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Downgrade in U.S. Debt Rating, Lower U.S. Growth Expected to Affect Mexican Economy

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There is real concern in Mexico that the recent move by a major bond-rating agency to downgrade the long-term US debt and the expected decline in the US economy could have major repercussions on Mexico's growth levels this year and next because Mexico's economy remains very closely linked to the US despite ongoing efforts to diversify its economic ties.

Standard & Poor's (S&P) on Aug. 5 downgraded long-term debt issued by the US Treasury from AAA to AA+ for at least two years, meaning that US debt can no longer be considered among the safest investments in the world. This is the first time the US debt has been downgraded in the history of the ratings. The downgrade followed the debate in the US Congress on raising the US debt ceiling. Two other rating agencies, Moody's and Fitch, had expressed the same concerns as S&P but in the end did not lower the US bond rating.

"A key concern will be whether the appetite for US debt might change among foreign investors, in particular China, the world's largest foreign holder of US Treasurys," said .

A recent report by Bank of America Merrill Lynch said foreigners owned just 1% of US Treasury bonds in 1945 compared with a record high of 46% currently.

The news that the US debt rating was lowered had immediate repercussions on the US stock market and on global financial markets, which fell significantly the day after the S&P action was announced. The Bolsa Mexicana de Valores (BMV) declined by 6% in the 10 days following the announcement. "This is not a simple cold," Finance Secretary Ernesto Cordero told reporters. "This is a serious matter that will have a moderately negative impact on Mexico's growth rate."

Cordero ruled out the possibility that Mexico would fall into a prolonged economic crisis even if the US economy goes south. But he also expressed doubts that either country would experience a recession. "Fortunately, our economic indicators are fairly robust, and we can endure," said the finance secretary. "Evidently, we still would have to face a situation where the capital markets might fluctuate in a negative manner, and our foreign exchange rate will remain volatile."

Mexican business organizations like the Cámara Nacional de la Industria de Transformación (CANACINTRA), Confederación de Cámaras Industriales (CONCAMIN), and the Centro de Estudios Económicos del Sector Privado (CEESP) agreed with Cordero that steps have been taken to protect the economy against a financial crisis, such as shoring up the level of foreign reserves. But they also raised concerns that such moves might not be sufficient to prevent any negative effects from a downturn in the US economy because the US is Mexico's principal trade partner.

CANACINTRA said the administration and Congress should ensure that the country moves toward implementing a balanced economic model in order to strengthen Mexican companies and stimulate their growth and their development. "This would prevent them from being affected by the wave of uncertainty," CANACITRA said.

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Mexican growth forecasts reduced

Still, many analysts believe the downgrade in the US long-term debt means an economic slowdown north of the border. This forecast, combined with concerns about economic problems in Europe, has prompted many private and government entities to scale down their growth forecasts for Mexico both for 2011 and for 2012.

"Our forecasts for growth had ranged between 4% and 5%, but now we are settling for a more conservative estimate of 4.3%," Cordero said in an interview with the television network Televisa.

The Banco de México also reduced its forecasts for 2011 and 2012. For this year, the central bank is projecting growth in a range between 3.8% and 4.8%, compared with a previous estimate of 4% to 5%. For next year, the projection is 3.5% to 4.5%, compared with an earlier estimate of 3.8% to 4.8%.

"There are several risks that could affect our growth forecasts," said Agustín Carstens, the chief governor at the Banco de México. "The biggest one is the possibility of a lower growth rate in the US."

Several private analysts expressed the same concern, prompting them to reduce their growth forecasts for Mexico slightly in 2011. For example, the Instituto Mexicano de Ejecutivos de Finanzas (IMEF) lowered its prediction to a 4.1% GDP growth from 4.2% a month ago. Goldman Sachs reduced its projection to 4.1% from 4.4%, and Barclays Capital left its prediction unchanged at 3.9%. Both Goldman Sachs and Barclays lowered their forecasts for 2012.

Julio A Millán, president of the Mexico City-based Consultores Internacionales, said no amount of financial protection by the Mexican government could stop the negative repercussions of a major US downturn. "We are not talking about a stone, but a boulder, falling upon the Mexican economy," said Millán, who noted that there was no way to endure a prolonged US recession considering how closely linked the two economies have become.

The International Monetary Fund (IMF), in a report issued in early August, also suggested that a prolonged slowdown in the US would represent a "heavy burden" for the Mexican economy.

European economic problems also a concern

The IMF and the Banco de México are just as worried about economic problems in Greece, Ireland, Portugal, and Spain as they are about instability in the US economy. "Even though the impact of unstable conditions in European markets appears under control, an increase in the global aversion to risk and a generalized flight to higher-quality investments could affect even solid debt instruments like those in Mexico," said the IMF report.

Carstens expressed similar concerns. "The precarious fiscal and financial situation in some European countries could affect their banking systems and result in lower growth," said the central bank's chief governor. "This would generate uncertainty among investors, resulting in a slowdown in the amount of capital that is invested in emerging economies."

The private sector is just as worried about the situation in Europe. Some analysts pointed out that the fate of the US economy is just as affected by European financial problems, and this puts emerging economies at even further risk. "Everybody is affected, but especially Mexico and Canada,

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because of their dependence on the US economic cycles," said Alfredo Coutiño, Latin America director for Moody's.

Still, Carstens emphasized that Mexico is doing everything it can to create a solid shield against global economic turmoil. "Mexico stands out because inflation has been relatively well-behaved here," Carstens said. "Lower prices for grains on international markets should help keep inflation in Mexico in check."

The IMF agreed that a solid monetary policy is the correct path for Mexico, which could lead to increased growth in 2012. "The inflationary pressures appear to be under control and are stable in the medium term, although rates are still above target," said the multilateral organization.

Negotiations on 2012 budget could be affected

Concerns about the US and European economies, along with the reduced growth forecasts, are certain to affect the 2012 budget negotiations, which President Felipe Calderón is required to submit to Congress by Sept. 8. The Congress must approve both the revenues and expenditures budgets by Nov. 15.

Some observers expect budget negotiations to be difficult, with the governing Partido Acción Nacional (PAN) expected to emphasize austerity to keep Mexico's economy stable. "The Secretaría de Hacienda y Crédito Público is preparing a responsible budget that ensures that we don't spend more than what we have," deputy finance secretary Carlos Montaño told reporters.

"It is very important to take pre-emptive measures as a method to endure contingencies," said PAN Deputy Gabriela Cuevas, a member of the budget committee (Comisión de Presupuesto y Cuenta Pública) in the lower house. "The federal government needs to get its priorities straight and bolster social programs to counter an eventual slowdown in the US economy."

But there will be pressure from the opposition Partido Revolucionario Institucional (PRI) and the Partido de la Revolución Democrática (PRD) to increase allocations to state governments and boost spending for social programs.

"These are going to be complicated negotiations," said PAN Deputy Luis Enrique Mercado, considered one of the administration's chief allies in the lower house. "This is an electoral year, and there is a desire by everyone to pull more money for their projects."

Some analysts agree that increased expenditures to states could benefit the PRI, which governs the majority of Mexico's 32 states. "This is going to be an important battle because states want to use the resources to fund their electoral machineries," said analyst Marco Cancino of the Centro de Investigación para el Desarrollo (CIDAC).

But the PRI contends that the PAN, the party in power, is just as capable of using the budget to benefit its candidates in the 2012 election. Deputy Francisco Rojas, the PRI floor leader in the lower house, said he would introduce legislation that protects against misuse of funds for electoral purposes. "I'm sure everyone agrees that we should protect the budget from electoral manipulation at all levels of government," said Rojas.

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