The Euro Crisis And the Mexican Economy

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Alex Domanski/REUTERS

The crisis in the eurozone has been at the center of international economic concerns since late 2009. The financial turbulence associated with the public debt crises in Portugal, Ireland, Italy, Greece, and Spain (known as PIIGS) have affected stock market indices and credit and banking institutions globally, as well as investor and consumer confidence levels in practically all countries in 2010 and 2011.

The epicenter of this crisis has been Greece, which constitutes 3.8 percent of the eurozone's gross domestic product (GDP). The prolonged negotiations between Greek authorities and officials from the International Monetary Fund (IMF), the European Central Bank (ECB), and the European Union (EC) about the austerity measures required for Greece to be able to receive a financial bailout of 160 billion concluded last February.

On February 12, amidst Molotov cocktails, tear gas, looting of stores, burning buildings, and the partial break-up of the coalition government, the Greek Parliament approved a new austerity program imposed as an unequivocal condition by the ECB, the EU, and the IMF for turning over the second bailout payment (the first payment, €110 billion, was doled out in May 2010).

On February 15, the Panhellenic Socialist Party (PSP) and the New Democracy Party gave their written guarantee to eurozone authorities of their commitment to respect the austerity plan if either of them won next April's elections. The plan consists basically of 3.3 billion in cutbacks; immediate lay-offs of 15 000 public employees, with a total of 150 000 over three years; a 20-percent cut in the minimum wage; and cutbacks in pensions. This, in a country that is now entering its third year of recession, with 21 percent unemployment —43.5 percent in the case of young people— wages that have dropped 20 percent, a foreign-trade deficit equivalent to 7.6 percent of GDP, and a public deficit of 9.1 percent of GDP (1.4 percent less than the one that existed at the time of the first austerity program and bailout package).

Finally, on February 20, the financial bailout was granted, at the same time that Greece's public debt was reduced by a discount of around €100 billion, negotiated with its creditors, putting its total debt at €206 billion.

What can be expected of the euro crisis after these agreements?

What can Mexico expect from the winds blowing across the Atlantic in the coming months of the continuing European storm?

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Facets of the Euro Crisis

The euro crisis has three facets: first, what has been called the "sovereign debt" crisis; second, the European banking system's great fragility; and lastly, the slow-down and eventual recession of the 17 economies that are members of the eurozone —and in fact, of all the European Union's 27 economies.

The so-called sovereign-debt crisis reached its climax with the recent events in Greece, but by no means did it end there or in Italy, Portugal, or Spain, whose economies will require a reduction in their fiscal deficit under recession conditions, and without being able to use a depreciation of their currencies to reactivate their competitiveness. To these macro-economic restrictions will be added the social tension and political conflicts sparked by the crisis and recessive policies.

The European banking system's fragility stems from its excessive exposure to public debt securities, particularly by the French and German banks in the last decade. The weakened state of Europe's banking system was thrown into relief the first two weeks of this year when banks deposited the highest amounts in history (€490 billion) in the ECB at overnight rates of 0.25 percent, instead of depositing them in the interbank market at 0.37 percent, while the cost of money is 1 percent for a deposit with a three-year maturity. This means that the banks prefer to maintain "liquidity cushions" given the low confidence levels in being able to recover interbank loans.

In the first quarter of 2012, the European governments will have to pay more than €457 billion in sovereign debt. Of that, Italy owes €113 billion and Greece, €14.5 billion. The possibility of Greece defaulting seems to have been avoided for the moment. A default by Italy would be a catastrophe that would cause the banking system to implode. In November 2011, European leaders declared that Italy was "too big to fail," given that it represents 18.5 percent of the eurozone's total GDP, the third economy after Germany and France.[1]

The third facet of the euro crisis is the recession. In addition to Greece and Portugal, which have been in recession since 2010, at the end of 2011 Belgium, Holland, and Italy were added to the list of European economies whose GDP had dropped in two consecutive quarters. EU authorities, perhaps with calculated optimism, think that at least for the first half of 2012, the rest of the EU countries will go into a "moderate recession," with an average annual drop of 1 percent over the eurozone as a whole.

> One of the main impacts of the euro crisis has been the reduction of economic growth expectations worldwide.

Depending on the depth of that recession in each country, especially the PIIGS, the public debt crisis and the banking system's fragility could be accentuated: because of the crisis, which the austerity policies will deepen, the governments will not be able to pick up enough revenue to pay for their bonds when they come due.

Until now, the ECB has favored "orthodox" policies that have sharpened the economy's recessive tendencies,[2] but an increasing number of voices in Europe are questioning this way of dealing with the crisis and suggesting they do what the U.S. Federal Reserve did in 2008 and 2009 when it acted as last-resort rescuer of the banks and insurance companies, injecting massive amounts of liquidity (known as quantitative easing), loans to banks in trouble, and massive purchases of debt and toxic assets.[3]

In line with the argument that European monetary authorities should play a more active role in dealing with the crisis, some even suggest they implement an inflationary policy to reduce the burden of the payment of the debt for governments, companies, and families, and thus lessen the economies' general decline. Others favor implementing a depreciation of the euro to foster exports and thus stimulate production.

Traditional ECB behavior changed in December 2011 when, in the face of the worsening Greek sovereign debt situation and its probable contagion of Italy and Spain, the ECB began what it called long-term refinancing operations (LTROs) in order to purchase public debt and inject liquidity (€500 billion) into the European banking system. Simultaneously, it proceeded to make more flexible conditions for accepting collateral for the lines of credit given to the banks.[4]

This change brought the markets temporary relief, reduced the costs of taking out debt for European countries in trouble, and, if this new kind of intervention by the ECB is confirmed, in the medium term, it could also be good news in terms of the perspectives for the euro crisis. It may not be good news if it is only an already tardy, momentary change, and, as a result, if 2012 becomes the year in which Europe enters into the maelstrom of massive fiscal adjustments-production crises-

defaults-banking crises. That would be a crisis that would shake the economic and financial world to its foundations and redefine the integration of the eurozone.

Banks with European headquarters could drain liquid assets from their branches in Mexico in order to have liquidity to face possible scenarios in which clients stage runs on their banks in Europe.

The Impacts of the Euro Crisis in Mexico

Up until now, the impact on Mexico of this crisis has been limited. It has mainly been confined first to the financial sphere, with a hike in the cost of placing government debt securities in the third and fourth quarters of 2011. Secondly, the exchange rate has been affected, with a devaluation of the peso *vis-à-vis* the dollar and the euro itself, moving from Mex$12.70 and Mex$17.50, to Mex$14.27 and Mex$18.94 respectively at the end of 2011. Thirdly, prices have risen with the peso/dollar exchange rate, key to the Mexican economy, and the inflation rate tends to rise, as happened in the last months of 2011. And fourth, the external sector has been affected because the depreciation of the peso tends to lower the price of exports and raise that of imports.

One of the main impacts of the euro crisis has been the reduction of economic growth expectations worldwide, in the United States, in Latin America, and, of course, in Mexico. Comparing 2011 to this year, what we will see is a global slowdown.

Taking into consideration the European recession, the United Nations Economic Commission for Latin America and the Caribbean (ECLAC) predicts that the Latin American economies will grow an average of 3.7 percent in 2012, compared to 4.4 percent in 2011. Its figures for Mexico come in at 3.3 percent for 2012, compared to 3.9 percent in 2011 (see Table 1).

If these growth expectations are compared with the predictions for GDP performance in Europe or the United States, Latin America is very far from a crisis. In fact, in the last summit in Davos, Switzerland from January 26 to 29, Latin America was dubbed an "oasis of growth, stability, and opportunities."[5]

In the case of Mexico, a 3.3 growth in GDP indicates that, after a 5.4 percent jump following the tumble caused by the U.S. 2008/2009 crisis, as Graph 1 indicates, the Mexican economy maintains its moderate performance levels for the last decade.

Mexico has followed a model of economic opening and de-regulation that has led to price, exchange-rate, and financial stability. At the same time, however, it has experienced sluggish production performance, and above all, insufficient creation of formal jobs.[6]

The open unemployment rate in December 2011 was 4.7 percent, comparing favorably with the high rates in the eurozone (10.6 percent at the end of 2011). Leaving to one side the important methodological and institutional differences in measuring unemployment, in Mexico, underemployment has reached major proportions. According to recent data from Mexico's National Institute of Statistics, Geography, and Information Processing (INEGI), the number of informal jobs (or the underground economy) rose from 12.8 to almost 14 million between the first quarter of 2010 and the last quarter of 2011. In that period, two out of every three new jobs were created by the informal economy.

The Mexican economy has lacked sufficient dynamism in recent years, creating an enormous social backlog; but its current monetary and financial stability, its low fiscal deficit, and the amount of its international reserves (US$145 billion)

Table 1

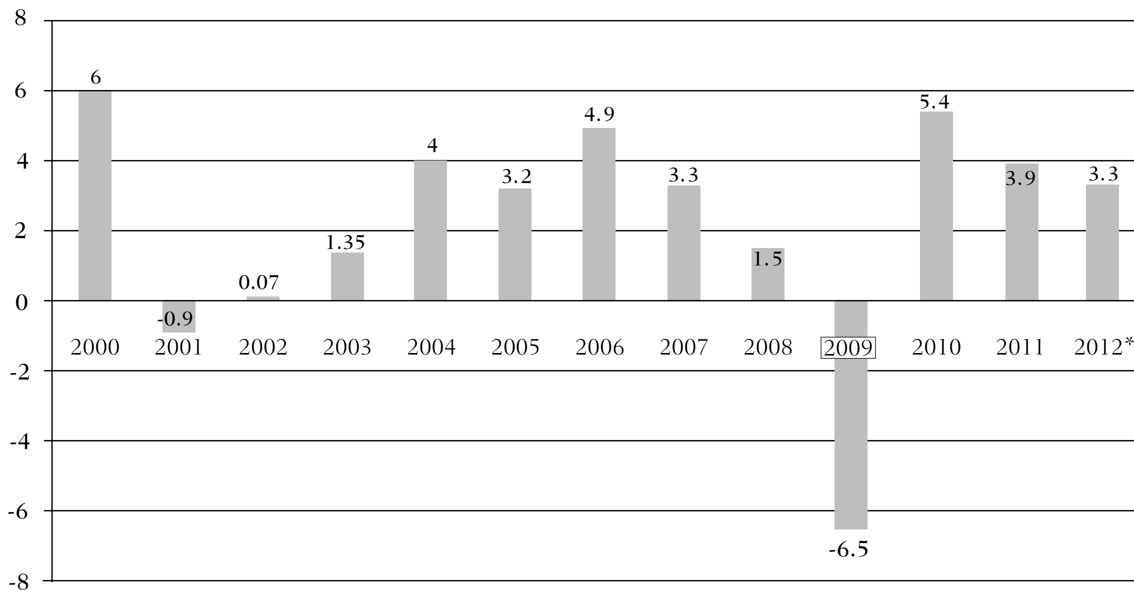
Latin America: Predictions of GDP Growth Rates 2011-2012 (%)

Country/Region	2011	2012
Argentina	9.0	4.5
Brazil	2.9	3.5
Chile	6.3	4.2
Mexico	3.9	3.3
Peru	7.0	5.0
Venezuela	4.2	3.0
Latin America	4.4	3.7

Source: ECLAC, "Balance preliminar de las economías de América Latina y el Caribe," December 21, 2011, http://www.eclac.cl/cgi-bin/get Prod .asp?xml=/prensa/noticias/comunicados/8/45478/P45478.xml&xsl=/prensa/ tpl/p6f.xsl&base=/tpl/top-bottom.xsl.

Graph 1

Mexico's Real GDP (annual rate of variation 2000-2012)*



* Data for 2012, projection.

Source: Developed by the author using INEGI data for 2000-2011; and for 2012, ECLAC, "Balance preliminar de las economías de América Latina y el Caribe," December 21, 2011, http://www.eclac.cl/cgi-bin/getProd.asp?xml=/prensa/noticias/comunicados/8/45478/P45478.xml&xsl=/prensa/tpl/p6f.xsl&base=/tpl/top-bottom.xsl.

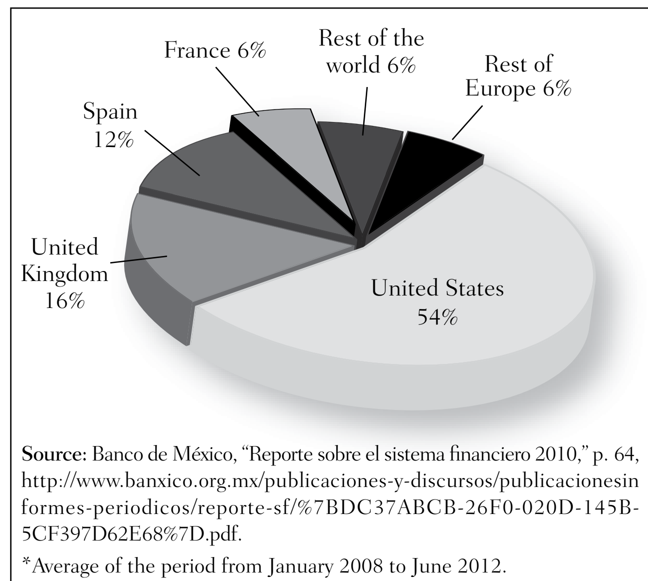
Changes prompted by lower Mexican exports to Europe are estimated to be marginal since the European market currently represents less than six percent of the country's non-oil exports.

will leave it relatively well-positioned to deal with the fallout from the European crisis. Initially, these effects will be cushioned by Mexican economic activity's high dependence on the U.S. cycle. These two conditions, both momentary and structural, will allow the Mexican economy to maintain margins of "de-linking" *vis-à-vis* the crisis in Europe. But even so, Mexico's economy will feel direct and indirect effects.

The indirect effects will be felt as the recession in the old continent slows down the U.S. economic recovery. Mexico's manufacturing sector and *maquiladora* export sector will be affected through trade channels. The changes prompted by lower Mexican exports to Europe are estimated to be only marginal since the European market as a whole currently represents less than six percent of the country's non-oil exports. Recent studies estimate that a one-percent drop in GDP in the eurozone would signify a marginal decrease of only 0.8 percent of

Graph 2

Exposure of Banks Operating in Mexico to Banks Abroad, by Country of Origin of the Counterpart*



Source: Banco de México, "Reporte sobre el sistema financiero 2010," p. 64, http://www.banxico.org.mx/publicaciones-y-discursos/publicacionesinformes-periodicos/reporte-sf/%7BDC37ABCB-26F0-020D-145B-5CF397D62E68%7D.pdf.

*Average of the period from January 2008 to June 2012.

those exports.[7] Also, a general decrease in the flow of European tourism to the rest of the world can be expected, but it will be offset in Mexico by two circumstantial factors that will bring in tourists from other places: the mid-year G-20 meeting slated for Los Cabos, Baja California Sur, and the intensive sale of promotional tour packages for the Mayan Zone because of "the prophesies about 2012."

Perhaps the most important direct effect of the European crisis on the Mexican economy may come from banking. As Graph 2 shows, the banks operating in Mexico are highly exposed to European banks, particularly from Great Britain and Spain. Given the credit crunch in the eurozone, banks with European headquarters could drain liquid assets —that is, money— from their branches in Mexico in order to have liquidity to face possible scenarios in which clients stage runs on their banks in Europe, as happened in Eastern Europe in 2009 and 2010. Something like that would have an impact on Mexico's banking system, raise the price of money, and accentuate the slowdown regardless of how the U.S. cycle performs.

In short, all this gives us an idea of the foreseeable impacts of the euro crisis on Mexico. It is impossible to estimate changes in foreign direct investment from Europe —erratic in any case— or the size and impact of any eventual withdrawal of European portfolio investments in the stock market or debt securities. Lastly, it should be mentioned that the scenarios sketched here for 2012 would vary drastically if the international economic context changes as a result of —from least to most likely— any stumble of the Chinese economy, greater deterioration of the stagnant Japanese economy, or the outbreak of military conflict in the Middle East. VM

Notes

[1] http://www.bbc.co.uk/mundo/noticias/2011/11/111111_euro_dilemas_.shtml.

[2] European Central Bank, *The Monetary Policy of the* BCE (Frankfurt: European Central Bank, 2011), 161 pp.

[3] J.J. Crespo, "Cuatro años de estrangulamiento crediticio y dos de eurocrisis," *Boletín Económico del* ICE no. 3018, Madrid, October 2011, pp. 27-37.

[4] Joaquín López-Dóriga O., "El BCE y su creciente papel en el alivio de la crisis europea," *El Economista*, January 25, 2012.

[5] http://www.eltiempo.com/economia/internacional/ARTICULO-WEB-NEW_NOTA_INTERIOR- 11023661.html, January 29, 2012.

[6] René Villarreal, "El modelo de apertura macroestabilizador. La experiencia de México," *Economía, teoría y práctica*, special issue, vol. 2, UAM, November 2009, pp. 11-41.

[7] Eduardo González and Sergio Luna, "Midiendo la exposición de México a la crisis de la zona euro," *Examen de la situación económica de México* no. 1019, vol. LXXXV, Banamex, November 2011, pp. 336-338.