shielded" it from any significantly adverse shock in the US economy. However, as the external crisis deepened, the official position of the Mexican government changed. Indeed from the, nearly arrogant, dismissal of the issue due to "decoupling", it shifted to expressions of progressively weakening confidence on the robustness of the Mexican economy as an invincible shield against external shocks, to one of moderate and the severe concern. And finally to the recognition that, notwithstanding its macroeconomic fundamentals and

countercyclical policies, Mexico was going to suffer a significant recession with a decline of close to 3% in 2009, with a significant impact on jobs and on the income of its population. This increasing awareness process has gradually led the Mexican government to implement economic policy measures targeted at reducing the adverse effects of the international crisis. But, instead of presenting a comprehensive economic stabilization strategy from the very beginning, the government has announced at different moments the launch of different economic programs and initiatives to address the situation.

The first response was the creation of the National Infrastructure Fund, announced in February 2008, to revitalize the domestic market by expanding the infrastructure in a period of five years. Among the latest major initiatives announced stands out the Program to Promote Growth and Employment (PICE), launched in October 2008, It includes actions in various areas to expand and reorient public expenditure, particularly in investment in infrastructure; the construction of an oil-refinery; additional financial support to small and medium sized enterprises; and the simplification of foreign trade administrative procedures and the establishment of foreign companies in the country.

In January 2009, the National Agreement to protect Families' Economy and Employment was released. Its is composed of a series of concerted actions between the Federal Government, state governors, the Legislative Power and several organizations from the social sector, the business and the workers. Such actions cover the expansion of government funds and support for a temporary employment program, the freezing of petrol prices in the country for the rest of the year, and the reduction in the price of utilities (electricity and LP Gas), plus more direct funding for the development banks (NAFINSA and BANCOMEXT). Recently, on February 10<sup>th</sup>, President Calderon sent two legislative initiatives to the Congress in order to amend the *Law of the Mexican Institute for Social Security (IMSS*, in accordance to its initials in Spanish) and the *National Institute of the Housing Development (INFONAVIT* by its initials in Spanish), to protect the income of employees that lose their formal jobs, -in particular providing earlier access to their long-term savings' account at INFONAVIT (initially destined for housing purposes). A few weeks later the Congress put forward a series of proposals to tackle the crisis, that have yet to be discussed in the legislative period. Among them, it

includes a proposal to extend the mandate of Banco de Mexico (the Central Bank) to explicitly consider low inflation and sustainable economic growth as its key objectives; or more specifically, to keep Mexico's economic activity as close as possible to its potential path of long-term growth. Much of these proposals, unless supported by additional fiscal resources and political will, will end up being simply ignored or ineffective.

The above mentioned programs are so far not fully articulated in a comprehensive national strategy -for that matter, neither are those of the US authorities. Whether in Mexico they will soon be -as has been announced- is uncertain. Moreover, some of their actions have yet to be implemented. For example, months have passed since the first announcement of the imminent construction of the oil refinery. However, to date it is not even clear where it will be constructed, not to mention when! Most likely, as the external crisis unfolds and its effects are more clearly felt in the Mexican economy, the Federal government -and state and local authorities- will announce or launch additional countercyclical initiatives. In accordance to statements of the Secretary of the Treasury: "*counter-cyclical measures for 2009, included in the PICE and the Agreement...imply a [additional] fiscal incentive of 1.8% of GDP*" (Carstens, 2009). Alternative estimates suggest that the special fiscal package proposed by the government amounts to around 2% of GDP (*The Economist*, February 2009). In addition Banco de Mexico has somewhat lowered interest rates. These reductions, however, are perhaps not sufficient given i) the long time response of its multiplier effect on investment and ii) the wide spread that exists between lending and borrowing rates, and the extremely high level of the former ones in real terms (due to the oligopolistic structure of Mexico's banking system).

The above mentioned figures of fiscal response, although lower than that of the response programs of the governments of Brazil and China, do reveal an intention to put in place -we believe just moderate- counter-cyclical policies. In fact, the Secretary of the Treasury recently stated that the priority in the conduct of the economic policy should be the boost to employment. (Carstens, 2009). We will have to wait to see in practice, how many additional economic and social programs are announced in response to the crisis, and, more precisely, to how many of them are actually and effectively implemented in a timely manner. And at the same time gauge the changes in the external

economic environment, mainly the US economy and the financial markets. Their combined impact will determine what extent will be the impact of the financial crisis on employment and economic activity in Mexico.

In any case, in this effort, we have seen that the the government is already getting additional external resources, through access to IMF and the Fed's extraordinary credit lines. In our view there is ample margin to use part of these funds -and thus increase external debt- for a more aggressive countercyclical fiscal or monetary policy. A key challenge is to extend the coverage of the social protection to urban centers –for example through the conditional cash transfer program *Oportunidades*- that will suffer acutely the adverse effects of the crisis. The economic decline of certain groups of the middle classes will merit special attention too.

Typically, prosperity phases developing mineral-rich economies – among them the Mexican one- have been triggered by the sudden abundance of external resources, the dramatic improvements in their terms of trade, or the massive inflow of foreign capital. These times of prosperity create resources and the opportunity to channel them to investment and social protection to alleviate structural constraints that impede long-term human development. However, the effective and efficient use of such extraordinary resources has been more the exception than the rule. Thus frequently, such extraordinary flows may end up just wasted, without having made any significant contribution to strengthen its international competitiveness or to expand its capacity of growth in the long term. In contrast, crisis times – triggered by adverse and severe external shocks- dramatically reveal the structural constraints of the Latin American economies, including the external restriction to growth, the weakness and vulnerability of their fiscal organization (on the tax/revenue, expenditure and accountability aspects), the shallowness of their financial intermediation system, as well as their crucial inability to generate enough quality jobs to reduce poverty and inequality.

Considering this background, is essential that the measures taken by the Mexican government to address the crisis are accompanied, sooner rather than later, by initiatives that help to lay the foundation of its long-term economic and social development, to alleviate poverty and improve its inequality. These initiatives should include the launch of a new fiscal pact to strengthen the public sector's revenues, reduce

its excessive dependence on oil and, at the same time, put in place a much needed program of public investment to modernize and expand infrastructure and improve education. Augmenting fiscal revenues in various points as a % of GDP is an essential requisite to insert the Mexican economy into a path of sustained development and growth. Without such resources, the scope of macroeconomic countercyclical policies to annul the adverse effects of major external shocks will be rather limited, without recurring to external finance. In times as those of today, when such access is problematic, the challenge may be daunting. Mexico in this sense bets that the credit lines agreed with the IMF and the Fed may prove to be sufficient for 2009-10. It is to be hoped that such assessment is correct.

The stress that the labor market in Mexico is experiencing, with its massive informal, unprotected sector will aggravate this year. Surely the issue of labor reform will be soon brought to the front line of debate as an additional element of an anti-crisis program. In this regard, a useful approach would, in our view, integrate some recommendations in favor of giving more flexibility to the workforce to reduce the entrepreneurs' costs of hiring labor if and only if at the same universal social protection mechanisms are put in place to cover the population independently of their insertion in the labor market. It should be evident that Mexico cannot and should not base its international competitiveness on cheap labor. The removal of the fundamental workers' rights is against this objective. The important point of the debate will be to identify how to mix in a proper manner the changes in labor regulations to lower the costs of recruitment of the workforce, increase incentive for their in-job training, and combined with a strengthening of the social protection and security system to universalize them and eliminate social/ individual costs of job losses or transitions.

It is an unanswered question whether the attention to the urgent problems caused in Mexico by the world financial crisis is or not combined with effective measures to remove key obstacles, key constraints binding Mexico's long term growth. In this endeavor, it seems advisable to change the "fiscal responsibility" law, and, instead, adopt a strategy similar to Chile, whose fiscal balance is set according to its long-term economic growth. Likewise, it is necessary to implement a strategy to improve financial intermediation for small and medium firms and productive investment. One element that would help in this regard is strengthening development banks. This point is already

included in some of the anti-crisis programs proposed by the Mexican government. Another might be implementing a policy, on the part of the banking supervisory authorities, for banks operating in the country to take into account in their strategy of allocation of credit, much more compliance with the key objectives of national development. Such strategic reorientation of financial intermediation of private banks to the major objectives of national development can be achieved thru various instruments of public policy among them the powers of persuasion and regulation that the monetary/ fiscal authorities have over the key financial agents/groups. Another element that would help is the revival of a new set of policies to promote innovation and industrial promotion. These changes involve a transformation of the role of the State and the market in the Mexican economy, essentially a change in the scope and forms of regulation and public sector intervention in the allocation of resources towards a long-term growth of the Mexican economy. Whether such transformation may or may not be put in place in the face of the current crisis is still a question whose “answer is blowing in the wind.

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