Mexico Reacts to the Global Financial System

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Mexico, which like Canada has a floating currency and inflation-targeting policies, has been affected differently by foreign exchange fluctuations. But both countries may be rethinking their hands-off approach to currency management—and Mexico might decide not to cut rates.

Mexico and Canada, operating in the shadow of China's explosive growth as a buyer of commodities and seller of cheap manufactured goods, haven't been affected the same way by the tides of global trade. For example, while Mexico's currency has weakened, the Canadian dollar has grown stronger. We think that much of the variation in impacts stems from the substantial differences in the two countries' economies.

Commodity Exports vs. Manufacturing

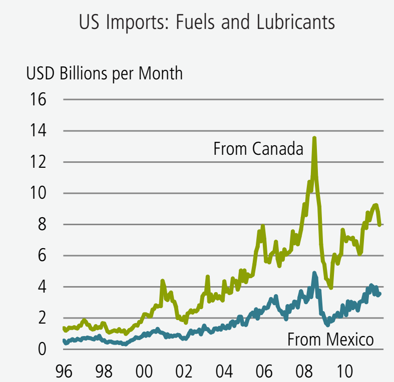
Mexico, which at one time depended heavily on crude-oil exports, has seen its oil production decline over time. What's to blame? A self-imposed requirement that PEMEX (the country's state-owned oil company) controls all oil exploration, combined with continual restrictions on Mexico's ability to obtain financing.

Canada, on the other hand, has seen a steady expansion of private-sector energy exploration into oil sands, oil shale and other high-cost areas. Supplying global markets, including China, with commodities has become an increasingly important part of Canada's international trade, and a replacement for manufacturing exports.

Mexico's growing stature as a low-cost manufacturing site is slowly supplanting its traditional commodity export orientation. Years of slow growth and modest wage hikes have combined with a weaker peso to leave Mexico's manufacturing sector with only slightly higher monthly wage costs than China's. Mexico has a much lower wage profile than Canada, an advantage that's helped guide investment and multinational expansion coming into North America toward Mexico. Increasingly, Mexico is focused on competing with China in manufacturing.

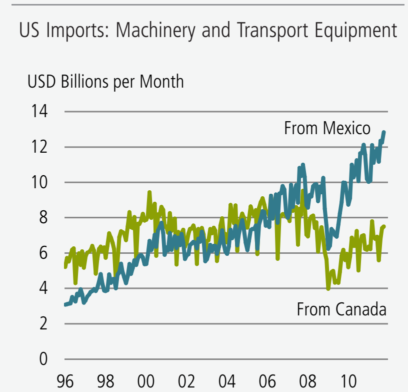
The different responses of Mexico and Canada to their economic opportunities can be seen in the makeup of their trade with the US. Canadian energy exports to the US have risen, and high energy prices have further increased the value of those

Display 1
Canada Leads in Energy Exports to US



Through December 31, 2011
Source: Haver Analytics and US Census Bureau

Display 2
Mexico Holds Advantage in Car Exports



Through December 31, 2011
Source: Haver Analytics and US Census Bureau

exports; Mexican energy exports haven't followed **(Display 1)**. However, Mexico's underperformance versus Canada's in energy trade is more than offset by the much faster pace of Mexican transport and machinery exports to the US **(Display 2, previous page)**.

Capital Flows React to Europe's Strains

While the trade accounts of Mexico and Canada reflect the impact of China's massive global footprint, capital flows reflect something else entirely—the deterioration in the credit standing of Europe's peripheral governments.

The decline in creditworthiness has set money in motion around the world as investors reposition their portfolios. Many sovereign wealth funds aren't allowed to put national assets at risk: the money that they pull from Europe is being redirected to perceived safer havens, notably Canada, with its increasingly rare AAA government-bond rating.

These flows overwhelmed, for a time, the growing difference in Canada's widening current account deficit compared with Mexico's **(Display 3)**, which has a much lower credit rating on its government bonds and doesn't benefit from a safe-haven perception.

Flows into Canada's bond market have been massive, especially when supplemented by the added demand from US investors, who face a shortage of high-quality bonds as a result of asset purchases by the US Federal Reserve through its quantitative-easing programs. After mid-2008, US investment in Canadian bonds skyrocketed while investment in Mexican bonds rose only modestly in comparison.

Rethinking a Hands-Off Currency Approach?

The long, relentless slide of the Mexican peso against the strengthening Canadian dollar took another downward leg last fall, as global risk aversion led to a broad sell-off in emerging currencies. Neither Canada nor Mexico intervened; officials of both nations have long embraced the view that currency movements are largely helpful in supporting national interest-rate policies.

But recent signals might point to a change in attitude. Mexico has finally acknowledged that the peso's weakness is a problem: it set a new policy of selling US$400 million whenever the peso falls more than 2% in a single day. That guideline replaces an option-based dollar-buying scheme that was designed to push the currency in the other direction.

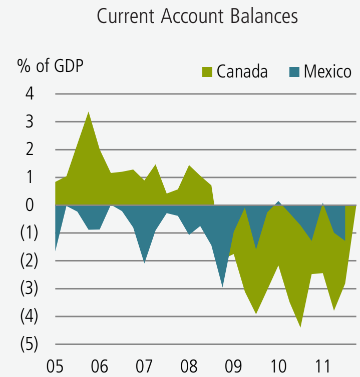
The Bank of Canada, meanwhile, has made clear that it considers the expensive Canadian dollar to be an even more important systemic influence on Canada than housing prices, which could be headed for a sustained boom. So, both Mexican and Canadian policies are moving to acknowledge the undesired effects of the recent currency extremes.

Rising Prices Could Be a Policy Factor

Also, Mexico's consumer-price-index-targeting framework has run into enough inflation pressure in the past month that rising prices may play a role in interest-rate policy decisions. In the minutes from the Banco de México's last meeting, officials acknowledged growing concern that peso weakness could become a source of unexpected inflation increases.

These concerns have grown in the past few months, stoked by higher food prices and a 3.8% annualized inflation rate—but also possibly due to the low value of the peso. As long as the Mexican currency remains weak, the central bank may have to forgo rate cuts, which the market had been expecting in response to possibly slower global economic growth.■

Display 3
The Bottom Line



Through October 1, 2011
Source: Banco de México, Haver Analytics, Instituto Nacional de Estadística y Geografía and Statistics Canada