Mexico Resilient in 2011 Amid Global Uncertainty and Sluggish U.S. Growth

By Jesus Cañas

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Mexico navigated a new wave of international financial volatility during the second half of 2011, growing 3.9 percent for the year—slower than the 5.5 percent pace in 2010 but ahead of the 2.2 percent annual average of 2001–11.

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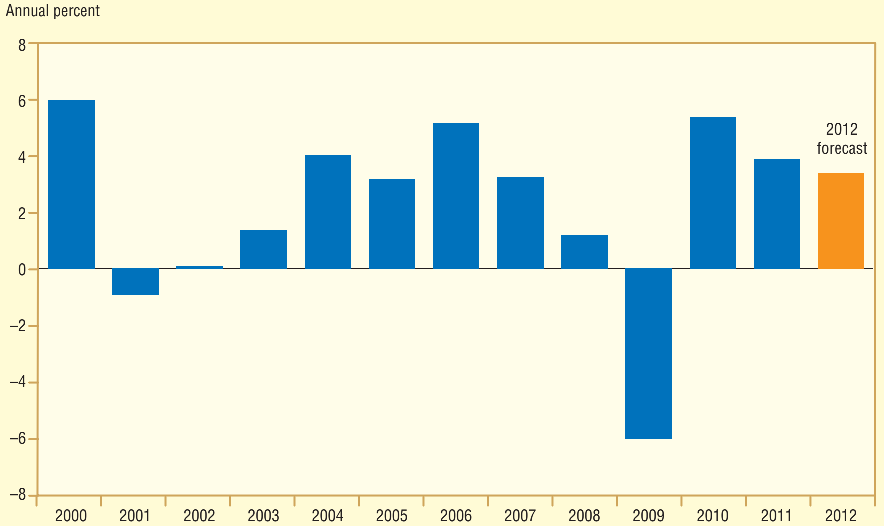
Weaker manufacturing output growth and a 2.3 percent decline in oil activity slowed expansion in 2011. Agricultural output also stagnated in 2011, while construction improved after experiencing no growth in 2010. The 2012 consensus forecast for a 3.4 percent rate of expansion is modest compared with the prior two years' data (*Chart 1*).

In contrast to the U.S. upturn, robust job growth has characterized Mexico's recovery since the 2009 recession. Formal-sector employment—defined as workers covered by Mexico's social security system—grew 4.1 percent in 2011, with more than 600,000 jobs created. Manufacturing accounted for 27 percent of the new jobs, while trade was responsible for 25 percent and business services for 18 percent.

Domestic demand also bounced back. Buoyed by relatively healthy banks, rising household credit and greater employment, retail sales increased 3.1 percent in 2011—sales volumes surpassed the precrisis peak year of 2008. Household credit rose 19 percent in 2011 after posting no growth in real terms in 2010.

Chart 1
Mexico's Gross Domestic Product Grows 3.9 Percent in 2011



SOURCES: Instituto Nacional de Estadística y Geografía; Banco de México Survey of Private Analysts (forecasts).

Manufacturing and Trade Growth

Mexico's rebound began in summer 2009, led by manufactured goods exports to the U.S., where the recession had ended that June.[1] This reliance on manufacturing and exports leaves Mexico vulnerable to global events. Notably, Japan's earthquake, tsunami and nuclear incidents in March 2011 arrested Mexican manufacturing growth. After annual average expansion of 6.8 percent during first quarter 2011, Mexico manufacturing decelerated in the second quarter to 5 percent as supply-chain disruptions took hold. Anecdotal evidence indicates that Mexican plants scaled back production, reflecting increased lead times for machine tools, wire harnesses and other Asia-made inputs.

In the second half of 2011, when uncertainty abated, supply chains were reestablished and orders returned to Mexican facilities. Manufacturing production rose 4.8 percent year over year, with manufacturing exports gaining 10 percent. Total exports grew 14 percent in 2011.

Mexico continues to be one of the best manufacturing platforms to meet U.S.

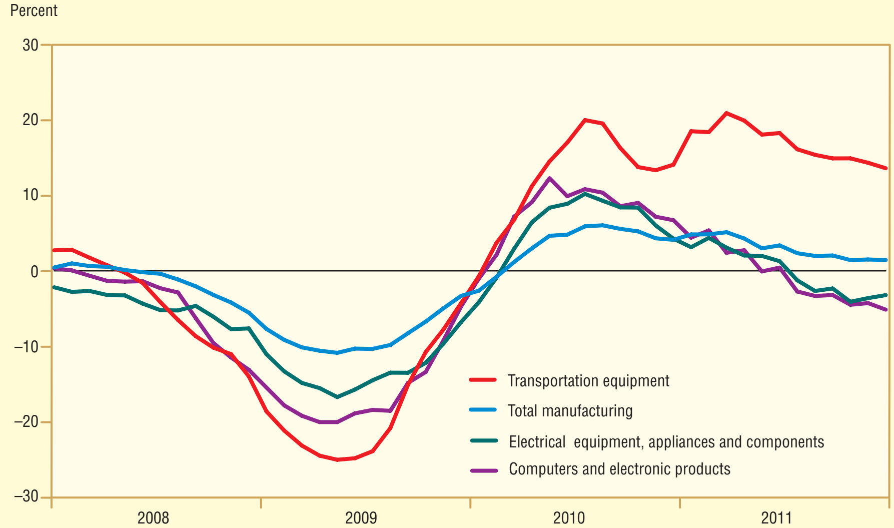
demand. Proximity, quick turnarounds on manufacturing design changes and a skilled and experienced manufacturing labor force are important advantages (*see the box "Intra-Industry Trade: The U.S.–Mexico Connection in Import, Export Data" on page 13*).[2]

Transportation equipment manufacturing, which includes motor vehicle production, has been crucial to Mexico's recent economic recovery and impressive job growth. Transportation equipment employment growth averaged 17.1 percent in 2011, up from 12.6 percent in 2010 (*Chart 2*). The sector represents 22 percent of Mexico's manufacturing production and 17 percent of its manufacturing employment. Thus, the uncertain performance of the U.S. economy and the question of whether the recent run-up in U.S. automotive demand can be sustained remain significant downside risks for Mexico.

Chart 2

Transportation Equipment Drives Mexico Job Growth

(Manufacturing employment, 12-month change)



SOURCE: Haver Analytics, with data from Instituto Nacional de Estadística y Geografía.

Withstanding Global Shocks

Mexico also navigated financial disruption in Europe in the latter half of the year. When global markets go awry, investors withdraw capital from emerging markets in search of safer outlets. The premium Mexico must pay on its debt relative to comparable U.S. instruments jumped more than 55 percent from July to September and reached levels not seen since July 2009 (*Chart 3*).

Foreign portfolio investment in Mexico, which tripled in 2010, grew just 4.1 percent in 2011. The diminished rate of investment flows helps explain a 15 percent peso depreciation against the dollar from July to December. In turn, the weaker peso fueled increased imported goods prices, pushing up inflation by year-end.

Mexico's solid macroeconomic fundamentals and the credibility policymakers earned over the past decade helped persuade the international community that the inflation pickup and peso depreciation were transitory.[3] After spiking during the third quarter, the global Emerging Markets Bond Index spread declined significantly. And, in a vote of confidence by international investors, Mexico in January issued $2 billion in 10-year bonds yielding 3.7 percent, the lowest rate the country has obtained for the maturity. Additionally, financial markets stabilized, with inflation slowing from November's levels.

Chart 3

Country Premium Stabilizes After European Union Scare

(Emerging Markets Bond Index and Mexico sovereign-debt spread over U.S. rates)

NOTE: The Emerging Markets Bond Index tracks total returns for international government bonds issued by emerging-market countries.
SOURCES: J.P. Morgan; Bloomberg.

More Remains to Be Done

Although Mexico has navigated recent global volatility and maintained monetary policy discipline and macroeconomic stability, economic development still languishes. Fiscal dependence on oil revenue, an inability to modernize oil production, rampant drug-related violence and lack of educational reform constrain growth.

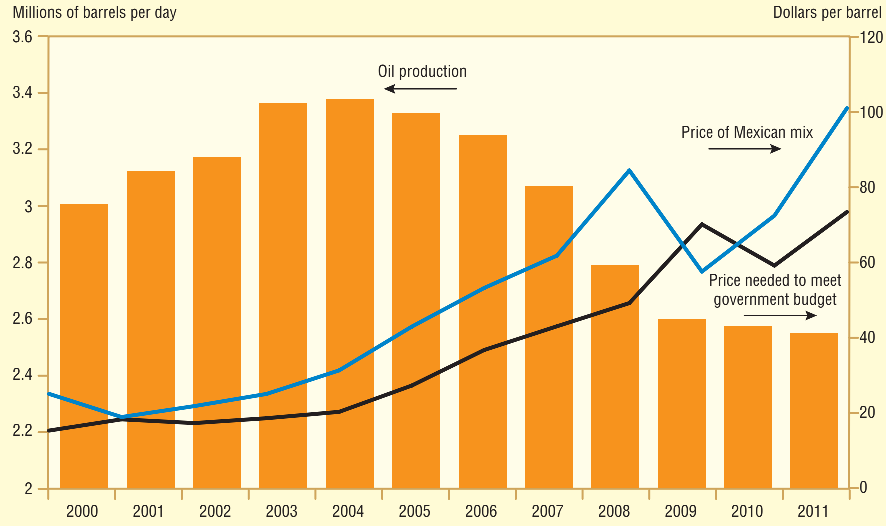
Mexican crude oil production reached a new low last September, 2.48 million barrels per day. In total, output declined about 25 percent from the 2004 peak. Poorly maintained and aging equipment, along with a failure to implement new technologies, raises the cost of oil production and feeds inefficiency. Moreover, the federal government takes about 50 percent of revenues from national oil company Pemex, draining it of capital-improvement and exploration funding.

Mexico is highly dependent on oil, which accounts for about 34 percent of government revenue. Higher prices and forward

The Mexican government can't always depend upon good luck and the globally determined price of oil to fund itself.

Chart 4

Higher Oil Prices Offsetting Tumbling Production in Mexico



SOURCES: Petroleos Mexicanos (PEMEX); Secretaría de Hacienda y Crédito Público.

thinking by some government officials have offset falling production (*Chart 4*). Mexico hedged all of its 2009 oil exports at $70 a barrel, resulting in a more than $5 billion gain when the price of the Mexican mix collapsed to $57 a barrel. In January, Mexico hedged an additional 211 million barrels—about 580,000 barrels a day—at $85 a barrel in anticipation of an economic downturn in 2012. However, the Mexican government can't always depend upon good luck and the globally determined price of oil to fund itself. Mexico's ability to collect taxes is abysmal, with tax revenues, excluding oil, totaling just 14 percent of gross domestic product.

Mexico has experienced an unprecedented rise in crime and violence over the past five years, with more than 47,000 people killed. The economic impact of this is significant, yet hard to quantify. Official statistics show that total foreign direct investment (including new investment, reinvested earnings and parent company accounts) fell 6.6 percent in 2011 after growing 24 percent in 2010. Especially telling is that new investment, excluding reinvested earnings and parent company accounts, declined 42 percent in 2011. While foreign direct investment flows may provide clues about the impact of increasing violence on investment decisions, it is unclear how much of the decline can be attributed to skittish investors or the global slowdown during the second half of 2011.

In the past two decades, Mexico has made great educational strides. Public assistance programs such as Oportunidades link payments to children's school attendance and have effectively improved performance in rural areas.[4] Nevertheless, Mexico still trails in terms of educational attainment. Upper-secondary education, such as preparatoria, vocational high schools and technical programs, provides the basis for advanced learning and training opportunities and prepares some students for entry into the labor market. Still, Mexico ranks second-to-last among Organization for Economic Cooperation and Development countries in upper-secondary education achievement, with a graduation rate of only 45 percent.[5] Additionally, a significant proportion of young Mexicans remain inactive. About 25 percent of 15- to 29-year-olds are neither in school nor in the labor force. Significant and rising numbers of young people lacking both education and jobs could potentially contribute to greater social instability.[6]

Exceeding the Consensus Forecast

While private analysts predict slower growth in 2012, there is potential for the Mexican economy to exceed the consensus forecast. First, the Blue Chip consensus forecast predicts faster U.S. economic growth this year. Second and more important to Mexico, analysts also anticipate strong industrial production growth and a pickup in auto and light-truck sales.

However, risks to the Mexican economy remain significant. An unanticipated acceleration of a global slowdown that impacts external demand will affect the U.S. first and Mexico later, just as it did in 2008 and 2009.[7]

In addition, oil prices may drop significantly. Mexico's July 2012 presidential election also poses a challenge because growing political uncertainty could slow growth if consumers, businesses or foreign investors hold back on spending as they await the outcome of balloting. Even though Mexico has yet to address many areas of vulnerability, solid macroeconomic fundamentals have allowed the country to successfully navigate another wave of global volatility, proving to the international community that it is well-fortified to withstand further external shocks.

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Notes

[1] See "Mexico Rides Global Recovery but Still Faces Hurdles," by Jesus Cañas, Roberto Coronado and Robert W. Gilmer, *Southwest Economy*, Third Quarter 2011.

[2] See "Maquiladora Recovery: Lessons for the Future," by Jesus Cañas, Roberto Coronado and Robert W. Gilmer, *Southwest Economy*, March/April 2007.

[3] See "The Conquest of Mexican Inflation," by Mark Wynne and Edward C. Skelton, Federal Reserve Bank of Dallas Globalization and Monetary Policy Institute 2011 Annual Report.

[4] Oportunidades is a government social-assistance program designed to target poverty by providing cash payments to families in exchange for regular school attendance, health clinic visits and nutritional support.

[5] See "Education at a Glance 2011," Organization for Economic Cooperation and Development, September 2011.

[6] See "The United States Should Borrow Mexico's Fiscal Discipline Manual (With Reference to Cantinflas, Guillermo Ortiz's Quip, Inflation Targeting and Many Comparative Metrics)," speech by Richard Fisher, Federal Reserve Bank of Dallas president, before the Bolsa Mexicana de Valores, Mexico City, Feb. 29, 2012.

[7] For details, see "Mexico's Año Horrible: Global Crisis Stings Economy," by Edward C. Skelton and Erwan Quintin, Federal Reserve Bank of Dallas *Southwest Economy*, Third Quarter 2009.

Intra-Industry Trade: The U.S.–Mexico Connection in Import, Export Data

Mexican trade—exports plus imports—reached $700.5 billion in 2011, with the U.S. representing about 65 percent of the total. Asia followed with 17 percent, Europe with 9 percent and Latin America with 6 percent.

The volume and composition of Mexican trade have significantly changed over the past 30 years. In 1980, trade as a percentage of gross domestic product was only 17.5 percent; today it represents 62 percent of economic output. Also in 1980, oil accounted for 58 percent of Mexico's exports; today, it's responsible for only 16 percent.[1] Thanks to the nation's evolution into a world-class manufacturer, some 80 percent of Mexico's exports are now manufactured goods.

A significant portion of U.S.–Mexico trade is intra-industry—trade that occurs within industries using similar factors of production on both sides of the border, spreading production across countries as each specializes in what it does best.[2] The table below lists the 10 largest U.S. imports from Mexico and the 10 largest U.S. exports to Mexico in 2011. Seven items appear on both lists, indicating extensive intra-industry trade.

As a result of highly integrated production processes between the two countries, Mexico's industrial production is highly correlated with that of the U.S. For example, transportation equipment was the top U.S. import from Mexico and the second-largest export to Mexico. Computer and electronic products was the second-largest U.S. import from Mexico and the top U.S. export to Mexico. This two-way exchange implies each country is sending the other the same product, just at different stages of production. In the transportation equipment category, U.S. factories send engines and navigation software across the border, while Mexico returns assembled cars back to the U.S.

The automotive industry plays an important and expanding role in U.S.–Mexico trade. Mexico saw its share of road vehicle production for the U.S. jump from 13.5 percent in 2005 to 22.3 percent in 2010. Outsourcing to Mexico increased during the recession, when U.S. automakers struggled to stay afloat.

Notes

[1] See "The United States Should Borrow Mexico's Fiscal Discipline Manual (With Reference to Cantinflas, Guillermo Ortiz's Quip, Inflation Targeting and Many Comparative Metrics)," remarks by Richard Fisher, Federal Reserve Bank of Dallas president, before the Bolsa Mexicana de Valores, Mexico City, Feb. 29, 2012.

[2] See "U.S.–Mexico Trade: Are We Still Connected?" by Jesus Cañas and Roberto Coronado, Federal Reserve Bank of Dallas *Business Frontier*, no. 3, 2004.

U.S. Trade with Mexico, 2011

Rank	NAICS code*	Imports from Mexico	Billions of U.S. dollars	Rank	NAICS code*	Exports to Mexico	Billions of U.S. dollars
1	336	Transportation equipment	60.9	1	334	Computer and electronic products	36.2
2	334	Computer and electronic products	52.3	2	336	Transportation equipment	23.6
3	211	Oil and gas	40.2	3	325	Chemicals	21.4
4	335	Electrical equipment, appliances and components	18.1	4	324	Petroleum and coal products	20.1
5	331	Primary metal manufacturing	14.4	5	333	Machinery except electrical	15.7
6	333	Machinery except electrical	14.0	6	331	Primary metal manufacturing	9.8
7	111	Agricultural products	7.4	7	335	Electrical equipment, appliances and components	9.2
8	339	Miscellaneous manufactured commodities	6.7	8	311	Food and kindred products	9.1
9	332	Fabricated metal products	6.0	9	111	Agricultural products	8.4
10	311	Food and kindred products	5.8	10	326	Plastics and rubber products	7.2
		Subtotal	225.8			Subtotal	160.7
		Other	36.9			Other	36.8
		Total	262.7			Total	197.5

*North American Industry Classification System.
SOURCE: U.S. International Trade Commission.