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Mexico: A safe vessel or a risky wreck in turbulent waters?

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Executive Summary

A confluence of Mexico's political and economic challenges has surfaced amidst today's global economic and financial crisis. Political challenges ranging from the Mexican Government's difficulties to restrain the country's drug cartels to now a flu epidemic have had an adverse impact on Foreign Direct Investment (FDI) and tourism. Economic challenges have been recognized following April's Group of Twenty (G-20) Summit in London as Mexico became the first country to tap the IMF's precautionary Flexible Credit Line.

Mexico: A safe vessel or a risky wreck in turbulent waters? (May 2009) examines Mexico's economic conditions with emphasis on its financial system and corporate sector. The report aims to raise questions on Mexican corporates' ability to refinance themselves in the international marketplace and the related issue of the credit ratings agencies' accuracy to price in Mexico's sovereign and corporate risk.

Mexico is now reaching for significant financial support from the IMF, for a total of over $47 billion, which may eventually help address government financing needs. Mexico's Central Bank also activated a $30 billion swap line with the U.S. Federal Reserve in order to aid struggling Mexican corporates, which is an arguably inappropriate use of this financing resource. The need for the IMF support and Federal Reserve swap line raises serious questions about how long Mexico will need to access external private credit again and the implications on the country's financial stability.

Mexican corporations are in serious trouble. Corporations such as Vitro, Durango, Comerci, and just recently Mexico's cement giant Cemex, have all encountered default scenarios. Losses forced Mexican paper producer Durango to file for bankruptcy in late 2008 and glass producer Vitro defaulted on more than $1.2 billion of debt in March. Most telling, as of early May, Cemex was in renegotiation talks with bankers for more than $14.5 billion in debt following a failure to issue a $500 million bond sale in March.

These corporations took unexpected currency risks bearing little relationship with their core businesses. Since they bet that the peso would be stable or rise, they were exposed when the peso weakened. As these contracts turned against them, the companies had to cover their foreign exchange exposure, which led to a major decline of the peso in an illiquid global market. Mexico's private sector has suffered enormously in terms of activity and financial losses, with serious effects on their viability, as exemplified by Cemex debt restructuring attempts.

Mexico's financial system faces similar difficulties. The report estimates over $300 billion in losses arising from the financial crisis, not including the losses from investments abroad, which may amount to $50 billion. A likely slowdown in investment flows, energy sector obstacles, and a fall in remittances demonstrate that there are other weak economic areas in Mexico. In these circumstances, Mexico's output in 2009 is projected to decline by at least 3 percent, the largest decline in GDP of any major Latin American country. Given Mexico's ongoing economic difficulties, questions may well arise about the effectiveness of the recent IMF loan and Federal Reserve swap line to address Mexican corporates' financing needs, and thus about Mexico's overall economic stability.

A broader policy discussion needs to take place over the role that the major credit ratings agencies have played in assessing Mexico's risk. The ratings agencies should give special consideration to the corporate and financial sectors and how their obligations can in effect be considered a contingent liability on the sovereign. Risk perceptions and spreads have been increasing, made worse by the drug-related violence and now the outbreak of porcine flu. Yet the ratings agencies do not seem to have captured these trends, at best lagging in the response to the crisis, and at worst failing to measure existing risk. A ratings correction from an overstated investment grade may well be overdue for Mexico at this juncture.

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Mexico: A safe vessel or a risky wreck in turbulent waters? [1]

Claudio M. Loser

Centennial Latin-America and

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1. Mexico and the World Crisis- Complacency After Years of Moderate Prosperity

It has been over a quarter century since Mexico confronted the Debt Crisis that engulfed most of Latin America. From that moment on, in 1982, and until the eruption of the *tequila* crisis in 1994-95, Mexico went through a painful and uneven process of adjustment. The dependence on oil and assembly exports, and growing external current account deficits made Mexico particularly vulnerable to international events, including sharp declines in oil prices and abrupt changes in private capital flows. These characteristics resulted in a stop-and-go process that required the frequent and generally unwelcome support by the International Monetary Fund.

While far from uneventful, the period from the *tequila* crisis until 2008 was one of the most stable in the recent economic history of Mexico. Economic growth was steady, although relatively low, and in general followed the path of the US economy. The fiscal and monetary management showed a prudence that allowed for a sharp and sustained reduction in inflation, and a strengthening of the balance of payments, and the Central Bank was able to accumulate a record level of international reserves. This was taking place when the political landscape changed drastically, with the peaceful end to the dominance of the Partido Revolucionario Institucional (PRI), and the eventual transfer of presidential power to the Partido de Accion Nacional (PAN). The political process has been far from easy, as illustrated by the contentious Presidential Campaign in 2006. However, economic performance remained surprisingly decoupled from politics.

The smooth macro-economic performance, in the context of the most sustained period of world economic expansion in recent times, gave Mexicans a sense of security and even of complacency that, in light of circumstances, was unwarranted. Furthermore, the government found it increasingly difficult to push its

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structural reform agenda in the fiscal, electricity, and the oil sectors. Because of these problems, and the emergence of China as a main trade competitor, Mexico's competitiveness suffered and the initial positive effect of NAFTA lost steam in recent years. These developments hampered Mexico's growth potential, even with stable macroeconomic conditions and may well explain the mediocre growth performance, even with high levels of FDI.

More recently Mexico's climate has been affected by the emergence of powerful drug-traffic gangs, linked to the US. These violent gangs have been involved in major turf wars and an open conflict with the Mexican police and army. The wars are centered in only a few geographic areas, mainly Chihuahua, Sinaloa, Michoacán, Guerrero and Baja California. However, the damage from the point of view of domestic and international perceptions and confidence has weakened the capacity of the government to operate effectively. Moreover, this perception plus the very recent outbreak of swine flu is having extremely serious effects on both FDI and, now more intensely, tourism.

In addition to the outburst of violence, Mexico is now confronting its worst economic crisis since the *tequila* crisis. It is being hit by the US-originated but already world-wide crisis. Export prices and external demand have dropped sharply, output and business confidence are plummeting, workers' remittances are declining, stock prices and corporate finances have weakened, the peso has depreciated sharply, and there are growing concerns about Mexico's ability to maintain its hard-won macroeconomic stability. Many voices are heard that predict an impending disaster, and even talk about a "failed" state.

This report presents a broad view of economic conditions in Mexico, with emphasis on its financial system and corporate sector. Section 2 provides a background discussion on the current international context. Section 3 describes briefly the current developments in Mexico, while Section 4 provides a discussion on the public sector finances and the current stimulus package, concluding that the ability of the country to engage in an expansionary policy is limited, even with the financial support just offered by the IMF. Section 5 deals extensively with the structure and developments in the financial sector, with particular emphasis on the corporate sector, which has been shown to be particularly vulnerable in recent months, even as risk ratings have remained deceptively stable. Section 6 presents an estimate of the losses in Mexico arising from the financial debacle, estimated at over US$300 billion, not including the losses from investments abroad, that can easily amount to US$50 billion. Section 7 suggests that even under difficult conditions, Mexico shows a resiliency that is not always recognized. However, there is dangerous path ahead that may put to the test this rediscovered ability to deal with crises. In particular the refinancing and demand problems in the corporate sector are of a magnitude that is already hurting the ability of Mexico to deal with the effects of the current world crisis. The financial risks will remain with Mexico for the rest of the year, even taking into account a positive response from the IMF, in the form of a massive loan. Government, the corporate sector, and international observers, not the least the rating agencies, will need to incorporate these risks into their assessment about the prospects for Mexico.

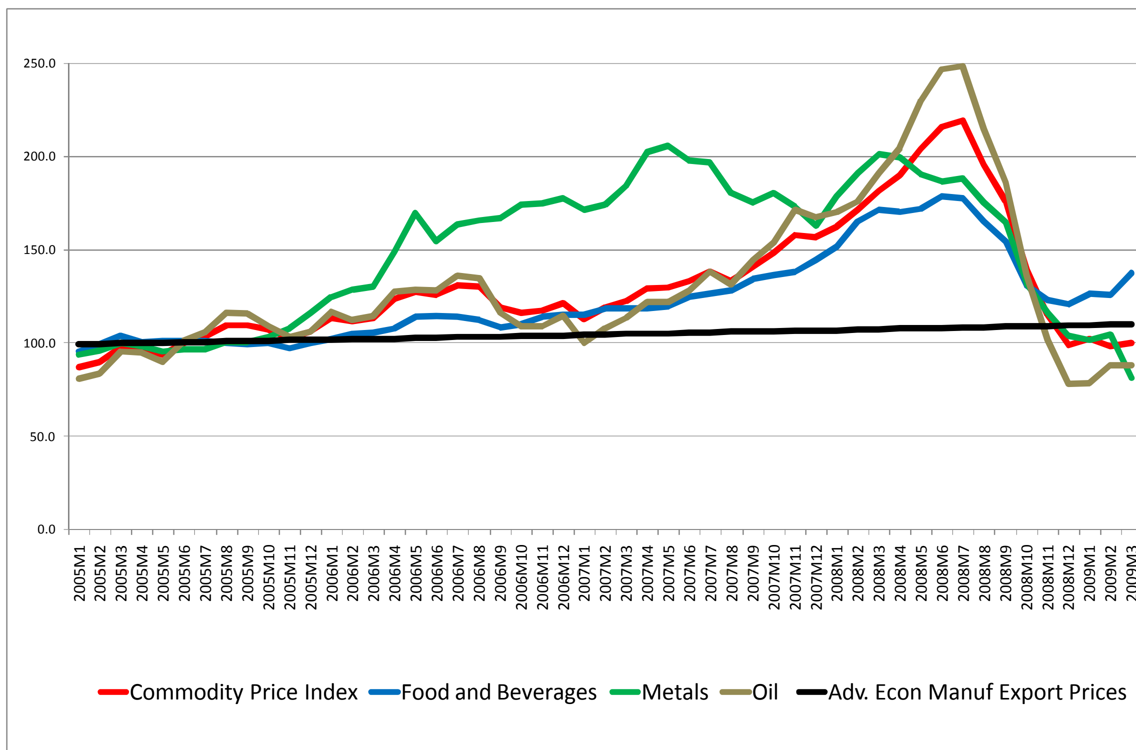
2. The International Environment

After a period of low and unstable economic growth, persistent crises, and high volatility that extended through the 1990s, Mexico made a very strong recovery. Inflation declined; the fiscal accounts and

monetary policy showed strength; international trade boomed; poverty was reduced markedly; and the external accounts were much sounder than they had been in decades. The limited initial impact of the world financial crisis gave rise to a sense of security that has now disappeared. The crisis is now in the open, as the impact on the external accounts and on domestic activity is very serious. The adverse terms of trade aggravate the situation, compounded by a massive loss in financial wealth.

The world confronts the most violent shock experienced by financial markets since the Great Depression of the 1930s. The crisis that followed the collapse of the U.S. subprime mortgage market in mid-2007, entered a tumultuous new phase in September 2008, and badly shook confidence in global financial institutions and markets. Intensifying solvency concerns triggered a cascading series of bankruptcies, forced mergers, and public interventions in the United States and Europe, which resulted in a drastic reshaping of the financial landscape. When the real estate bubble burst in the US and Europe, investors moved to commodities, which subsequently collapsed (Figure 1).

Chart 1: Evolution of Commodity Prices (2005=100)



Source: IMF: Commodity Prices; and own estimates

Global growth slowed substantially in 2008, and a recession is in place throughout advanced and emerging economies. The world will register a decline in activity for the first time in half a century. Recovery is expected at best for late 2009 or early 2010.[2] Economic activity is likely to decline by up to two percent in Latin America, and by 2.5-3% or even more in Mexico (Table 1); a deep recession is affecting the newly

[2] International Monetary Fund, World Economic Outlook, October 2008, and April 2009.

industrialized countries of Asia (NICs) and Japan; and growth rates in Emerging Asia are falling sharply. This is shocking for regions that had experienced very strong growth for at least a decade. On the positive side inflation, which was very high in early 2008 driven by a surge in commodity prices, has moderated but this entails a risk of deflation for the first time in many years.

The loss of capital valuation of financial assets world-wide has reached well over US$50 trillion. This loss amounts to about the equivalent of one year of world GDP, excluding the loss in value of real estate. In response, the authorities of many countries, particularly the European Union and the US, adopted extraordinary measures to stabilize the markets, providing liquidity and other financial support on a massive scale, extending deposit guarantees and adopting legislation whereby public funds are used to support problematic assets of banks.

Table 1: Selected Countries: GDP growth and Inflation- 2002-09

	GDP(%, annual)			**Inflación (%, annual)**		
	2002-07	est.2008	Proj2009	2002-07	est.2008	Proj2009
México	2.9	1.6	-2.5	4.4	5.7	4.0
Argentina	5.6	6.6	-2.5	11.9	25.0	10.0
Brazil	3.2	5.1	-1.5	7.3	6.3	4.5
Chile	4.5	4	.5	3.3	8.5	4.5
Perú	6.0	9.2	1.5	2.3	5.5	3.5
Venezuela	4.7	5.5	-4.0	22.0	32.0	30.0
Latin America	3.8	3.8	-1.0	7.1	8.5	6.0
NICs	5.1	2.1	-3.9	5.1	4.0	3.2
China	10.5	9.0	6.0	2.5	4.5	2.5
India	7.9	7.3	5.0	4.8	9.2	5.0
USA	2.6	1.1	-2.6	3.0	0.1	1.4
World	4.5	3.4	-1.0	2.0	3.5	2.0 1/

1/ Inflation refers to consumer prices in Advanced Economies

Sources: IMF, and Own estimates

The national rescue operations have been followed by major swap transactions between the Federal Reserve of the US and other central banks of industrialized economies and a few emerging economies, including Mexico (in this case for US$ 30 billion), to support the currencies of those countries in the face of continued pressures in foreign exchange markets. However, the high dependence of Mexico on external capital flows put additional pressures on the balance of payments. This has changed to some extent by the announced commitment by the most important economies of the world in the context of the April G-20 meeting in London to mobilize up to US$1.1 trillion to help the process of global recovery. Once this process is completed (which is unlikely to take place quickly) most of the financing would be provided by the IMF. Already Mexico has benefited from the new approach of the multilateral organizations, and particularly from the less conditional approach embodied in the Flexible Credit Line (FCL) of the IMF. Specifically, Mexico has been granted US$47 billion, on the basis of its track record, and with the right to

draw on the credit line at any time. Disbursements are not phased nor conditioned on compliance with policy targets as in traditional IMF-supported programs.

3. The Impact of the World Crisis on the Mexican Economy

The Mexican economy, being directly linked to the United States, to oil, and violence, has suffered more than most countries in Latin America. The slowdown in that country has had a direct impact on the growth of economic activity, now showing a sharp decline. While the value of oil exports rose at a rate of 50 percent during the first half of 2008, the subsequent decline in world prices- at one point about three quarters from its peak- has had a negative effect on export revenues. This occurred even as Mexico hedged its oil exports, securing higher prices than those prevailing in the spot markets at present. The impact on government revenue will be very significant this year. Oil receipts constitute more than one third of total revenue, or 8% of GDP. The decline in prices, together with the more worrisome secular decline in production and proven reserves, after years of under-investment in the public sector and no private sector involvement because of the effective constitutional ban on its participation is already affecting the public finances and will continue to do so.

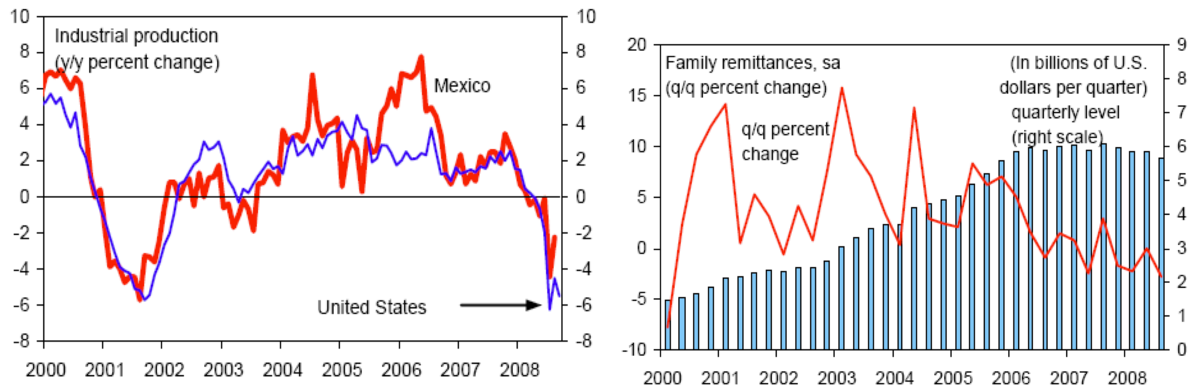
Non-oil exports have fallen sharply as the pace of exports to the US has collapsed. Shipments to the United States constitute about 60% of total Mexican merchandise exports, while more than 75% of imports come from the US, and the US recession has shown up in Mexican industrial output (Chart 2). This trend could not be offset by the improved price competitiveness of Mexico on account of the devaluation of the peso since last year, or the proximity to the US. This may be further affected by the serious problems now reshaping the US automotive industry, and which may reduce on a permanent basis production of cars in North America.[3] Tourism receipts have and can be expected to decline sharply in 2009, as the concerns about drug conflicts, and now the flu epidemic, and sharply lower incomes in advanced economies impact the travel industry, notwithstanding a much more attractive exchange rate. In line with these developments, business confidence has plummeted.

Balance of payments pressures have been aggravated by a decline of workers' remittances that, amounting to some US$ 23 billion a year or about one half of oil exports, are now Mexico's second largest source of foreign exchange. Remittances over the last fifteen years have become a major channel of prosperity and poverty reduction. These flows have been stable, and acted as a countercyclical force for Mexico in the past.[4] However they are highly sensitive to economic conditions in the countries of employment and new immigration to them. With many emigrants working in areas of the US, that have been hit hard by the recession, remittances started to fall in 2008 (See chart 2). The prospects for 2009 are equally dire for the well-being of millions of households, as remittances decline and some workers return.

[3] While the possible reduction in US car manufacturing is a serious issue, Mexico may gain because it has lower production costs than its NAFTA partners, and specializes in smaller US, Japanese and European car manufacturing.

[4] "The Macro-Economic Impact of Remittances in Latin America-Dutch Disease or Latin Cure?" Claudio Loser, G-24 Technical Papers, 2006 (See G-24 website, Technical Meetings).

Chart 2: Mexico: Economic Activity and Remittances



Sources: Mexican Authorities and IMF-Mexico Staff Report 2008

Capital flows to Mexico are also declining, both on account of reduced short term financing, and a fall in foreign direct investment (FDI). FDI averaged US$20 billion a year and reached US$27 billion in 2007, the highest level received by any country in the region, but fell to US$18 billion in 2008. It may easily decline by one half in 2009, compounding the effect of lower or negative portfolio flows. In the end, the combination of low prices, reduced demand for manufactures by the US, falling remittances and a decline in FDI will be extremely harmful for Mexico. While the external current account may not deteriorate much, as imports contract, the existing conditions will maintain Mexico negative growth territory for the remainder of the year, and with only a slow recovery in 2010, according to most analysts.

The situation of Mexico is further complicated by the weakening of the financial position of the corporate sector, described in more detail below. Sovereign risk premiums increased by 300 points (3 percentage points), in the last quarter of 2008, and have not declined so far this year. Actually, Mexico's sovereign spread exceeded that of Brazil for the first time in recent history (chart # 3) even as spreads have declined in recent weeks, in response to the announced IMF loan to Mexico. The losses resulting from poor investments in derivatives by corporations, and the well known difficulties in credit markets in Mexico and the US has put additional stress on the economy. The authorities provided liquidity to the market in recent months to help reduce the risks to the private sector, and further support may be forthcoming on the basis of the external support obtained.

Sovereign credit ratings have remained stable for Mexico, as for other emerging economies, to an extent that can be considered too high. In light of the ratings agencies' disastrous performance in assessing financial markets risks throughout the current crisis, their poor timing, particularly ahead of a crisis, and a lack of transparency in assessing emerging market risk in the past, they have lost considerable credibility.[5] Thus, even with those stable ratings for government paper, risk premiums on sovereign and corporate paper have increased in line with developments in emerging economies and the specific problems affecting Mexican corporations. The agencies are certain to be reviewing their ratings, and a correction is justified.

[5] See Washington Post, Editorial Page, of April 19, 2009, for a lucid discussion of the problems of rating agencies.

Inevitably, a belated announcement at this time will create further pressures on Mexico's sovereign even as the private sector, correctly, has already seen losses in their credit standing. The problem will be aggravated as some of the private liabilities are increasingly perceived as contingent liabilities of the government, to the extent that it is lending increasing amounts to companies in distress.

So far the Mexican authorities reacted in a prudent way, initially adjusting interest rates to avoid an acceleration of inflation, and recently being able to loosen policy as interest rates world-wide have declined. The strong fiscal position built over recent years has helped preserve Mexico's credibility regarding macroeconomic stability, and a good business climate. However, the decline of oil revenues is posing new risks to the Mexican economy, beyond the protection provided by the lower Mexican peso. These dangers are illustrated in Chart 4, which shows how the external current account and fiscal balance may deteriorate in 2009, notwithstanding the peso depreciation, in light of the worsening conditions surrounding Mexico, and will sharply lower tax revenues due to much lower economic activity and exports.

Chart 3: Interest Rate Spreads –Mexico and Comparators

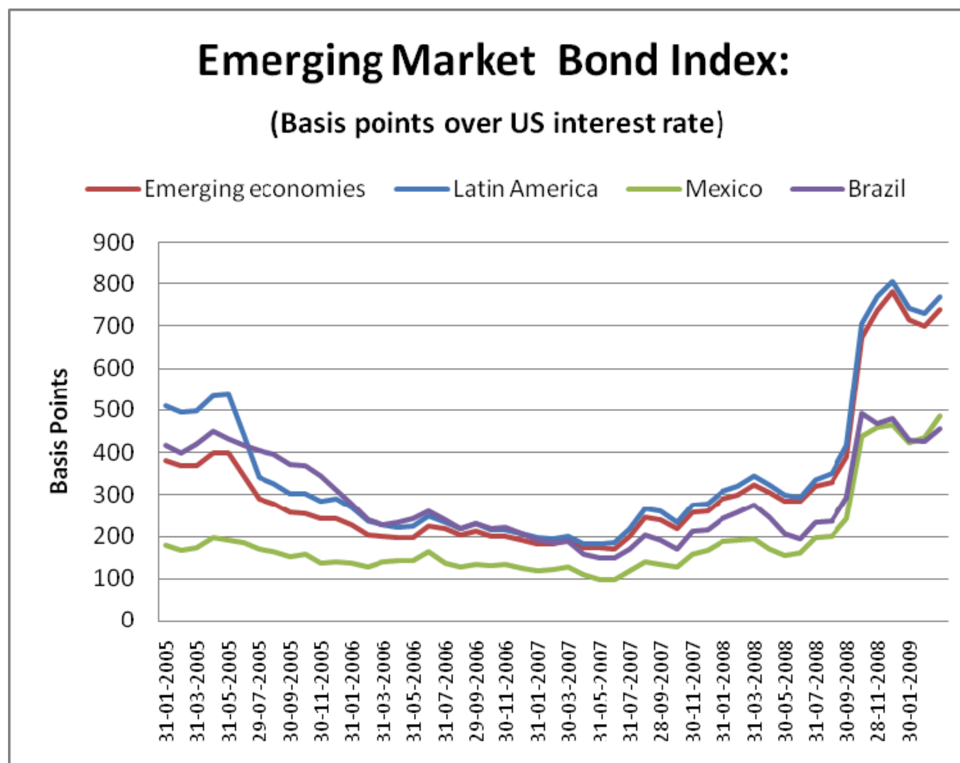
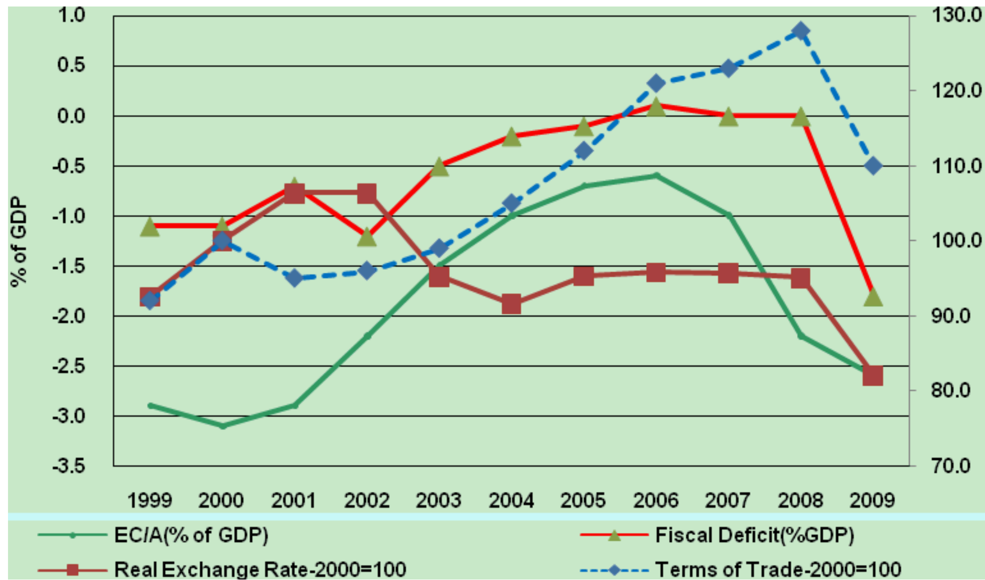


Chart 4: Mexico -Current Account, Fiscal Outcome, Real Exchange Rate, and Terms of Trade



Source: IMF, ECLAC, Official data, and own estimates.

4. The Public Sector and the Crisis

a. The Public Finances

Public finances up to the time of the tequila crisis had the reputation for being the weakest link, or often the cause in many circumstances, in Mexico's crises in the face of domestic or external shocks. While problems persist, it has so far been in a much stronger position to deal with the problems that the economy faces. So far the overall fiscal position of the government, even after the bailout of the financial system, has been solid, with the traditional definition of fiscal outcome in virtual balance, and with a relatively small deficit when adjusting for non recurring revenues.[6]

As a consequence, the public sector debt has declined by about 10% of GDP since 2003, and now stands at 32% of GDP. Moreover, most of the public debt is issued in domestic currency. While in the past debt had been dominated by foreign currency borrowing, this segment of the public debt represents less than 20% of the total, and is more than sufficiently covered by the ample level of international reserves. Under these conditions the government has considered feasible to introduce a fiscal stimulus package, in the order of 1% of GDP that could be absorbed in current circumstances. However, reductions in revenue are most likely to impose a serious constraint on the government's intent to expand the stimulus effort.

[6] The estimates do not include the costs of the IPAB, the banking stabilization fund established after 1994, to deal with toxic assets that banks held at the time.

The role of PEMEX (the state oil company) is particularly important with regard to revenues, because other sources of taxation are small as a proportion of GDP compared to countries at a similar level of development. Moreover, oil output has been declining and is expected to be 15 percent below its most recent levels over the next five years and, come down further subsequently. This can only be reverted either by massive (but unlikely) public funds or by a more aggressive agenda that involves large private sector participation, which is not permitted at present. This will require a major reform of the tax system, even though efforts to pursue a reform agenda faced strong political opposition in the past.

Finally, in the presence of significant problems in the corporate sector, pressures are certain to emerge to bail-out the companies in trouble. The Bank of Mexico and the government have taken measures in this regard, but are likely to be close to the limit unless they expand indebtedness. Continued massive support would be a worrisome development in terms of financial sustainability, as the government may have to increase its indebtedness well beyond a sustainable position, particularly if they engage in massive financial rescue operations and even take over the liabilities of the private companies.

b. Stimulus Packages: How Much Can Mexico Afford?[7]

At a time of widespread economic crisis, many countries have been announcing fiscal and credit packages aimed at softening the impact of lower commodity prices and reduced external demand. These measures are being taken on top of the currency devaluations in many larger countries. Several issues arise in this regard for Mexico: are the announced measures large enough to shore up demand? How do they compare with the efforts of advanced countries? Can Mexico afford to do this? Table 2 lists recently announced stimulus packages in some Latin American and Asian countries, as well as those in the US, and Japan. The table includes numbers for public debt, both total and net of international reserves, to reflect the ability of the countries to finance the increased spending. It does not include the requirements arising from reduced government revenues (which may increase the financing requirement easily by 2 to 4% of GDP.

With the exception of China, the packages among emerging economies are considerably smaller than those of the US and Japan (6 percent of GDP) and Germany (not shown, at 3 percent). In these countries, even with high levels of debt to GDP, their size and the depth of capital markets allows them to increase spending. In China, Chile and Peru, a very low level of net debt and high reserves allow for the proposed effort. In Mexico, small domestic financial markets, and the general creditor understanding that Mexico cannot increase debt significantly beyond the recent and prospective multilateral borrowing, the prospects for a further stimulus package are very limited.

[7] C. Loser, By the Numbers, Latin American Advisor, Inter-American Dialogue, January 2009.

Table 2: STIMULUS PACKAGES: Selected Countries				
Country	**Announced Amount of Stimulus (2009-10)**		**Gross Public Debt**	**Public Debt, net of International Reserves**
	US$ billion, annual	(% of GDP, 2008)		
Mexico	10.8	*1.1*	*32*	*23*
Peru	3.2	*2.5*	*31*	*1*
Chile	4.0	*2.2*	*19*	*6*
Argentina	3.8	*1.2*	*59*	*46*
Brazil	16.0	*1.0*	*57*	*46*
China	300 (586) 1/	*7.1*	*18*	*-30*
USA	800 (1150) 1/	*5.6*	*38*	*38*
Japan	250	*5.2*	*153*	*128*

1/Estimated expenditure in 2009-10. Number in parenthesis reflects announced total package

Sources: National data; Press Releases; IMF; Eurostat, and own estimates

5. The Finances of the Private Sector

a. The Structure of the Financial System

The structure of Mexico's financial system has been strongly shaped by the recent economic history of the country, specifically the after-effects of the *Tequila* Crisis. The collapse of the financial system and of the public finances after foreign financing vanished, 1994 resulted in a streamlining of the banking system, under strict prudential and supervisory regulations, and a public sector that reduced its deficits, and shifted its financing away from foreign financing. As the process of integration under NAFTA intensified, Mexico attracted large amounts of Foreign Direct Investment, while at the same time started a significant process of investment abroad by a group of world-class enterprises.

Table 3 shows the importance of domestic, and particularly bank and stock market financing. What is striking is how small the relative size of the financial system is, when compared to the US, or even Latin America. On average, Latin America has one of the smallest financial sectors at 176%, of GDP, far lower than that of Asia at 370%, the US at 442%, or the European Union at 545%. Mexico's financial system, while highly sophisticated, is one of the smallest among major emerging economies, at 100% of GDP.

To some extent the limited size of the financial system has been offset by sustained level of capital inflows, with a stock totaling US$640 billion as of end 2008, mainly in the form of into FDI, and portfolio investment.[8] It is important to note that Mexico also has become a significant holder of assets abroad. On

[8] The stock of portfolio investments is reflected in the table, as part of portfolio holdings of the different types of instruments available to foreigners in Mexico.

the basis of balance of payments and Foreign Investment Position data, presented by the IMF through end-2008, it can be estimated that investment abroad amounted to some US$150 billion, excluding foreign reserves (US$95 billion). These assets do not include the sizable informal investments, including real estate, traditionally held by Mexicans, and which are not covered by official statistics. [9]

Table 3: Mexico: Indicators of Size of Capital Markets (US$ billion and as percent of GDP)

	2007		2008		USA (2007)	Latam (2007)
	US$	% GDP	US$	%GDP	% of GDP	% of GDP
Stock Market capitalization	397.7	*38.9*	202.6	*20.3*	*144.3*	*63.5*
Bank Lending	384.3	*37.6*	327.3	*32.7*	*81.1*	*55.4*
Public Sector	223.2	*21.8*	199.0	*19.9*		
Private Sector	161.0	*15.7*	128.3	*12.8*		
Public Non Bank Debt	163.0	*15.9*	191.7	*19.2*	*47.8*	*40.4*
External	55.4	*5.4*	56.9	*5.7*		
Domestic	107.6	*10.5*	134.8	*13.5*		
Private Non-Bank Debt	71.9	*7.0*	75.9	*7.6*	*168.6*	*17.4*
External	71.0	*6.9*	73.0	*7.3*		
Domestic	0.9	*0.1*	2.8	*0.3*		
Total Financing	1016.8	*99.4*	797.5	*79.7*	*441.8*	*176.7*
Public debt1/	324.0	*31.7*	320.0	*32.0*	*47.8*	*40.4*
Public debt(net of reserves)	236.9	*23.2*	224.9	*22.5*	*47.3*	*28.0*

1/Includes liabilities of IPAB and Pidiregas

Sources; Global Financial Stability Report- IMF (Oct. 2008), WEO- IMF, October 2008Banco de Mexico, SHCP Mexico; World Federation of Exchanges

b. The Impact of the Crisis on the Private Finances

The impact that the world crisis has had on the Mexican financial markets has been significant. The main areas of stress have been the loss of valuation of companies; the investments of local companies in foreign markets, including toxic assets; the general conditions of the banking system; and problems in external financing. All these developments can be traced to the recessionary forces coming from the US and other major economies and the disruption in financial markets. However, the structure of the financial system suggests that Mexico is limited in its exposure to financial risks to a greater extent than many other countries, in part due to the ironic situation of its small financial system.

The **stock market** experienced a sharp fall in line with those of advanced countries, and extended throughout the year, in contrast with what happened in other emerging economies where the reduction began in the middle of 2007. The S&P 500 index of the United States fell by 36% from June to end-2008,

[9] IMF, International Financial Statistics.

the Japan Nikkei index fell by 37% and an equivalent decline in Europe. The Mexico index fell by 29 %, in local currency, of course aggravated by a decline in the value of the peso of some 25%. The major stock market in Latin America, the Bovespa Index of Brazil, declined by 49%, and among Asian countries, the stock markets declined by 36% in Korea, 41% in India, and 48% in China, in most cases accompanied by currency depreciations. From end-2008 conditions deteriorated further and the Mexican Bolsa Index declined by about 26% by mid March, but by end April was only down 2 % for the year.

Initially it was thought that Emerging Markets had not been exposed to **"toxic" financial assets**, one of the most explosive aspects of the crisis. However, it soon became clear that in many markets, including Korea, India, China, Brazil and Mexico, companies were invested in derivatives, particularly regarding foreign exchange risk, and, to a lesser extent, commodities. The fall in international prices and the devaluation of local currencies had an important impact on the finances of these companies and therefore, their share values suffered, generating strong pressures on the exchange market.

In the specific case of Mexico, the derivative losses came to the fore when the third largest supermarket chain, Controladora Comercial Mexicana, declared bankruptcy, citing that out of total losses equivalent to US$2 billion, US$1.4 billion were tied to a loss in peso derivatives. Other nonfinancial firms, like hospitality related company Grupo Posadas; steel and consumer product conglomerate Alfa; tortilla maker Gruma; Giant cement producer Cemex and glass producer Vitro also disclosed large trading losses tied to financial derivatives. There were other firms with losses, but the bulk was represented by these companies. These firms took unexpected and unusual currency risks having little relationship with their core businesses. Because they had bet that the peso would be stable or rise, they were caught exposed when the peso weakened. As these contracts turned against them, the companies had to buy dollars to cover their exposure, which intensified the devaluation in an already illiquid global market. [10]

The concerns arising from corporate exposure to derivatives have compounded existing fears about the **health of the Mexican corporate sector**, with their operations already adversely impacted by the U.S. downturn and financial crisis. The list of Mexican corporations threatened by speculative positions on currency derivatives is limited but losses are an estimated US$4 to US$5 billion. These losses may appear small in terms of the size of the Mexican economy, but a high percentage of their equity value could consume a significant part of the funds available to the Government, if the losses were to extend further. It is true that Mexican companies with large dollar-denominated debt are generally exporters to the U.S., which provides them with some natural exchange-rate hedge. Exporters also tend to have long-term debt and, therefore, are less exposed to short-term currency fluctuations. In fact a study by IMF staff suggests that companies in Mexico reduced their currency mismatches in their balance sheets.[11] These events

[10] E. Quintin and E. Skelton "How much will the global financial storm Hurt Mexico" Southwest Economy Federal Reserve Bank of Dallas, Nov-Dec. 2008.

[11] H. Kamil and B. Sutton "Corporate Vulnerability: Have Firms Reduced Their Exposure to Currency Risk? In Regional Economic Outlook: Western Hemisphere-IMF, Washington DC November 2008, and IMF; Mexico- Selected Economic Issues- January 2009.

reduced the risks to Mexican Corporations, although, a number of them still were hit hard by the world economic downturn, in light of their high exposure to trade with the US and other advanced economies.[12]

There was some improvement from the trough in the fourth quarter of 2008. Nevertheless, the financial markets remain very fragile, even with government intervention, as economic conditions in Mexico and the US have continued to weaken, and together with the concerns about violence and health, are generating considerable uncertainty about the capacity of Mexican companies to obtain adequate financing, at a time when the appetite for lending to emerging market corporate has been sharply curtailed, and some of the Mexican firms depend on this type of foreign financing.

The perceived problems have resulted in an **increase in risk premiums, as noted above**. For the first time the EMBI spread for Mexico exceeds the spread for Brazil, which in the past had much higher spreads, but is now seen as more decoupled from the US. Such increase in spreads will clearly have a direct effect on sovereign borrowing but possibly more so for enterprises. In fact CEMEX, after having engaged in a major renegotiation of its debt recently announced its intention to renegotiate this agreement with considerable adverse impact on its ratings. In light of CEMEX's difficulties and the perceived risk in the private sector, with the corporate average risk premium is at least 300 points (3%) above the sovereign. In recent weeks the prospects for CEMEX have improved, as the US has reduced tariffs on cement, and also the Bank of Mexico has indicated its intention to use the Federal Reserve swap money to provide liquidity to enterprises in difficulties.[13] While not many other companies seem in such a difficult position at present, with the possible exception of Vitro, the prospects remain cloudy. A central question is whether the cement giant is being hit by its aggressive expansion policy, and the impact of the global crisis on its international business, thus affecting its ability to refinance its USS15 billion in debt, but the issue extends beyond the circumstances of that company. To the extent that private corporations and state owned corporations (like PEMEX and the Electricity Companies) pressure the government and the Central Bank for financing, the constraints on Mexico will become more apparent, particularly as debt service payments remain high. Again, a realistic assessment by the ratings agencies would be central for a clear perception of Mexico's risks and prospects.

Commercial banks in Mexico did not invest to any significant degree in "toxic" financial instruments, but they are being hit by the sharp contraction in external credit and the problems of their customers, including CEMEX. However, even with these problems, the Mexican banking system has been highly profitable, with a good capital base, and with a domestic deposit base that is larger than their loan portfolio. The banking system is highly concentrated, and dominated by Foreign Banks- five of the six largest banks are foreign owned, and this may well create pressures on the system, to the extent that US, Spanish and other foreign-

[12] While derivative bets worked against the financial position of many companies, the government did well. To protect the budget, the authorities hedged about 70 percent of PEMEX exports, at a price of US70 a barrel (adjusting for imports of fuels). The IMF projects that the Mexican mix (of a somewhat lower than average quality) could average about US48 a barrel. This would entail a profit from the hedge of US$6 billion, something that the markets do not seem to have fully accounted for.

[13] The Federal Reserve, while supporting private companies at home, may express its concern about the use of the swaps for the same purpose. The original objective of the funds was to help stabilize the financial and foreign exchange markets and not to provide loans to corporations.

owned banks may withdraw lines of credit from Mexico to preserve the health of their home operations, as detected in a recent IMF study.[14] Even so, the banks are narrowly exposed to foreign risks, because they are constrained by strict regulations. They focus mainly on the domestic markets, and thus are not incurring risks similar to financial institutions in the advanced countries, where the banking system is much larger and banks have tended to be more invested in the troubled assets. Mexico has been helped by the small size of the national financial system and strong supervision and prudential regulations, an inheritance of the crisis of 1994-95.[15] [16] Thus, the risks tend to be concentrated in possible disruptions in traditional flows related to international trade and foreign investment; and the contraction in international economic activity. Nevertheless, the problems in the financial system arising from the combination of lower exports and share values could be very serious, as other shocks hit Mexico in the next months. Moreover, a loss of confidence could hit this small banking system very hard.

With significant levels of assets abroad, either as investments by companies or holdings of individuals, the international crisis is hitting Mexico also on account of the reductions in returns for those investments abroad, and growing financing difficulties for the investing corporations. This problem did not exist when Mexico was fundamentally on the receiving end and were not capital exporters, as is the case at present.

6. The Loss in Financial Wealth in Mexico

Between 2003 and 2007, the value of financial assets in Mexico grew somewhat faster than GDP, and the ratio increased by 12%, to a level of 100% by end-2007. During the same period, the ratio of world financial assets to GDP grew at a more torrid rate of 45% to a total level of 420% of GDP.[17] Clearly these operations deepened the capital markets, but also constituted the base of the speculative bubble that was building up. The rise in the ratio of Financial Assets to GDP in Latin America was more modest -from 135% to 176%- representing an increase of 30%.[18] The subsequent fall in values from these levels have been enormous; the loss of wealth at a world-wide level during 2008 exceeded USS50 trillion. The losses are proportionally smaller in Mexico, but still represent a major shock for an economy that is only now starting to redevelop its financial system. Moreover, while the worst of the crisis may be over, it is dangerous to disregard the risks of a further shock in the months to come, from which Mexico could hardly be decoupled.

[14] IMF, World Economic Outlook, Chapter 4, April 2009.

[15] The index of Financial development and Stability, developed by the Centennial Group, and presented in Emerging markets in October of 2008 show that Mexico developed considerable institutional strength, with index levels that exceed what could be expected in light of its levels of income. In turn the development indices (reflecting the depth and structure) are below what is expected in light of per capita income. This is the opposite of what was observed in the case of Asian countries. This is confirmed by other studies carried out by the IMF.

[16] "Financial Markets in Latin America, Claudio Loser, in "Growth and Development in Emerging market Economies", Harinder Kohli, Ed. Sage Publications, 2008.

[17] These assets include collateralized financial instruments (mortgage backed securities or MBS, and Collateralized debt obligations or CDOs). They do not include complex financial derivatives like CDS (Credit Default Swaps).

[18] These ratios are far from stable. Since the publication of the series by the IMF in the Global Financial Stability Report in 2001, the ratios of financial assets to GDP declined through 2003, reflecting the effect of the bursting of the technology bubble at the beginning of the decade, and rose subsequently.

Table 4: Mexico and Latin America: Losses Arising from the Financial Crisis

	Value end-2007 (in US$ bill)	Percentage loss from end 07	Estimated Loss 2008 US$ billion	% of GDP	Notes
Latin America					
Stock market Capitalization	2292	55%	1261	34.1	1/
Public and private debt	1456	20%	291	7.9	2/
Bank Assets	1989	29%	567	15.3	3/
Total Assets	5737		2119	57.3	
Mexico					
Stock market Capitalization	398	41%	161	15.8	4/
Public and private debt	235	17%	39	3.8	5/
Bank Assets	384	30%	114	11.2	6/
Total Assets	1017		314	30.7	

1/Assumes an average loss of 40% in value and 25% depreciation
2/Assumes an average loss of 20% in value (increase in spreads)
3/Assumes 5% loss in local currency value and 25% average depreciation
4/Assumes an average loss of 24% in value and 22% depreciation
5/Assumes an average loss of 17 % in value (increase in spreads)
6/ Assumes a loss of 10% in value, and a depreciation of 22%

Source: Global Financial Stability Report (IMF, October2008), Bloomberg news, Mexican government, and own estimates

Table 4 provides a stylized calculation of the possible losses arising from the crisis in Mexico and Latin America, through the end of 2008. The numbers should be viewed with caution, as they show a broad order of magnitude, and not a detailed calculation. They are based on data on the size of world financial markets for end-2007, the most recently available globally. The table includes an estimate of the impact of currency depreciations, the decline in stock prices, the loss of value of debt, and the effect of depreciation on deposits. The estimate does not include the loss in the value of assets held abroad, or the value of physical assets, like housing. Even so, the estimated losses are stunning- more than US$ 2 trillion (57 % of GDP) in 2008 for Latin America, and a loss of US$314 billion (32% of GDP) for Mexico.[19] The losses can become larger as more problems of the corporate sector show up in the next months. Already the private sector incurred losses during the year that could easily add up to several tens of billions of dollars.

Added to the lower income from exports, remittances, and significant losses in holdings by Mexicans abroad, this decline in wealth will have an enormous impact on domestic expenditure. The terms of trade/export decline effect will aggravate the situation, as it will reduce incomes by 2-2 ½% of GDP. This decline in potential income is compounded by a sharp decline in exports, particularly to the US[20], and a loss of wealth, including on foreign assets, equivalent to almost 40 % of GDP. Under these circumstances it is

[19] C. Loser, By the Numbers, Latin American Advisor, Inter-American Dialogue, November 2008

[20] Export values, including oil, declined by 20 %in the fourth quarter of 2008, compared to the third, and 10% compared to the last quarter of 2007. Furthermore, exports in January 2009 were almost 20 percent below the values registered in December 2008.

not surprising to expect that Mexico's economic growth in 2009 will decline by at least 3 percentage points, and in addition , an unavoidable setback in the fight against poverty.

7. Summary and Concluding Remarks

Mexico now faces a challenging period ahead as it absorbs the impact of the world financial crisis, particularly in the next twelve to eighteen months. While most people understand the close links to the United States, the perception that these links had weakened has been painfully refuted by the facts. NAFTA has brought prosperity to Mexico, but national production and financial markets are closely interconnected, and the impact of the world financial collapse is a witness to this fact.

The economic situation is extremely difficult, because of the US recession, the underlying problems of strong competition from China in particular, and declining oil production. This is compounded by a fragile financial position for a number of large and medium sized enterprises, the level of violence by drug-related gangs, and now the flu epidemic. These elements can lead to an imminent crisis, even as the discussion shows a nuanced reality. Activity is very weak, confidence has declined sharply, political tensions are rising, and the main markets for Mexico's goods and services remain fragile. The problems ahead are daunting for the second largest Latin American economy and key economic partner of the US.

Even with large financing made available by the IMF, the total financing requirements of Mexico exceed those amounts. External amortizations in the first two months of the year amounted to US$28 billion, and domestic debt obligation falling due over the same period were in the order of US$20 billion, according to official data. While the projected financing requirements cannot be extrapolated simply from those numbers, it indicates the difficulties ahead.

Mexico has followed generally cautious prudential and macroeconomic policies, and this protected it so far, but this seems now insufficient, as the crisis has hit Mexico's financial system hard. **Moreover the financial losses resulting from the crisis are very large, at over US$300 billion.** The country generally ranks well in terms of economic freedom, competitiveness, and even in terms of corruption, even if the record is far from outstanding. And Mexico is high among larger Latin American countries in terms of Ease of Doing Business, as reported by the World Bank. But the financial system has major vulnerabilities, some coming from foreign owners who may want to protect their home finances. The dangers may be contained by the authorities, but the problems are there even in the relatively small and controlled Mexican system.

The private sector has been contaminated because of its exposure to "toxic" derivatives. In addition, some private corporations are extremely vulnerable to a further decline in activity, even abroad, for those invested outside Mexico. Furthermore, the weakness may contaminate the government as it becomes more involved and it absorbs the liabilities of the private sector. As the problems of highly leveraged companies are made public, like the case of CEMEX, fears of contagion become heightened, and reflected in higher spreads. There are increasing fears that these problems may extend to other companies, and that is a possible outcome. There will be pressures for the government to provide significant help to some of the companies in trouble, but that should be restrained mainly to those in the financial system, because of their systemic implications. Any larger involvement could not be absorbed by the Government, even with more resources.

Mexico has dragged its feet in pursuing the needed reforms in the Oil and Energy Sectors, the reform of the state, and in increasing competition in many areas of the economy, including telecommunications and TV networks, and in strengthening property rights and the enforcement of contracts. This reduces further the country's ability to absorb shocks. There is also the danger of a reversal in open trade and investment policies, even though Mexico has shown an excellent track record. There may a temptation to blame the Advanced Economies for many of the problems that Mexico faces. But big mistakes occurred not in only in the advanced economies, so that the blame cannot be easily shifted to others.

The main points arising from this report could then be summarized as follows:

- Mexico's economy and financial sector have been hit extremely hard by the world financial crisis. The situation is extremely serious, and the effect on output, wealth, and on poverty is critical. The country will likely record the largest decline in GDP of any major Latin American country in 2009.
- The crisis has hit at a time when Mexico had experienced a loss of competitiveness particularly with respect to China, and has seen a secular decline in oil production due to low investment in the sector.
- The private sector has suffered enormously in terms of activity and financial losses, with serious consequences on their viability, as exemplified by CEMEX debt restructuring attempts.
- The government was able to shield itself from the effects of the crisis in the short run, including through financial support from the Federal Reserve and the IMF.
- However, the government's intention to lend to firms in difficulty entails a rise in contingent liabilities that will seriously aggravate its financial position.
- Risk perceptions and spreads have been increasing, made worse by the existence of drug-related violence and now the outbreak of porcine flu. However, ratings agencies have not captured these trends, at best lagging in the response to the crisis, and at worst failing to measure existing risk.
- With high uncertainty in credit markets, and even with a flexible exchange rate, the existing tensions will seriously strain Mexico's ability to respond to the crisis, further complicating its prospects.
- A slow recovery could only be expected after the adjustments in the corporate sector are worked out over the next twelve months, including through bankruptcy or debt workouts, but this not a guaranteed outcome.

Mexico seemed well prepared to deal with an external crisis. Unfortunately the shock is far greater, and the defenses may not be enough, to deal with the consequences of the crisis. This is further clouded by what can be described as a mistaken assessment of risks by the ratings agencies. The authorities have a full plate finding a balance between economic stimulus and support of corporate survival on the one hand and financial viability on the other. However, an adequate assessment of the situation by the agencies and the pursuit of the right policies are not, unfortunately, a foregone conclusion.

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