http://www.gfmag.com/archives/23-march2008/417-cover-story--mexico.html#axzz2lmQknjyz

GLOBAL FINANCE

Cover Story : Mexico

MEXICO

Mexico's recent economic progress could be derailed by turmoil in the US economy and the outcome of the US presidential election.

High aspirations: Mexico is hoping its economy can resist a US downturn.

The last time the US economy posted a slowdown, after the 2001 terrorist attacks, the Mexican economy contracted by 0.2%, nearly crushing its industrial sector. With the threat of a US recession looming large and uncertainties over what US-Mexican relations will look like once a new occupant moves into the White House next year, the outlook is beginning to look gloomy south of the border. However, Mexican government officials say the country is better prepared this time around to meet the challenge.

Mexico's finance ministry estimates assume the US economy will grow by a meager 1.8% this year, prompting officials to reduce their own 2008 GDP forecast in February to 2.8% from the 3.7% forecast the ministry included in the federal budget last September. This would be Mexico's slowest expansion in three years, after posting 3.2% GDP growth last year. Local banks had already adjusted their forecasts ahead of the government. Banamex, Citi's Mexican subsidiary, cut its 2008 growth outlook to 2.9% from a previous 3.6%, while BBVA Bancomer slashed its prediction to 2.7% from 3.4%.

With 80% of Mexican exports going to the United States and domestic capital markets moving nearly in tandem with their counterparts in New York, a US recession would have a swift impact on Mexico—and perhaps test many of the structural reforms implemented by the Felipe Calderón administration that have helped to at least partly decouple the two economies. Calderón has tried to ease Mexicans' fears about a potential US slowdown, saying, "We will seek growth opportunities from within ourselves, in our internal market, in the strong productive apparatus and in the country's competitiveness."

Calderón's reform package includes a fiscal overhaul launched last September that should boost federal revenues by 1.5% of GDP this year, as well as labor reform to introduce greater flexibility. The next hurdle is energy reform, which legislators say should be ready by April. The controversial plan would open the Pemex state-owned oil monopoly to partnerships with private investors to inject capital into a company struggling with rising debt and dwindling oil reserves. Oil accounts for 40% of federal revenues, and, with its output of 1.3 million barrels a day, Pemex is the United States' third-largest oil supplier.

The Mexican government's 2008 budget will boost investment by 45%, the biggest increase in 45 years, with most additional spending earmarked for infrastructure projects that will boost competitiveness and create jobs. The aim is to spark 5% annual GDP growth by 2012, falling short of the 6% growth that analysts say is needed to generate the 1.3 million new jobs Mexico requires each year to absorb workers entering the job market. But the Calderón administration counters that its $295 billion public-private infrastructure investment program approved last year should alone create 800,000 jobs.

According to a Merrill Lynch report, "A positive political agenda should create three positive effects in the medium-term: (1) reduce the country's growth dependence on US activity and oil prices; (2) reinforce domestic engines for growth: credit, domestic consumption and productivity gains; and (3) promote GDP per capita growth, also addressing Mexico's social agenda: improve social services and decrease poverty." Merrill Lynch expects economic growth will be supported by 22% credit growth this year, along with a 4.1% expansion in domestic consumption.

US Election Raises Tension

While Mexico is hoping to shield itself from a US recession, it may be harder for it to stay out of the US presidential election as Republican and Democratic candidates alike tackle the issues of immigration, drug trafficking and free trade. Calderón recently asked US presidential candidates to tone down the anti-immigrant and anti-Mexican rhetoric in their campaigns. But candidates may be responding to genuine concerns, as a recent Zogby poll in the US shows more than 76% of respondents said a candidate's position on immigration will be a "very important" or "somewhat important" factor in deciding whom to vote for this year. Another 36% said "job creation to stem migration" is the most important foreign policy measure the US should take toward Latin America.

The fight against drug trafficking, likely to be a key concern for the next US president, is already being tackled by the Mexican government, with the Calderón administration deploying more than 24,000 troops to regions with high drug production and trafficking activity, as well as extraditing drug lords to the US and seizing large amounts of illicit drugs. The moves have been well received in Washington, where the White House last October announced a $1.4 billion military and security package designed to help Mexico and Central America tackle drug cartels.

"Given the dimensions of the problem, cooperation with the government of the United States is indispensable," Mexico's foreign minister Patricia Espinosa told the press. The US aid package is made more politically palatable to Mexican authorities by, unlike the controversial Plan Colombia, not involving any deployment of US military personnel to Mexico.

Both governments may find themselves embroiled in a less congenial dialogue this year over the future of trade between the two nations. In January the last remaining exceptions to the North American Free Trade Agreement (Nafta) were lifted, allowing US corn, sugar, beans and milk to enter Mexico under the pact. While the measure could help lower food prices, Mexican farmers are less than thrilled and not only have unleashed street protests but have called on their government to renegotiate the treaty, which went into effect in 1994.

According to Lawrence Kogan, president and CEO of the Institute for Trade, Standards and Sustainable Development (ITSSD) in Princeton, New Jersey, the controversy may lead to "managed" trade, which he feels is a euphemism for quota-like restrictions on trade in selected agricultural products. "Mexican farmers may end up receiving the short end of the stick here," says Kogan. "We must wait and see what is ultimately agreed to and then wait to see how it is actually applied in practice."

Kogan, also a professor of International Trade Law and Policy at Seton Hall University, says the impact on Mexican exports to the US could be determined by who wins the presidency. "A Democratic Congress would likely become emboldened if a Democrat were in the White House. Assuming the Republicans fail to retake Congress, Congress would be more inclined to

impose new environmental, health and safety, and labor standards through Nafta and the WTO to raise the cost of Mexican goods and services so that they no longer could compete effectively with US products," he says.

Meanwhile, capital market investors remain cautiously bullish on Mexico. Merrill Lynch predicts a 23% total return on Mexican equities this year, below the 26% Latin American average and 28% for Brazil, but higher than Chile's 22% and Argentina's 19%—adding that the appreciation will be driven by 16% earnings growth (in US dollars) in 2008 and 11% in 2009. Citi upgraded Mexican shares to overweight, arguing that a US recession has been nearly fully priced into Mexican stocks. The sovereign also set a new fixed-income benchmark in January that extended its yield curve to 2040 and saw the order book soar to $3 billion for a $1.5 billion issue that had been upped from an initial $1 billion.

Mexico's central bank governor Guillermo Ortiz remains more cautious, saying at the World Economic Forum in Davos that Mexico has not yet felt the full impact of the global economic crisis, and there could be more pain ahead. "We're in round one or two," he said, "but this is a 15-round fight."

Antonio Guerrero
Tags: Emerging Markets