Macroeconomic Analysis

Might Turkey affect Mexico?

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In the past few weeks Turkey has been through bouts of significant financial turbulence. The Turkish lira has depreciated by 22% in August and by about 60% so far this year. An event of this nature in an emerging economy usually has effects on other emerging economies. The fall of the lira has affected the majority of emerging currencies. South Africa and India have seen their currencies depreciate significantly. In Mexico, the peso has not escaped these effects and has experienced increased volatility.

In this situation it is worth asking: might the situation in Turkey have a significant contagion effect on the Mexican economy? It seems to me, for various reasons, that the probability is low. We should look first at the direct paths of contagion. In the case of Mexico in relation to Turkey, these paths are almost negligible. Mexico's exports to Turkey represent just 0.05% of its total exports, while imports of Turkish products account for 0.19% of Mexico's total imports. Investment flows are even less significant.

What about indirect pathways? These may come to the fore if there is an increase in the perception of risk vis-à-vis emerging markets in general.

In this case the phenomenon could be accentuated, since the US Federal Reserve is in a cycle of interest rate increases. I think that in the case of Mexico this possibility of indirect contagion is also limited. This is due to the fact that the country's fundamentals are solid and compare favourably with those of the majority of large emerging countries. In fact, we have seen that the currencies that have suffered most as a result of the Turkish situation have been those of countries with weak fundamentals, such as high rates of inflation or problems with external financing.

Although Mexico's inflation rate has increased since last year, it is single-digit, and expected to fall, unlike that of other emerging economies. As for the question of external financing, the country faces no significant challenges. The current account deficit is 1.8% of GDP, a manageable level which is financed entirely by FDI.

Furthermore, Mexico has already performed the task of increasing short-term interest rates, which at their current level represent one of the best choices, if not indeed the best, for risk-adjusted return among all emerging countries. Mexico's fiscal situation also compares favourably with that of other emerging countries. As I have mentioned on previous occasions, the country's level of public debt is not high. All these factors indicate that Mexico's fundamentals are robust compared with the universe of emerging countries, and that makes the risk that investors will decide to reduce their exposure to Mexican assets due to Turkey's problems relatively low.

But if the pathways of contagion are limited, why did we see volatility in the peso when problems arose in Turkey? The explanation is that the peso is a currency with high levels of liquidity, which allows investors to reduce their exposure to emerging markets faster. But this is reflected in short-term volatility. In fact the markets have reacted positively to Mexico due to the good prospects for NAFTA, and have not reacted negatively to the more restrictive monetary policy in the US or the Turkish situation. The result is that the peso is the only emerging currency to have appreciated so far this year.

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