5-5-2004

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Category/Department: Mexico
Published: 2004-05-05

President Vicente Fox's administration is pleased with signs of economic recovery in the early part of the year, but some private-sector economists say this optimism appears to hide some major structural economic deficiencies. The Fox government is basing its optimism on the global economic activity indicator (indicador global de la actividad economica, IGAE) released in mid-April.

The report showed a growth of 3% in the IGAE during February compared to the same month in 2003. The IGAE takes into account the same measures as GDP, but excludes forestry and fisheries. "Mexico is now resuming the course of growth," Fox told business leaders in Monterrey. "In the first quarter of this year...we are going to attain growth of more than 3%.'

Fox's projections are in line with estimates presented by Finance Secretary Francisco Gil Diaz at a meeting of business leaders. Gil forecast Mexico's GDP growth for the first quarter of the year at 3% or higher. The Banco de Mexico (central bank) has shown similar optimism, projecting GDP growth at least at 3% to 3.5% for 2004.

With the right conditions, said central bank chief governor Guillermo Ortiz Martinez, Mexico's economy could grow even higher than 3.5%. The Banco de Mexico is scheduled to release its official growth estimate for the January-March quarter sometime in mid-May.

If the economy performs as expected, the growth rate for this year would be close to three times higher than the 1.2% increase in GDP in 2003. Still, the Banco de Mexico's positive outlook for this year is tempered by a note of caution about the recovery experienced in January-March. "[This recovery] is purely cyclical in nature," said deputy governor Everardo Elizondo. "We must work to make it permanent."

The bank also notes that a growth rate of 3% to 3.5%, while much higher than a year ago, is still below Mexico's potential of 4.5% to 5%. "This limits the capacity of the country to create jobs and address the problem of extended poverty," said the bank, which noted that Mexico will fail to reach its capacity for a fourth consecutive year.

Mexico continues to rely heavily on US

The recent economic recovery, however, is tied primarily to a small recovery in the US economy. This was reflected in an increase in the value of goods exported to the US market, during January-March. The US acquires 90% of all goods sold by Mexico to overseas buyers, and this was a major reason for the increase of 8.8% in exports during February. A primary reason for the growth in exports to the US are high oil prices and the increased demand for capital goods such as...
construction equipment. The reliance on the US market for exports has raised some red flags in the private sector.

In a report released in late April, the Instituto Mexicano de Ejecutivos de Finanzas (IMEF), said many Mexican exporters are beginning to lose ground in the US market to competitors from other countries such as China.

There are other factors beyond the control of Mexico that threaten to halt the country's fragile economic growth, such as the prospect of high US interest rates, which will increase borrowing costs and further slow the influx of foreign investment. Direct foreign investment last year declined to US$10.73 billion, its lowest level since 1996, the Banco de Mexico said in a recent report. Still, administration officials are confident that Mexico will be able to weather the effects of US rate hike. "The majority of our public debt in domestic and international markets is for extended maturation periods, which for us represents an important protection," said Gil Diaz.

Ironically, the high interest rates also weaken the peso, which promotes exports and reduces imports. As of May 5, the Mexican currency had weakened to 11.39 pesos per US$1.00 and is forecast to reach US$11.50 pesos per US$1.00 by the end of the year. Some analysts are concerned that this level of weakness in the peso may not be sufficient for Mexico to turn back the growing competition from China in the US market. "About 47% of Mexico's exports compete directly with China in the US market," said Ricardo Amorim, chief Latin America economist for IDEAGlobal in New York.

Even with the peso's recent weakness, the Mexican currency has remained fairly stable against the US dollar for almost two decades. Mexico's annual inflation rate amounted to only 3.98% in 2003, the lowest level since the Banco de Mexico started to keep records in 1969. Trends in the US markets are not the only factor affecting interest rates in Mexico, as the Banco de Mexico has propped up short-term interest rates twice since late February to curb inflation.

The government has targeted annual inflation at 3% in 2004, but the target now seems out of reach with accumulated inflation for January-March reported at 1.57%. The central bank has predicted that annual inflation for 2004 could surpass the target by about one percentage point, bringing it close to 2003 levels.

Higher-than-expected consumer prices in the first quarter of the year resulted from high fuel and food prices. The price of food was influenced by a shortage of meat due to health-related restrictions on imports of beef and poultry (see SourceMex, 2004-01-21 and 2004-02-18).

Some analysts say the higher inflation rate could actually represent a small dose of good news for the Mexican economy because it would reflect a spike in consumer demand. "If Mexico begins to grow and the foreign exchange rate depreciates, this would be reflected in higher inflation," said an analysis from BBVA Bancomer.

**Foreign investment slumps**

The reduced influx of new foreign investment remains a concern for many analysts, who view an influx of foreign capital as a solution to reverse the contraction of the Mexican manufacturing sector.
The loss of manufacturing base limits the capacity of Mexico to respond to an increase in demand in
the US, some analysts say. A recent report published by the Confederacion de Camaras Industriales
(CONCAMIN) finds 3,600 companies shut down operations during 2003, resulting in the loss of
thousands of jobs.

Companies involved in manufacture of textiles and clothing; food, beverages, and tobacco, and
metalworking took the biggest hit. The downturn in the manufacturing sector is not limited to last
year, but has been a problem during the Fox government’s entire term in office. According to analyst
Arturo Vieyra of the Grupo Financiero Banamex, the manufacturing sector contracted by about 6.4%
during the three-year period between 2001 and 2003. Of special concern is the loss of maquiladora
operations to China and other countries (see SourceMex, 2002-07-17 and 2003-09-17).

Lack of energy, tax reforms hamper sustained recovery Many business leaders put equal blame on
the Fox government and on the Congress for Mexico’s fragile economy. They say the two branches
of government have been unable to come up with meaningful tax, labor, regulatory, and energy
reforms, which are continuing to inhibit the flow of foreign capital into the country. "As long as
we do not have dramatic legislative changes, especially regarding energy, we will continue to see
a reduction in the level of foreign investment that comes into our country," said Antonio del Valle
Ruiz, president of the Consejo Mexicano de Hombres de Negocios (CMHN).

The Centro de Estudios Economicos del Sector Privado (CEESP) concurs with the CMHN, but
cautions that legislative changes in and of themselves do not guarantee the level of steady growth
needed by the Mexican economy. "To enter into a path of sustained growth it is imperative to
implement the institutional changes that will guarantee not only a more competitive climate but also
appropriate political and juridical systems," said the CEESP.

Mexico loses manufacturing, moves toward service economy

Some analysts say one byproduct of the loss in manufacturing is to move Mexico toward a service-
oriented economy. A report produced jointly by CEESP and Consultores Internacionales (CI) said at
least 60,000 of the 80,000 new jobs created in the formal economy in the first quarter of the year were
in the service, retail or construction sectors.

The spike in construction, however, has not been as much the result of increased commercial
development but more a function of government expenditures on low-income housing and
infrastructure projects. Even so, IMEF points out that the increased construction activity has been a
"positive boost" for the domestic economy. The increase in construction activity may be slowed by
the rising price of steel. High steel prices have led to an increase of 5% to 7% in construction costs
thus far this year, said Hector Aguirre Moncada, president of the Camara Nacional de la Industria
de Desarrollo y Promocion de Vivienda (CANADEVI).

The increased jobs in the retail sector are the result of improved sales at department stores and
grocery chains, which grew by 13.4% in the first part of the year. Retailers anticipate total sales this
year to grow by an average of 26.4%. "This is an impressive growth rate," said Economy Secretary
Fernando Canales Clariond. Even with the small recovery in construction and retail jobs, the rate of
unemployment remains very high relative to a year ago.
The March jobless rate was reported at 3.86% of the economically active population (EAP), more than a full percentage point above the rate of 2.82% in the same month in 2003. The high rate of unemployment has reduced the labor force in the formal economy by 3.7% so far this year and by 13% since President Fox took office at the end of 2000, said a report published by the government's statistics agency (Instituto Nacional de Estadisticas, Geografia e Informatica, INEGI).

Still, the Fox administration insists that the job picture is improving. Labor Secretary Carlos Abascal Carranza notes that 129,000 jobs were created in the formal economy in January-March, a trend which he expects to continue throughout the year. "We have reasonable expectations that this year will be better than last year both in terms of economic growth and job creation," said Abascal.

A worrisome trend, say business leaders, is the explosive growth of the informal economy. CONCAMIN estimates that 20,000 informal positions replaced the 3,600 formal small businesses that went bankrupt in 2003. The majority of those new informal businesses are involved in sales of prepared foods such as tacos, torta sandwiches, and quesadillas. "They don't have a formal building nor do they pay taxes," said CONCAMIN. INEGI estimates that 11 million Mexicans now make a living from the informal economy, but they also account for 8% of the country's GDP.

**Mexico expands trade with Japan, European Union**

A recent analysis by the World Trade Organization (WTO) suggests that Mexico could benefit from a global economic recovery anticipated for this year. According to the WTO report, a world economic rebound would increase the level of global trade by about 7.5%, providing direct benefits to countries like Mexico. The report cautions that the recovery trend may be stifled by the US budget deficit, high oil prices, and reduced consumer demand in Europe. The Fox administration is taking some steps to boost trade opportunities with the European Union (EU) and Japan.

In late April, the Fox government signed a protocol to extend its trade accord with the EU to the 10 countries that are joining the European trade bloc this year. The Mexico-EU trade agreement, completed in 1999, covers 90% of all goods and services traded between the two markets (see SourceMex, 1999-12-01). The agreement went into effect at the start of 2001. The new members of the EU are Cyprus, Slovenia, Slovakia, Estonia, Hungary, Latvia, Lithuania, Malta, Poland and the Czech Republic. With the additions, the EU will become a market of 400 million consumers, EU officials estimate. "We have a trade partner in the EU," said Porfirio Munoz Ledo, Mexico's ambassador to Brussels. "If this partner expands, this is good for us".

Mexico and Japan also are expected to formally enter into a free-trade agreement sometime in August. The two sides completed negotiations on the accord in March (see SourceMex, 2004-03-17). By signing the accord in August, the agreement would be ready in time for the Mexican Senate to ratify in the Fall, said the Secretaria de Economia (SE). "Our intention is for the agreement to take effect at the start of 2005," said Angel Villalobos, deputy economy secretary for international negotiations. Mutsuyoshi Nishimura, Japan's ambassador to Mexico City, said the agreement would be highly beneficial to Mexico from an economic standpoint. "The agreement could boost Mexico's GDP by at least 1%," said Nishimura. (Sources: The Financial Times-London, 02/23/04; Bloomberg news service, 04/06/04; Reuters, 04/04/04, 04/06/04, 04/26/04; Notimex, 04/05/04, 04/28/04; Spanish news service EFE, 04/29/04; Milenio Diario, 01/23/04, 04/07/04, 04/29/04, 04/30/04; The Herald-Mexico
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