Nation set to earn its way out of the shadows

The Financial Times
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Published: May 09, 2007

Iván Isaias is meant to be buying the groceries at the Wal-Mart Supercenter in Buenavista, a central neighbourhood of Mexico City. Instead, he and Olimpia, his girlfriend, are in the supermarket's electronics department eyeing shelves full of hi-fi equipment with flashing lights and heavy price tags.

A decade ago, high interest rates and a lack of credit would have made it almost impossible for Mexicans such as Mr Isaias, a 19-year-old with a full-time job at McDonald's and part-time work as a clown, to contemplate buying the Sony system he is about to put in his shopping trolley.

Nowadays almost anything seems possible: Mr Isaias has accounts at two banks, and if his savings are not enough both are happy to lend him the money at rates that fit relatively comfortably with his income stream.

"We have a sound system at home but the CD's packed up and, well, it's time to upgrade," he says.

Mr Isaias is a beneficiary of an expansion in bank lending and consumer credit that are the most striking features of Mexico's recent economic improvement. Twelve years after debt default and devaluation threatened the breakdown of the country's entire financial system, banks are lending again.

Consumer credit – which virtually collapsed in the late 1990s – is recovering: it increased to 12 per cent of output in the first quarter of 2007 compared with only 6.9 per cent in the second quarter of 2002, the lowest level it had reached since the crisis.

A growing number of Mexicans are borrowing money too to buy their own houses, with mortgage lending up by 157 per cent since the end of 2004. And a string of new banks have begun to offer loans and mortgages to poorer Mexicans – such as Mr Isaias – who have traditionally been ignored by the financial system. The Elektra retail group started this trend five years ago when it launched Banco Azteca. Other newcomers include Wal-Mart of Mexico, the local subsidiary of the US retail giant, which will launch banking activities later this year.

Underpinning all this has been a gradual consolidation of macro-economic and financial stability. Consistently tight fiscal policy has reduced deficits. This year the government expects to record a small surplus. Inflation has been falling consistently for most of the past 12 years, averaging 4.4 per cent in the last six years compared with 22.5 per cent in the period between 1995 and 2000. Interest rates – in real terms – are now 3 per cent, and the government last year became one of the first in any emerging market to place 30-year local currency bonds.

"Mexico's main financial variables have converged with the standards of developed countries," wrote analysts recently at GEA, the Mexico City-based consultancy that is part of the New York-based Latin Source network. Other trends, too, have been positive. First, Mexico continues to benefit from investment flows from the US, with manufacturers and a growing number of service companies continuing to invest to take advantage of duty-free access to the North American market agreed 13 years ago. Foreign direct investment has averaged $20.5bn since 2000.

The sharp rise in remittances from Mexican workers living in the US, from about $6bn in 2000 to $23bn, has been another source of stability. However, there are now clear indications that the rate of increase of remittances is beginning to slow. In the first three months of 2007, migrants sent back $5.35bn, only 3.4 per cent more than in the same period of 2006.

Income from oil has helped ease spending pressures, in areas like poverty relief and infrastructure. After a decade of virtual paralysis, the government is beginning to step up investment in infrastructure, earmarking 10,470.7m pesos for building roads in 2007, more than double the amount allocated in 2006. Under construction are some 923km of new highway.

Overall, after a disappointing five years in which growth averaged only 2 per cent per year, the economy picked up speed last year, expanding by 4.8 per cent.

Above all there are signs that Mexican politics, too, are again becoming more stable, after a tumultuous year marked by a divisive election campaign, allegations of fraud and the prospect of civil unrest. After the vote in early July, supporters of the defeated left-wing candidate, Andrés Manuel López Obrador, occupied the centre of Mexico City and when the moderate conservative Felipe Calderón – victor by the narrowest of margins – was finally sworn in, the ceremony took place in a congress building encased in steel fencing and surrounded by riot police.

Mr Calderón, however, has made an impressive start, winning popularity by sending in troops to states affected by drug-related violence and extraditing 15 gang leaders to the US.

In congress, the president has cleverly knit together a political alliance between his own rightwing National Action Party and the centrist Institutional Revolutionary Party, the party which was ousted from government after 71 years in office by Mr Calderón's predecessor, Vicente Fox, in 2000.

The 2007 budget has been agreed smoothly and without fuss. And Mr Calderón has unexpectedly been able to quickly push through a reform of Mexico's public pension system, raising the possibility that structural reforms – such as changes to the tax system and a liberalisation of the energy sector – may also be achieved.

"He has accomplished one thing that didn't look possible a few months ago," says Luis Rubio, a political and economic analyst in Mexico City.

"That is that nobody has any doubt who is president. He has accomplished far more than he aspired to."

Investors have warmed to the new mood of optimism, with the Mexico City stock exchange regularly hitting new records in recent weeks. Overall, say economists, Mexico appears less vulnerable to the vagaries of external markets. A slowdown in the US or a sustained fall in the oil price will do some damage but not as much as it would have done a decade or so ago.

"At the beginning of the decade exports were really Mexico's only engine of growth. This is no longer the case," says Jonathan Heath, head of research at HSBC in Mexico City, who points out that in 2006 private consumption grew just under a percentage point quicker than the overall economy.

In the longer term there are also signs that this same constellation of economic trends may bring about a social and political shift. Alejandro Hope, a political analyst at GEA, a Mexico City-based consultancy, says the number of families with incomes of between about $600 and $1,500 per month increased from just over 5m in 1992 to more than 9m in 2004, creating a "constituency in favour of economic stability".

There are hints here of a shift similar in some respect to that which took place in Britain in the 1980s and early 1990s, when the extension of home- and share-ownership was accompanied by growing Conservative electoral success. In fact, recent polls by GEA have shown that the growing number of Mexicans who are borrowing from banks or own their own homes are more likely to support Mr Calderón.

Mexico though remains a society scarred by the scale of social exclusion. However appealing are comparisons with European experience (Agustín Carstens, the finance minister, recently compared its circumstances with those of Spain in the early 1980s), the reality is that the economy will need to grow much faster if it is provide work for the more than 12m families that currently earn a living in the under-productive informal economy.

GEA, in fact, estimate that Mexico will need to grow by 6 per cent a year – something that has not occurred since 2000 – and on a sustainable basis, just to absorb new entrants to the labour market. Formal unemployment may not be rising much but only because 400,000 Mexicans a year are emigrating – mostly illegally – across the northern border.

Part of the problem is that under Mr Fox, Mexico made no real progress in pushing through structural reforms. Labour markets also remain inflexible, inhibiting the ability of business to respond to shifts in demand. Virtual or actual monopolies in areas such as telecommunications and electricity mean that services are expensive. Telecommunications – still dominated by Telmex and its mobiles subsidiary, América Móvil – is perhaps the most controversial.

"They regard it as an accomplishment that tariffs have not increased when elsewhere in the world they are coming down," says Mr Rubio. Business is also frustrated by the complicated and time-consuming tax system and the weakness of the judicial and police apparatus. Notwithstanding Mr Calderón's high profile initiatives against the drugs trade, violence has shown no let-up in recent months, with 677 officials killed by drugs mafias in the first three months of 2007 compared with 480 in the same period of 2006.

For all these reasons, even though Mexico has become more financially stable over the past decade, it continues to lose ground in the annual league tables that measure competitiveness compiled by the likes of the Switzerland-based IMD, the World Economic Forum and AT Kearney. According to the IMD's World Competitveness Yearbook, Mexico fell from 36th place in 2000 to 53rd in 2006.

Mr Calderón seems more committed than his predecessor to push through the structural changes that Mexico needs. But in spite of his positive start, analysts point to numerous potential pitfalls as he moves to press ahead with the reform agenda. Constitutional restrictions could limit Mr Calderón's room for manoeuvre in the battle to trim back the power of the monopolies. In congress, relations with the PRI will require careful management, particularly since the former monolith is much more fragmented than it once was. Moreover, Mexico may be more independent than it was but it would still be vulnerable to a sharper than expected slowdown in the US economy or a fall in the oil price. As Mr Hope puts it, "overconfidence could prove to be the most dangerous enemy this government faces over the next few months".