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The recent volatility in the global financial markets has raised some concerns about Mexico's economic situation during the transition from President Vicente Fox's government to the administration of the new president, who will take office the beginning of December. Mexico will hold its presidential election on July 2, with center-left candidate Andres Manuel Lopez Obrador of the Partido de la Revolucion Democratica (PRD) in a tight race with pro-business conservative Felipe Calderon Hinojosa of the center-right Partido Accion Nacional (PAN).

Roberto Madrazo of the former governing Partido Revolucionario Institucional (PRI) is running a distant third in the public-opinion polls.

Calderon has promised to follow the same economic policies as Fox. Lopez Obrador has attempted to walk a fine line, promising to boost government spending to help the poorest sectors of society while trying not to appear anti-business. "With Calderon, the markets know what to expect, but with Lopez Obrador, things are more uncertain," said Tonatiuh Rodriguez, who manages US$3 billion of debt for pension fund Afore XXI.

The election, which some analysts say could be the most disputed race in recent history, has created a good deal of uncertainty in Mexico's financial markets. The election period has combined with a surge in global interest rates to raise concerns about possible economic volatility. "We're postponing certain investment decisions because we know the electoral process will increase volatility," said Rodriguez.

US interest rates drive volatility

Beyond the uncertainty about the elections, the rise in global interest rates has been linked directly to an increase in the US inflation rate, which carries with it the strong probability that the US Federal Reserve will boost interest rates. This has created volatility in global financial markets for most of May, including a major downturn in almost every stock exchange on May 22. On that day, the Indice de Precios y Cotizaciones (IPC) at the Bolsa Mexicana de Valores (BMV) registered a decline of more than 4%, its worst drop in four years. "The increase in financial volatility is primarily a response to expectations of reduced liquidity at the global level," said the economic analysis unit at Grupo Banamex.

In Mexico, the principal concern about the increase in US interest rates is that the differential with Mexican rates would widen significantly, which could have a direct impact on the peso. "Obviously, [such an increase in US rates] is going to have a minor impact on the exchange rate as long as there is not a similar increase in domestic interest rates," said Joost Draisma, a World Bank economist who covers Mexico.

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The crash of the Mexican peso in 1994, an election year, closely followed a sharp increase in US interest rates. "While no one is predicting a 1994-style crash, several observers have drawn parallels between the two interest-rate moves and noted that the recent shift has had a negative impact on Mexico's leading financial indicators," said the London-based Financial Times newspaper.

Guillermo Ortiz Martinez, chief governor of the Banco de Mexico (central bank), said the situation is much different this year than it was in the months leading to the 1994 peso devaluation. For example, he noted that the increase in US rates in 1994 was drastic and unexpected, rising from 3% to 6%.

The US Federal Reserve is now making sure that the markets are aware of possible changes in US interest rates and any increases are not likely to be as high as those in 1994. Finance Secretary Francisco Gil Diaz said the negative reaction of the global finance community to the possible hike in US interest rates might be temporary. "We have reason to think that this is a passing episode," Gil told reporters covering the meeting of finance ministers from member countries of the Organization for Economic Cooperation and Development (OECD) in Paris on May 23.

Gil emphasized that the decline experienced by the Mexican stock exchange was part of a global pattern and not a sign of any weakness in Mexico's financial structures. "This is not a phenomenon specific to Mexico but part of a general trend," said the finance secretary. "We have the ability to withstand this situation."

Peso devaluation a concern, but unlikely

The Fox administration and the Banco de Mexico have taken steps to ensure that economic conditions in Mexico are stable enough to provide a smooth transition to the next administration. They note that a strong GDP growth this year, new mechanisms to manage interest rates, and an adequate supply of foreign reserves will prevent an economic meltdown similar to the one that hit Mexico during the transition from the administration of former President Carlos Salinas de Gortari (1988-1994) to that of former President Ernesto Zedillo (1994-2000).

The devaluation of the Mexican peso at the end of 1994 followed massive capital flight from the country, as investors rushed to cash in their short-term bonds because of concerns of political instability. The Jan. 1, 1994, uprising of the Ejercito Zapatista de Liberacion Nacional (EZLN) was said to have been one of the major catalysts for the capital flight, which caused the level of Mexico's foreign reserves to fall sharply. As a result, the Mexican economy went into a tailspin in 1995, forcing the government to borrow emergency funds from the US government and multilateral institutions (see SourceMex, 1995-01-04).

Ortiz noted that Mexico, like most emerging markets, is better prepared this year to withstand any situation similar to that of 1994. "They have accumulated reserves [and] pegged exchange rates have been largely abandoned so central banks do not have to commit to certain exchange rates," he said. There was little threat of crisis during the last presidential transition, as the Zedillo administration took several key steps to manage foreign reserves and boost confidence in the Mexican economy. One of those steps was to obtain standby loans from multilateral institutions for use in case the foreign-exchange supply dipped to dangerous levels (see SourceMex, 1999-06-30).

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As it turned out, the government did not have to use that pool of money. International reserves during the Fox government have risen to a record US$72.8 billion, which is more than sufficient to cover the country's entire external public debt. The high foreign-exchange levels are tied in part to the increase in global oil prices, which has resulted in a surge in Mexico's oil-export revenues. Mexican banks, which are much more stable than they were in the 1990s, also report a high level of reserves on hand. "The banking sector has a very good level of capitalization," said Hector Rangel Domene, president of the administrative council at Grupo Financiero BBVA Bancomer.

The Fox government has used some of the oil-revenue windfall on domestic programs, channeling some of those funds to state governments. Government expenditures, however, have been relatively modest, with Fox continuing to place a high priority on controlling inflation to promote economic stability. The Fox government has brought annual inflation down to about 3.2%, compared with almost 9% during the last year of the Zedillo presidency (see SourceMex, 2001-01-17). Fox's three predecessors, Zedillo, Salinas de Gortari, and Miguel de la Madrid (1982-1988), followed this same formula.

The emphasis on controlling inflation by limiting government spending has put Fox at odds with legislators from the PRI, PRD, and other smaller opposition parties. The difference in philosophies has been manifested in the campaigns, with Calderon pledging to follow Fox's policies while Lopez Obrador and Madrazo are seeking to use more of Mexico's oil profits to benefit the population at large.

Strong GDP growth could provide stability

Administration officials and some private economists are quick to point out that strong GDP growth has contributed to confidence in the Mexican economy. In early May, the government's statistics office reported a GDP growth of 5.5% for the January-March quarter, in large measure the result of a surge in manufacturing activity and increased expenditures on construction. "[This GDP growth rate] significantly reduces the probability of a scenario of economic crisis at the end of the electoral process," the Centro de Estudios Economicos del Sector Privado (CEESP) said in a recent report.

The growth in manufacturing was especially evident in the automobile sector, which reported an increase of 54% in production. "The Mexican economy was already showing signs of healthy growth beginning in the second half of 2005," said deputy finance secretary Alejandro Warner. Because of the strong first-quarter results, the Mexican government is now projecting a growth rate of about 4.5% for 2006, compared with only about 3% in 2005 (see SourceMex, 2005-12-14), said presidential spokesperson Ruben Aguilar. The new forecast is almost a full percentage point above the forecast of 3.6% growth used to develop the 2006 budget (see SourceMex, 2006-01-04).

As recently as February, the administration was still projecting this year's GDP growth at the 3.6% level. Private economists and multilateral organizations agree that Mexico's economy may perform better than originally anticipated, but they say the government may be a bit optimistic. An average of the responses from private economists who participated in a survey by the Banco de Mexico in late April put GDP growth at 3.92%. The OECD this month forecast Mexico's GDP growth rate for 2006 at 4.1%, while projections from the International Monetary Fund (IMF) placed growth at 3.5%. Furthermore, the IMF noted that Mexico's GDP projection would fall below the expected 4.3% growth rate for Latin America as a whole.

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Similar comments came from the Centro de Analisis y Proyecciones Economicas para Mexico (CAPEM), which has projected a growth rate averaging 2.2% for Fox's entire six-year term in office. "Latin America would have grown twice as much during this period," said CAPEM analyst Antonio Castro Quiroz.

The expected increase in US interest rates in the near term could eventually put a damper on GDP growth in Mexico. The higher US rates would reduce US consumer spending, which would affect Mexican exports to the US market. The US accounts for about 90% of Mexico's exports. "The stagnation in the US real estate sector in recent months could be a sign that the US will experience an economic slowdown," said columnist Rodolfo Navarrete in the Mexico City daily business newspaper El Financiero. "This will no doubt affect US demand for our products and hurt our manufacturing sector."

Some analysts say, however, that any major impact from higher US rates will not be manifested immediately. "You will start to see worry about growth in the United States in 2007, but for this year everything looks good," said Alvaro Rodriguez, chief financial officer at Mexico's glass-manufacturing company Grupo Vitro. Critics say Fox has failed to create jobs Some critics in Mexico point out that the tendency of the Fox government and its predecessors to focus primarily on low inflation and GDP statistics tends to ignore other societal factors, such as unemployment.

One of Fox's promises during his presidential campaign was to create 1 million jobs annually. The Fox administration has fallen far short of that goal, producing only about 2.8 million jobs during his first five years in office. "Fox can say we don't have inflation in Mexico," said political analyst Lorenzo Meyer of the Colegio de Mexico. "Of course, we don't have inflation, but we don't have jobs either. Low inflation is something that is really positive for those who have an income. But people need jobs."

The lack of employment opportunities in Mexico, said Meyer, has contributed to the massive emigration to the US. More than 2 million Mexicans have crossed into the US in search of employment since Fox took office in 2000. "Fox cannot cope with the demand for jobs in Mexico," Meyer told Copley News Service. "The economy is not working. We cannot blame the US. It's our own problem, and it's a problem that we cannot solve."

Furthermore, the jobs that have been created during the past five years pay too little to help most Mexicans make ends meet. Per capita income has risen by an annual rate of less than 1% from 2001 to 2005, said Meyer. (Sources: La Crisis, 02/06/06; The Herald-Mexico City, 02/22/06; The Financial Times-London, 05/08/06; Reforma, 04/20/06, 05/16/06; Copley News Service, 05/17/06; Los Angeles Times, Associated Press, Agencia de noticias Proceso, The New York Times, 05/18/06; Milenio Diario, 04/20/06, 05/02/06, 05/15/06, 05/18/06, 05/22/06; El Financiero, 04/20/06, 05/15/06, 05/18/06, 05/22/06; Reuters, 02/16/06, 02/17/06, 05/02/06, 05/23/06; El Economista, 02/20/06, 02/23/06, 05/10/06, 05/18/06, 05/19/06, 05/23/06; La Jornada, 03/02/06, 04/20/06, 05/18/06, 05/19/06, 05/22/06, 05/23/06; Notimex, 05/01/06, 05/18/06, 05/22/06, 05/23/06; Bloomberg news service, 05/17/06, 05/22/06, 05/23/06; La Cronica de Hoy, 05/23/06; El Universal, 02/22/06, 05/03/06, 05/18/06, 05/24/06; Excelsior, 05/03/06, 05/18/06, 05/19/06, 05/24/06)

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