



Economic policy in Mexico

Damage control

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A Latin American country softens recession with counter-cyclical policies

MANUFACTURERS and banks are firing workers. The value of wages fell last year. Credit card debts are piling up. The economy began to contract in the last quarter of last year. Mexico has been here before. But there are two big differences between this recession and the three that preceded it in the past quarter of a century. This time the problem stems from economic mismanagement in the United States, not at home. And for the first time Mexico's government is in a position to lean against the economic cycle with expansionary fiscal and monetary policies.

On January 16th the Bank of Mexico, the independent central bank, cut its benchmark interest rate by half a percentage point (to 7.75%). It was the first cut since April 2006, but will not be the last. Having worried about inflation, which climbed to 6.5% last year, the bank is now more concerned about the sinking economy.

Days earlier President Felipe Calderón unveiled fiscal measures amounting to an injection of 1% of GDP, including cuts in energy prices, extra investment in roads, railways and oil wells, and measures to extend medical cover, welfare benefits or temporary jobs to the unemployed. That comes on top of an expansionary budget for this year, and a previous fiscal stimulus last October (which included extra payments to poorer Mexicans). All told, the government is injecting about three percentage points of GDP.

Officials are under no illusion that this will prevent recession. Few countries are as vulnerable as Mexico to the turmoil originating in the United States. The North American Free-Trade Agreement has tied industry in both countries closely together (see chart). Remittances from Mexicans working across the border fell sharply in November, while fewer tourists will venture south. The finance ministry talks of zero growth for 2009, but that is "optimistic", says Guillermo Ortiz, the Bank of Mexico's governor. It assumes a recovery in the United States (and Mexico) in the second half of the year.

Officials hope, however, they can at least limit the damage from the global credit crunch. This hit Mexico suddenly in September, when the peso devalued (it has lost about 25% of its value against the dollar). Several Mexican companies lost billions on derivative contracts (one of them, Comercial Mexicana, a large retailer, went bankrupt). The foreign banks that dominate Mexico's financial system stopped lending, as they shored up their balance-sheets at home.

The government stepped in, guaranteeing credit lines and offering loans to small businesses through the development bank, Nafinsa. The peso has stabilised after the central bank spent \$15 billion of its reserves; it still has \$85 billion, plus a swap line of \$30 billion from the United States Federal Reserve which it has not used. The volume of bad debts is rising, especially on credit cards. But the financial system is solid, and credit is available again—at a price. The risk premium (over the yield on United States treasury bonds) on Mexican corporate bonds has risen fivefold to

over 1,000 basis points, says Mr Ortiz.

The government's efforts are aimed at limiting the social impact of recession. The fiscal measures might save up to 150,000 jobs, says one official. Even so, with about 900,000 joining the workforce each year, unemployment is bound to rise (it climbed from 4% to 4.8% in November alone). Migration to a recession-hit United States no longer offers much of a safety valve.

In past recessions Mexico has had to cut public spending. That it is different this time is tribute to the health of public finances. Public debt is only around 30% of GDP (and a fifth of that comprises contingent liabilities that the government may never have to repay). Only \$3.2 billion of foreign public debt falls due this year—and the government has already raised \$2 billion in a bond issue last month. Skilful hedging by the finance ministry has softened the fall in the price and production of oil, which provides a third of government revenue. Mexico presold its oil output for 2009 at \$70 a barrel—almost twice the current market price.

If recession persists into 2010, the government can still stimulate the economy, albeit on a smaller scale, points out Alejandro Werner, the deputy minister of finance. When the economy was growing, the government saved a sum equivalent to 1.8% of GDP in stabilisation funds which have not yet been spent. And the devaluation of the peso means that dollar oil revenues will go further in pesos.

This greater resilience applies, too, to Mexico's manufacturing industry. Many firms went bankrupt or moved in the last recession in 2001, when they were unable to compete with China after it joined the World Trade Organisation. Those that remain are much more efficient and have cut costs "furiously" since the middle of 2007, according to Alfredo Thorne of JPMorgan, an investment bank. They will be helped by devaluation. This might normally prompt more American firms to move south of the border. They are being discouraged by a wave of violent crime.

The recession is a blow to Mr Calderón's hopes of winning a majority in a legislative election in July. It is a small consolation that the government can act to curb the damage. It would be a bigger one if it felt emboldened to undertake the structural reforms—of monopolies in energy, telecoms and television, for example—that Mexico needs to become a more dynamic and competitive economy.

