### The Scouting Report – Mexico's Economy *Politico* Senior Editor Fred Barbash and Leonardo Martinez-Diaz March 11, 2009

**12:30 Fred Barbash-Moderator:** Our guest today is Leonardo Martinez-Diaz. An international political economy fellow, he focuses on the emerging economies, and the role of banking and finance and global governance. He is Deputy Director for the Partnership for the Americas Commission.

Welcome Leonardo. And welcome guests. Let's get started.

**12:30 Leonardo Martinez-Diaz:** Hi, Thanks for having me.

**12:31 [Comment From Laurie, Washington, DC]** What links the Mexican economy so closely to ours? Is it their reliance on the U.S. as an export market?

**12:32 Leonardo Martinez-Diaz:** Trade is a major link. Some 85% of Mexican exports go to the United States. However, there are other important links. Mexican workers living in the U.S. send some \$20 billion back to Mexico every year. Mexico also receives about half of its foreign direct investment from U.S. investors. And finally, the US and Mexican financial systems are linked closely.

**12:32 [Comment From Ron, Bethesda, MD]** Did Mexican banks make the same sort of disastrous decisions U.S. banks made? Is there a Mexican equivalent of the subprime housing crisis? Is there a credit squeeze there too?

**12:35 Leonardo Martinez-Diaz:** First thing to remember is that about 80% of the Mexican banking sector is actually owned by foreign banks, such as HBSC, Citigroup, and the Spanish Santander and BBVA. Luckily, most of those banks (except Citi) have not been hit too hard. Also, the Mexican subsidiaries were run mostly independently of the parents, and they did not get lots of exposure to toxic assets. The banking system is well capitalized and in much better shape than in 1995, when the last crisis hit.

**12:35 [Comment From Heather]** Can you quantify the severity of the knock-on effect of loss of remittances on top of decreased trade, etc...? What are your growth forecasts for this year and next and when do you expect the recovery to begin?

**12:37 Leonardo Martinez-Diaz:** Remittances fell by about 3% year on year. This is the first time they have fallen since records began to be kept in 1996. On the upside, the falling value of the peso means that these remittances are stretching farther. On the downside, as Mexican workers lose their jobs in the U.S., remittances will fall further. On growth, the latest forecasts are a 1.5-2.5% contraction in the Mexican economy for 2009. A lot depends on what happens here.

**12:38 [Comment From Xan, Alexandria, VA]** I've already heard some commentators say that we should be watching Mexico as a possible "failed state," because of the economy, the political instability, the drug violence. Is it really that dire?

**12:42 Leonardo Martinez-Diaz:** "Failed state" has been used a lot lately. Mexico was put in the same category as Pakistan in a recent study by the US military. However, this

is quite overblown, in my view. The drug violence is indeed quite serious. Over 4,000 people were killed last year alone. However, about 60% of that violence took place in three Mexican states, and most of that violence took place in three border cities. In other words, the violence is very concentrated geographically, and it is being contained. Drug violence is not disrupting the major financial and business centers. Also, the Mexican government has lots of resources at its disposal to fight the cartels, and there is little threat that the violence will disrupt the federal government. That said, things will probably get worse before they get better. The Merida Initiative could help at the margins.

**12:42 Fred Barbash-Moderator:** Is there a significant "investor class" in Mexico--as there is here with 401(k) plans, for example, and if so have those individuals and families experienced a comparable decline in asset values? What might be the political consequences of this?

**12:45 Leonardo Martinez-Diaz**: Well, access to financial services in Mexico remains limited, and the percent of the population that could be called an "investor class" is probably less than a quarter of the population. In the past decade, Mexican consumers have been offered all kinds of new financial services, but these are mostly consumer loans and mortgages and such. Many workers do have private pension funds, and these have lost value along with the stock market. However, this is unlikely to have major consequences. Most people had no assets to lose, and the rich have hedged by putting their money elsewhere.

**12:45 [Comment From Heather]** How do you think the government will resolve the ownership issue with Citibank's ownership of Banamex?

# 12:45 Leonardo Martinez-Diaz: Good question.

**12:48 Leonardo Martinez-Diaz:** There are a couple of complexities here. Citigroup owns 100% of Banamex, Mexico's second largest bank. Citi, as you know, is in deep trouble, and there is talk that the US regulators might take it over. This would be a problem, because Mexican law forbids foreign governments from winning domestic banks. So I suppose negotiations would have to take place if Citi gets taken over. Citi might be forced to sell Banamex (Brazilian banks are loving the prospect), or some other, legally imaginative, arrangement might be devised to keep Banamex in Citi's hands. Citi wants to hold on to the Mexican bank, as it is in good shape and it has proven to be extremely profitable.

**12:48 [Comment From Julia, Washington, DC]** Latin American countries experienced sharp reductions in poverty and improvements in inequality in the past years. What was Mexico's accomplishment in this area? How will the financial crisis hit the poor in Mexico? Is the government taking any actions to protect this segment of society?

#### 12:48 Leonardo Martinez-Diaz: Very important question, Julia.

**12:51 Leonardo Martinez-Diaz:** Since the 1995 crisis, Mexico has seen significant reductions in poverty. Part of this was simply several years of sustained economic growth, but targeted cash-transfer programs from the government have also helped. The crisis will hit the poorest in several ways. Unemployment is a major concern, especially in the informal sector, where there is no safety net. Remittances, which are

essentially dollar-denominated welfare payments, are declining. And as inflation increases, the poor will see rising prices in food and fuel. The government has frozen energy prices for the time being, but it will find it difficult to keep doing this for much longer.

### 12:51 [Comment From Nicole]

What is Mexico doing to diversify its trading partners and reduce dependency on the US? Is it doing enough?

**12:51 Leonardo Martinez-Diaz:** This has been a major question in Mexico for at least 100 years.

**12:54 Leonardo Martinez-Diaz:** Mexico's close connection to the US economy is a huge asset most of the time, but sometimes (like now), it can be a major vulnerability. For a long time, governments have been trying to diversify. They have tried to find new markets and lure investors from Japan and Europe, but the gravitational pull of the US economy has been too great. In recent years, Mexico has had more luck exporting to other developing countries, including many in the rest of Latin America, which it has long ignored. Mexico is also looking to Brazil, exploring possible complementarities. Perhaps this crisis will help spur diversification.

**12:55 [Comment From david, clearwater, FL]** With the infamous violence in Mexico, tourism has fallen off. How much? How destructive to Mexican economy?

**12:55 Leonardo Martinez-Diaz:** Very pressing question, as you can imagine.

**12:58 Leonardo Martinez-Diaz:** Tourism is a major source of foreign exchange for Mexico, and it's a major industry. On the downside, the crisis in the US will lead some US tourists to tighten their belts. (American tourists are by far the largest category of tourists to Mexico). The security situation, and the lurid news stories, have not helped. On the upside, the weakening peso will attract U.S. tourists. This is why tourism numbers have been up this year. Also, the famous tourist destinations (Cancun, Puerto Vallarta, Acapulco) are largely untouched by the violence, so they will suffer less. Tourism in border towns will suffer most, because as I mentioned, this is where the real violence is taking place.

**12:58 [Comment From Lester]** Is there going to be a Mexican version of our economic stimulus plan?

**1:00 Leonardo Martinez-Diaz:** Yes, its already in place. It will amount to 1-1.5% of GDP and, like here, it will have a strong infrastructure component. The problem is that such projects take time to go online, and that they will reach only certain sectors of the economy. However, the economy needs all the help it can get.

**1:01 [Comment From Aaron]** Will corruption increase as Mexicans become more and more desperate for income?

**1:03 Leonardo Martinez-Diaz:** Corruption has long been a concern in Mexico. In the past 15 years, progress has been made in this area. There are more watchdog agencies, transparency has increased (a Freedom of Information Act has helped), and citizens are more likely to demand their rights and not pay bribes. However, the crisis

could set this back. Already, there are indications that less people are reporting income taxes, and the amount of tax evasion could increase significantly. The same may happen with other kinds of taxation.

1:03 Leonardo Martinez-Diaz: This will add to the government's fiscal headaches.

**1:04 [Comment From Jess]** What type of impact will the current situation in the US and Mexico have on free trade agreements like NAFTA and others? What's Obama going to do in relation to these agreements?

**1:06 Leonardo Martinez-Diaz:** As you recall, NAFTA was in the headlines a lot during the campaign, especially talk of renegotiating NAFTA. The crisis will have a negative impact on trade in general, not just NAFTA. Already, there are indications that countries are becoming more protectionist, raising tariffs and increasing anti-dumping measures. The "buy American" provision in the stimulus package was widely seen as a protectionist move. In this context, the talk of renegotiating NAFTA will become more complex. Before, the focus was on labor and environmental standards. Now, we're talking about the meat of the agreements--tariffs and other barriers.

**1:07 [Comment From Ron]** Do you think that keeping the U.S. auto industry afloat is important in making sure that the Mexican economy doesn't fail?

**1:07 Leonardo Martinez-Diaz:** This is a good follow-up to the NAFTA question.

**1:09 Leonardo Martinez-Diaz:** US automakers have extensive manufacturing facilities in Mexico. Not just auto parts, but assembly. Auto production fell by over 50% in January, year on year. So Mexico is feeling Detroit's pain, and it will get worse. Luckily for Mexico, it has also been successful in attracting German and Japanese automakers to set up plants in Mexico, which is relatively cheap in terms of labor costs and close to the US market. The crisis in Detroit will probably change the patterns of investment and auto production in Mexico in the future.

# 1:10 [Comment From Mark]

You say that when the U.S. sneezes, Mexico gets pneumonia, but is there any reverse effect? Does the downturn in Mexico have any effect on what's happening to the U.S. economy?

**1:10 Leonardo Martinez-Diaz:** This is an interesting question.

**1:12 Leonardo Martinez-Diaz:** Remember that Mexico is about 1/20th of the size of the US economy, and that because it so closely connected to the US economy, the impact tends to flow in the direction of Mexico. Having said that, the fact that lots of US companies have operations in Mexico means that Mexico can help US companies regain competitiveness. If Detroit and other US corporate capitals get their act together, they can use the Mexican production base effectively to help the US economy recover.

**1:13 [Comment From Torrey; Tampa, FL]** Over recent years, the Mexican federal government has invested heavily in the land, sea, and air transportation infrastructure. Does the federal government have enough cash reserves to complete the current projects and still provide a "reasonable" stimulus package?

**1:16 Leonardo Martinez-Diaz:** I believe that infrastructure, especially that connecting the US and Mexican markets, will be critical for the future of the Mexican economy. And as you point out, the current and past administrations in Mexico get this. But the fiscal constraint will be serious. This year there will be some money for these projects, in part because tax revenue was better than anticipated and because Mexico has been able to hedge on the price of oil, so it will not suffer too much this year from the fall in the oil price. However, in 2010, the fiscal situation will get much worse, as the full impact of the oil price will hit Mexico, tax revenue will decline, and getting credit abroad will be more difficult. Big ticket items will have to be off the table for a while.

**1:16 [Comment From Lester]** What do you think should be the U.S.'s involvement in helping the Mexican economy?

1:17 Leonardo Martinez-Diaz: An important and sensitive political question.

**1:18 Leonardo Martinez-Diaz:** In 1995, you will recall that the US helped put together a multi-billion rescue plan for Mexico. Pres. Clinton used an obscure fund to make this happen, as Congress refused to give him the money. Clinton paid a big political price, but it worked out in the end. The package helped Mexico get out of the crisis, and the US got its money back with interest, early. What is different now?

**1:20 Leonardo Martinez-Diaz:** Things are not as serious this time. The Mexican banking system is in much better shape, so a banking bailout is unlikely. What the US can do to help is two things: provide an emergency swap line to lend Mexico dollars quickly, in case of an emergency (this swap line is already open). And two, it should use its influence in the IMF and World Bank to help Mexico get emergency financing if it needs it.

**1:20 [Comment From Katie; Washington, DC]** Drug sales in the United States generate an estimated \$15-\$25 billion for Mexican drug cartels each year, paid in the form of bulk cash and in arms. Many say this allows the cartels to continue their fight against the Mexican government. What policies can the U.S. government change or enact to stop this unintentional funding of the drug cartels?

**1:21 Leonardo Martinez-Diaz:** Well, this is also a sensitive political issue, one in which I feel the political debate is moving forward.

**1:24 Leonardo Martinez-Diaz:** Ultimately, the only way to deal with the drug problem is to cut consumption. After years of fighting the "war on drugs" with few results, many in Washington are rethinking the options. We need better drug education programs (a redesigned DARE). Drug courts have also been touted as a good, innovative solution. The other policy that could help is controlling the flow of arms south, as well as the availability of guns along the border. The Obama administration has already endorsed this idea.

**1:25 [Comment From david, clearwater, FL]** Do you think that things can ever reach the point in Mexico that vast numbers of its citizens will flee north to the US for sanctuary?

**1:26 Leonardo Martinez-Diaz:** Short of a major ecological catastrophe, I don't think so. But let's talk about the impact of the crisis on immigration.

**1:29 Leonardo Martinez-Diaz:** I haven't followed these numbers recently, but in general, we know that Mexican migration to the US tends to follow the US business cycle quite closely. So we can safely expect migration to fall, with a small time lag. In the last crisis, many people left Mexico because Mexico's economy was tanking, but the US was doing fine. Now Mexico is in trouble, but things in the US are worse. So the calculation has changed for many migrants. As soon as things appear to get better in the US, numbers will pick up. Immigrant networks are very good at communicating information about the availability of jobs back and forth across the border.

1:29 Fred Barbash - Moderator: I think we have time for one more question....

**1:30 [Comment From Samantha, Washington, D.C]** Do you expect any significant reversal of the trend towards integration between the US and Mexico as a result of the crisis? How is Mexico's role in the global supply chain likely to change?

**1:30 Leonardo Martinez-Diaz:** This is a really interesting question, as we have touched it partially above. A couple more thoughts...

**1:33 Leonardo Martinez-Diaz:** As I mentioned, the crisis could offer non-US investors an opportunity to expand their holdings in Mexico and use it as a launching pad into the US market. Brazilian banks want to enter Mexico if Citi leaves, penetrating a major market and potentially using it as a bridge to enter the US market. Non-US car companies could expand their capacities in Mexico as Detroit declines. And perhaps other investors, which before chose to invest in China, might be lured into Mexico as a result of a declining peso, which makes investments cheaper and Mexican exports more competitive. In short, the Mexican economy could become less dominated by US investment, but it will remain oriented toward the US market.

**1:33 Fred Barbash-Moderator:** Leonardo: Thanks so much for doing this Q & A, which was enlightening for all of us on an important topic. And thanks to all our guests as well.

1:33 Leonardo Martinez-Diaz: Thank you. This was a pleasure. I had lots of fun.