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2004: A "GROWTH PUZZLE" SOLVED

After a couple of years of modest economic performance, Mexico's GDP growth reached 4.4% in 2004. The improvement was particularly strong at the close of the year, with annualized GDP growth for the 4th quarter at 4.9%. Sources of demand were also more evenly distributed. Total merchandise exports were up 14.5% from 2003 which was matched by similar increased demand for imports (up 15.6%). Private consumption remained strong: retail sales grew 4.9% during 2004 and durable goods did particularly well, with sales of new vehicles, for example, for the first time reaching more than one million units. But the main comeback was in investment. During 2001-2003, gross fixed investment registered an average annual rate of change of –2.4%. An improvement started to take shape during the first quarter of 2004 (annual change of 4.5%) which was then further consolidated; for 2004 as a whole, gross fixed investment rose 6.1%, with both construction (5.1%) and purchases of machinery and equipment (7.1%) contributing to the result.

These results can be explained by the hypothesis developed in our previous report regarding the "growth puzzle", i.e. the fact that Mexico was lagging behind the economic recovery in the US. We argued that the productive link between the US and Mexico was still working and therefore attributed the "growth puzzle" to a sectoral pattern of recovery in US import demand that was temporarily biased against Mexico´s main export lines. In particular, this anomaly seems to have been associated with the cycle of electronic goods, an activity which accounts for 23% of total US manufactured goods purchases from Mexico.

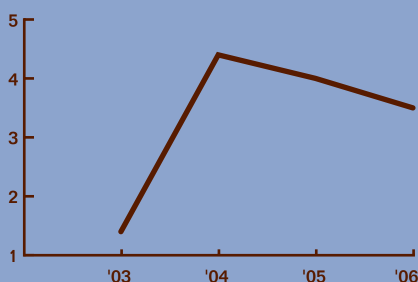
That said, more intense competition from other countries cannot be overlooked. Moreover, losses in market share have led to the expected response – gains in labour productivity. Thus, our expectations of a limited impact of the export-led recovery on job creation were fulfilled: at the end of 2004, formal employment was only 2.1% above the level of December 2003. But the impact of this weak labour market on local demand was to some extent compensated by another factor. The expansion of banking credit to consumers and mortgages amplified the initial stimulus of the export-led recovery and led to a higher contribution of local demand to overall economic growth. We underestimated this effect because it had no precedent; since the peso crisis of 1995, credit circuits had remained closed. This is the first time they interacted with recovery within the context of North American integration. Productivity gains along with weak labour-market conditions translated into lower unit labour costs and therefore, increased profitability and investment. Thus, profitability *cum* reactivation of credit circuits are behind the strong reaction of investment.

MACROECONOMIC AND FINANCIAL PERFORMANCE

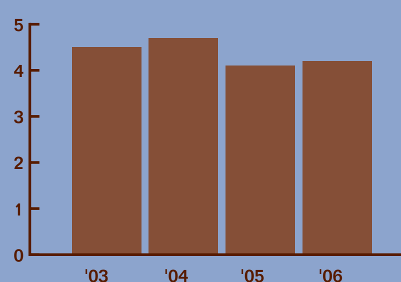
The 2004 current account deficit (CAD) stood at US$9.4 billion, or 1.4% of GDP. Three items stood out: a) high oil prices; b) tourism (a surplus of US$3.9 billion), and c) foreign remittances – mostly from Mexicans working in the US – worth US$16.6 billion. The fact that oil revenue only represented 12.5% of total export revenue should not lead to an underestimation of its importance for public finance: 33% of total government revenue came from this source and its rate of growth (14.5% in constant pesos) was far higher than the increase in non-oil public revenue (1.6%). As expenditure discipline was mantained, the public sector borrowing requirements went from 2.5% of GDP in 2003 to 1.8% in 2004. As a consequence, the debt-to-GDP ratio (39.4%) was below the original goal in the 2004 budget.

The financing of the CAD was easilly met by a capital account surplus of US$13.7 billion; in fact, FDI inflows (US$16.6 billion) more than covered the CAD. In addition, there was a renewed apetite for local currency denominated securities: the inflow of portfolio investment totalled US$7.6 billion, the largest amount since 2000. We believe this is a reflection of

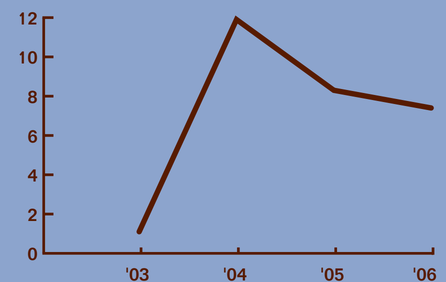
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



worlwide liquidity levels, as also suggested by the record-low level of country risk (166 basis points over US Treasuries at the close of 2004). The stronger inflow that the former implies was partially "sterilized" by a substantial reduction (US$5.9 billion) in foreign currency denominated indebtedness, which involved both the public and the private sectors.

Put together, these facts suggest that increased international liquidity during 2004 led to a portfolio recomposition which in turn could explain why the Mexican peso was one of the few currencies that did not grow stronger vis-à-vis the US dollar in 2004: fluctuations in the relative value of assets denominated in these two currencies (i.e. movements in the exchange rate) were made redundant by a stock adjustment running in the same direction (i.e. from US dollars to pesos). Such a stock adjustment could reflect the adaptation of economic agents to a growing degree of coordination — either *de facto* or *de jure* — of monetary policies in North America. As a matter of fact, Mexico's central bank already considers the Fed's decisions as an explicit factor influencing its own monetary policy decisions.

However, perfect monetary coordination requires convergence of inflation rates. This is not yet the case: inflation in Mexico during 2004 was above the upper limit of the central bank´s target (i.e. 3% plus/minus one percentage point). This was mostly explained by the performance of volatile items not included in the core CPI index, but nevertheless led to a tightening of monetary policy at the end of 2004. Thus, local interest rates are not only reflecting the gradual increases implemented in the US, but also an additional, transitory tightening in Mexico.

OUTLOOK FOR 2005

Two main forces will determine aggregate performance in the near future: the inertial effect of the 2004 recovery and the rate of expansion of the US economy. The former is expected to last a bit longer than in the past due to the reactivation of credit circuits, while the impact of the later will be below 2004 levels. Therefore, economic growth will be stronger in the first half of 2005 and then it will slow down. By then, a third force could start to exert some influence: with the 2006 presidential election approaching, political issues will become prominent in the minds of economic agents. Overall, we expect GDP growth of 4% in 2005. The contribution of the internal market to GDP growth will be slightly larger, particularly from investment. This mix of sources of growth should lead to a current-account deficit of 1.6% of GDP. This is a manageable figure, which reflects a steady improvement in Mexico´s recurrent sources of currency revenue, such as foreign remittances, the improvement in categories such as tourism and temporary conditions such as high oil prices. In this respect, public finances during 2005 should remain favourable.

Regarding financial variables, better behaviour of volatile components and a tighter stance by the central bank have led to a decline of inflation and we believe that the figure for the end of the year (3.9%) will be within the range of the central bank's target. Therefore, after high levels at the beginning of 2005, interest rates should be lower during the second half, although the beginning of the political cycle at the end of the year could somewhat limit this decline. Our forecast assumes that the 28-days Cete (treasury bill) rate will average 9.4% during the year. Therefore, our forecast also assumes that the exchange rate will close at 11.5 pesos per US$ in 2005, a figure which compares with 11.2 pesos per US$ at the end of 2004.

RISKS AND UNCERTAINTIES

Clearly, the key issue to follow is economic activity in the US and the factors that could affect it. As a major oil exporter, the direct impact of higher prices is positive for Mexico. Nevertheless, higher oil prices would also mean lower economic growth in the US and therefore, less demand for Mexico's manufactured exports. This indirect, negative impact would more than compensate for the direct, positive impact, thus leaving Mexico in a worse off situation.

Second, the international macroeconomic adjustment on Mexico has so far been limited to portfolio recomposition. Therefore, the stock recomposition toward peso-denominated assets would be validated if the peso also appreciates against the US dollar; a stronger-than-expected peso cannot be ruled out. Higher local interest rates during the beginning of 2005 have led to a strengthening of the peso vs. the US dollar and a flatter Mexican yield curve. This suggests that the temporary tightening of monetary policy has affected demand for US dollars rather than longer-term liquidity in pesos.

Last but not least, politics will become increasingly important as the 2006 presidential election approaches. Indeed, the political landscape is full of uncertainties, but so far markets have shown remarkable behaviour regarding day-to-day political issues.