Economic Update: The economy should pick up in the second half of the year
August 2003

1. Overview

Since NAFTA entered into force on 1 January 1994, Mexico's economic performance has been increasingly associated with the ups and downs of the US manufacturing sector. The ongoing stagnation of the US industrial sector continued to affect in a negative way the performance of Mexico's economy during the second quarter of the year, although the central bank, Banco de México, expects the economy to pick up in the second half of the year.

Like many other countries in the world, including Latin America, the performance of the Mexican economy is particularly vulnerable to the international environment. The Mexican government continues to pursue new business opportunities abroad, using bilateral free trade agreements (FTAs) to support the country's export sector, a major driving force of the economy. Mexico has signed FTAs with 34 countries, including those of the European Union, EFTA, Israel, most of Central and South America, NAFTA, and the government expects to finish the latest one, with Japan, in early 2004. There are other ongoing negotiations.

The government of President Vicente Fox has been able to keep most macroeconomic variables healthy and in check, which granted Mexico's the investor grade in 2001, and it has remained with no variations since, contrary to other Latin American countries.

As soon as North America starts growing again, Mexico is strategically positioned to experience high rates of economic growth. The government remains applying a mix of policies through fiscal discipline, responsible management of public debt, and prudent execution of monetary policy. It all has translated into **(1) low inflation**, **(2) low interest rates, (3) stability of the exchange rate**, **(4) historic high levels of international reserves, (5) significant reduction in country risk**, and **(6) larger inflows of foreign direct investment (FDI)**.

2. International Environment

The recent improvement in consumer confidence in the US and the bright perspectives of the international equity market have not been enough to encourage the manufacturing activity to increase and promote a reduction in the unemployment rate in the US, Mexico's major trading partner. The continuing stagnation in the US industrial sector translated into a real decline of **5.2%** in Mexico's manufacturing production during the April-May period of 2003. This result is mostly attributed to the problems faced by the automobile industry, a key sector of the economy.

In the second quarter of 2003, the US economy grew **2.4%.** Banco de México is confident the performance of the Mexican economy will improve as long as the trend continues.

Figure 1. Mexico's Historic Macroeconomic Variables (1994-2002)

	GDP growth	Inflation rate	Interest rate	FDI*
1994	4.4%	7.1%	14.1%	9.7
1995	-6.2%	52.0%	48.8%	7.0
1996	5.2%	27.7%	31.4%	6.3
1997	6.8%	15.7%	19.8%	10.4
1998	5.0%	18.6%	24.8%	6.0
1999	3.6%	12.3%	21.4%	10.1
2000	6.6%	9.0%	15.2%	12.5
2001	-0.2%	4.4%	11.3%	23.2
2002	0.7%	5.7%	7.1%	7.7

* Billions in US dollars.
Source: Banco de México, INEGI, Secretaría de Economía

3. Real Economy

The Global Economic Activity Index (IGAE), a monthly indicator of GDP-related activity, experienced **no change** in May 2003 compared with May 2002 (Figure 2). However, the seasonally - adjusted figure suffered a contraction of **0.53%** with respect to April 2003. On the other hand, employment in the key in-bond (maquiladora) sector started to grow again.

Figure 2. Global Economic Activity Index January - May 2003 (year-to-year real variation)

Economic Activity	Var. %
Total	**0.0**
Agriculture	**0.6**
Industrial	**-2.3**
Mining	3.9
Manufacturing	-3.5
Construction	1.2
Electricity, gas, and water	1.0
Services	**1.1**

Source: INEGI

Unemployment continues to grow. According to the Mexican National Statistics, Geography and Information Institute (INEGI), the source for most official data in the country, the unemployment rate reached **3.41%** in June 2003, higher than the **2.81%** observed in May 2003, and higher than most expectations.

President Fox reacted immediately to the news, asking all 32 governors to come up with plans to create new jobs in the short run. The tight conditions of the labor market help to explain the reduction in retail sales, which slowed down, from **3.6%** on the first quarter of the year, to **0.4%** in the 2003 April-May period. Still, sales were higher in the northern half of the country.

The most recent monthly survey that Banco de México applies among 30 leading analysts from the private sector shows that economic growth for the second and third quarters of 2003 are expected to be **0.79%** and **1.96%** respectively. However, these figures remain subject to the performance of the international economy.

Banco de México forecasts GDP to grow **2.0**% in 2003, although most private sector analysts expect this figure to fall between 1.3 and 1.8% (Figure 3). For 2004, Banco de México expects GDP to grow **3.61%**, which would be a high for the government of President Fox.

Figure 3. 2003 Economic Expectations of the Finance Ministry and Private Sector Analyst

Concept	Private Sector	Ministry of Finance
GDP)	**1.3 – 1.8**	**2.0**
Inflation	**3.79**	**3.0**
Peso / US dollar exchange rate (end of 2003)	**10.68**	**10.1**
28-day Cetes rate (end of 2003)	**6.19**	**7.5**
Public deficit/GDP	**0.53**	**0.5**
Current account (billion US dollar)	**-14.1**	**-18.0**

Source: Banco de México and Ministry of Finance

Expectations on inflation are now very similar between the private sector and the central bank for the first time in 37 months. Banco de México makes weekly adjustments to the liquidity limits for all commercial banks, which remained unchanged throughout the first August fortnight. There is a difference in the expectations on the end-of-the-year peso/US dollar exchange rate. The market does not consider possible the central bank estimate, while private sector analysts do not expect any significant deviation for the rest of the year from the current level, as the peso has absorbed all international shocks.

4. External Sector

Mexico's international trade has been adversely affected by the weakness of both domestic and external demand. During June 2003, the trade balance registered a deficit of **US$ 211 million**. This deficit was significantly lower than the **US$ 295.2 million** registered in May 2003.

During the first semester of 2003, the deficit reached **US$1.6 billion**, **47.4%** lower than the one reported during the same period in 2002.

For the first semester in 2003, the total value of imported goods and services was **US$ 81.5 billion,**. this is, **0.5%** higher than the one for January-June of 2002.

On the other hand, during the first semester of 2003, the total value of the exported goods and services was **US$7 9.9 billion**, **2.4%** higher than the one during the first semester of 2002. While the oil-related exports increased **41.2%**, the rest decreased **1.2%**.

One of the consequences of a smaller demand for imports, and the relative stability of the price of the Mexican oil mix, is that international reserves continue at an all-time high, above **US $50 billion**. The amount of reserves sold by Banco de México at periodic auctions remains subject to the actual level of reserves available.

5. Financial Sector

The year-to-year inflation rate for June 2003 was **4.27%**, lower than the **4.7%** for the May 2002-May 2003 period.

Expectations among private analysts for the 2003 inflation rate have fallen under 4% and they are quite in line with those of the central bank. In July, the average expected rate was **3.79**%, down from **4.01%** in June.

On the other hand, at the end of July the leading 28-day CETES (Treasury bonds) interest rate was **4.14%**, **21 basis points** lower than the one in May. The consensus for the expected 28-days Cetes rate within the private sector analysts by the end of 2003 is **6.19%**, **30 basis points** lower than the forecasted the previous month. By the end of 2004, it is expected the rate will remain under 7%, at **6.50%.** While commercial banks hasvestarted to provide loans to the industry, reversing a three-year trend, demand remains high.

After some swings during mid-July, the peso-US dollar exchange rate became stable again around 10.50 late last month. At this point, market analysts expect to see mostly lateral movements for the rest of the year and see the peso move smoothly to the 10.65 band by the end of the year.

The Mexican Stock Index (IPyC) closed July at **7,320** points, this is, an annual rate of return of **19.5%.** Most major companies, like Bimbo, America Movil, Grupo Modelo, Cemex, and Walmex (Wal-Mart), reported excellent results for the second quarter by the end of July, raising hopes for a better performance of the economy during the second half of the year.

The favorable perception on Mexico's country risk is being mirrored by a continuing decrease in sovereign spreads and a reduction in the JP's Morgan Emerging Markets Bond Index (EMBI+) from **230 basis points** at the end of July, to **231** at the end of June 2003. Ratings by other agencies and international investment banking houses offer a positive outlook.

6. Public Finances

As a result of the favorable developments in the price of the Mexican oil mix in the international market, and the increase in non-recurrent revenues, the fiscal balance improved. During the first half of 2003, the public sector overall balance accumulated a surplus of **62.2** billion pesos, **147.2%** higher in real terms than the surplus registered in the same period in 2002.

The public sector primary balance (total public sector revenues less expenditures other than interest payments on public debt) had a surplus of **164.9** billion pesos for the first six months of the year. Still, the government is due to make most of its expenditures during the second half of the year, which will bring this surplus very close to zero. Banco de México forecasts a public sector deficit of **0.53%** of GDP in 2003 and **0.54%** in 2004, in line with current fiscal behavior of the Fox Administration.

7. What to look for this month

Mexico remains committed at improving competitiveness, reducing red tape, protecting private property, and expanding international markets to increase investment flows. Most governors will submit their plans to create new jobs in August.

Congress will finish this month the assignment of presidents for commissions among the seven parties represented in order to start on September 1st. The government has started talking to the leaders of the political parties in order to ease the way to get approval for the energy reform.