Manuel Sánchez: Three issues for Mexico's economic outlook

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the United States-Mexico Chamber of Commerce, New York, 14 July 2011.

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I would like to thank the United States-Mexico Chamber of Commerce for the opportunity to share some of my thoughts on the Mexican economy, including both the conditions it faces currently and its outlook. I will focus on three questions which have recently gained particular importance, in the hopes of shedding some light on possible answers. First, do recent indicators of moderation in Mexico's economic activity substantially change its growth prospects? Second, are capital inflows to the country bound to continue, and if so, will they generate any financial problems? And third, what are the main challenges to the consolidation of price stability in Mexico? These comments, of course, are my own responsibility and do not necessarily represent those of the Bank of Mexico.

Current and future economic conditions

As you know, since the second half of 2009, along with the world economy, Mexico has been undergoing a process of economic recovery. The upturn has included positive annual growth rates for the industry and services sectors, which together account for approximately 94 percent of GDP. As a result, by the beginning of 2011, the levels of the monthly Global Economic Activity Indicator (IGAE) and of these two main components surpassed their corresponding values prior to the global financial crisis.

The improvement of economic conditions has occurred in tandem with the recovery in the United States, Mexico's main trading partner. This has been particularly clear in view of the rebound of U.S. industrial production, which maintains a remarkably high correlation with Mexican industrial production through its manufacturing-export component. Hence, the initial engine of the upturn was external demand through highly dynamic non-oil exports, which account for more than 80 percent of total exports and include a high proportion of automotive exports.

Domestic demand in Mexico has also been in the process of recovering although at a less impressive pace. In particular, consumption, as measured by monthly retail sales, started to exhibit a clearer path of growth only since the middle of 2010. Among other factors, this lag may reflect unemployment rates which, on average, have been approximately two percentage points higher than their corresponding average before the crisis.[1] It may also reflect the deterioration of real wages, which has partially reversed course in recent months. Both factors may contribute to an explanation of relatively depressed levels of consumer confidence. On the other hand, gross fixed investment has shown a moderate rebound in all major components, especially construction. Business managers appear to be reacting cautiously to the atypically slow recovery of the global economy and uncertainties over the extent of future expansion.

Some less encouraging recent data point to the possibility that the Mexican economy has entered a weaker growth phase. In particular, GDP in the first quarter exhibited lower seasonally adjusted growth than in the previous quarter, including deceleration in the industrial sector. The slowdown in Mexican industrial production coincides with that observed in the world economy, heavily influenced by factors that may be transitory. These include

[1] The average national unemployment rate was 3.4 percent from 2000 to 2008 and 5.4 percent since 2009.

high oil prices, reflecting political tensions in some oil-producing countries, and supply-chain disruptions resulting from the tragic events in Japan last March. Oil prices fell during the second quarter, and recent developments as well as the reconstruction efforts underway in Japan seem to point toward a possible V-shaped recovery in that nation. Partly as a result of that, Mexican industrial activity and motor vehicle production, in which Asian manufacturers participate significantly, have exhibited a rebound in the second quarter.

It is too early to tell whether the recent weakening of worldwide industrial activity is a temporary phenomenon or not. At this point, the odds do not seem to allow us to discard the possibility of a soft patch rather than a definitive change in the trend. In any case, it is evident that the Mexican economy, and in particular, industrial production, will continue to depend on the strength of U.S. economic activity.

Although in recent months forecasters have cut their projections for world and U.S. economic growth, their baseline scenarios imply a continuation of the recovery. Against this backdrop, the Bank of Mexico estimates that the Mexican economy will grow between 4 percent and 5 percent in 2011 and between 3.8 percent and 4.8 percent in 2012. The domestic drivers of growth will continue to be financial stability, the expansion of banks' lending to the private sector, including consumer credit, and further increases in employment and real wages.[2]

The main downside risks to economic growth in Mexico are external. Most importantly, the United States and other advanced countries face the challenge of maintaining their economic recovery while gradually implementing exit strategies from their unusually expansionary monetary and fiscal policies. A particularly worrisome problem could be the fiscal consolidation that some countries will have to undertake in order to make their public-debt paths sustainable. A second risk is the possibility of persistently higher oil prices, which may hamper global growth. A third contingency regards a recovery in Japan that is slower than expected.

Financial markets and capital flows

By the time recession ended in the United States and Mexico, financial markets had attained more normal conditions. Indeed, global uncertainty and fears expressed in the flight to quality which had disturbed the Mexican stock, currency and bond markets during the crisis, eased substantially by the middle of 2009. Since then, asset prices have rebounded, if not at a steady pace. In particular, the Mexican stock market has surpassed its pre-crisis highs, although this year it has experienced downward adjustments.

Bond spreads, as expressed by the JP Morgan EMBI for Mexico, have tightened and stabilized during the first half of 2011 to around 160 basis points, slightly above its average in the same period of 2006. Consistently, the domestic yield curve has shifted downward, especially for the short- and middle-term interest-rate structures. These developments seem to reflect both lower country-risk perception and expected inflation based on the difference between nominal and real interest rates in domestic bond markets.

Additionally, the Mexican peso has gained value against the U. S. dollar, although somewhat less vigorously than the currencies of many other emerging economies. The lesser extent of Mexican peso appreciation may be partly due to the uncertainty regarding the sustainability of the U.S. economic rebound in light of the tight links between both economies. Moreover, recent news of further 7 sovereign-debt problems in some economies in the European Monetary Union (EMU) has triggered international financial volatility, putting transitory

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[2] For example, this year, Blue Chip forecasts for U.S. output growth for 2011 fell from 3.2 percent to 2.5 percent and for 2012 from 3.3 percent to 3.0 percent from February to July. However, the corresponding projections for Mexico were raised from 3.9 percent to 4.3 percent (2011) and from 3.8 percent to 4.0 percent (2012).

pressure on the peso exchange-rate. Until the weak fiscal and financial situation of the EMU is solved comprehensibly, an event that may yet take some time, additional financial turbulence from this source cannot be ruled out.

As in other emerging economies, the upsurge in financial asset prices since 2009 has been fueled by substantial portfolio inflows to Mexico. These flows have been directed both to the equity and fixed income markets, most notably via government bond purchases. The total holdings of government securities by foreign investors have reached unprecedented levels, close to US$68 billion as of the end of June, more than 23 percent of the total outstanding.

To date, there does not seem to be a cause for concern regarding the effects of these capital flows to Mexico. Such movements seem to reflect a search for higher yields, given the extremely low interest rates that prevail in the United States and other advanced countries and the relative improvement of Mexico's economic prospects. This search for yield occurs in the context of a Mexican peso that is freely convertible and now traded 24 hours with ample liquidity. An additional favorable factor seems be the inclusion in 2010 of Mexican government bonds into the Citigroup World Government Bond Index (WGBI), which is used as a benchmark by many index fund managers and institutional investors. As of now, there are no apparent signs of overheating in spending or the gestation of a credit or asset boom as a result of these flows, either of which could endanger control over inflation or the stability of the financial system.

However, a possible reversal of these flows may translate into volatility and asset price declines, including exchange rate depreciation. Yet, if such an eventuality materializes, the functioning of the economy should not be affected, provided that monetary and fiscal fundamentals remain strong, and the banking system highly liquid and well capitalized. An additional element of strength will continue to be the flexible exchange-rate system that has served as a shock absorber in previous turbulent times.

In any case, the financial authorities will have to continue monitoring potential risks from various sources that may impair the functioning of the financial system, to prevent this from occurring and to act accordingly if an adverse situation emerges. This responsibility implies making progress in measuring systemic risk, strengthening the prudential regulation and supervision of the system, and perfecting the resolution mechanisms for insolvent financial institutions.

Challenges to price stability in Mexico

Monetary policy in Mexico has been conducted according to the constitutionally mandated primary objective of seeking the stability of the purchasing power of the national currency. To express its commitment to this mandate, since 2001 the Bank of Mexico has implemented its monetary policy within an explicit inflation-targeting scheme. Starting from double-digit annual inflation, references were gradually reduced, and since 2003 the permanent target has been 3 percent annual inflation. This commitment refers to headline inflation as measured by the National Consumer Price Index (INPC). A variability range of plus/minus one percentage point around this benchmark was added later, an addition which should not be interpreted as a target but as an acknowledgment of uncertainty stemming from the highly volatile nature of some components of the price index.

In 2008 the Bank of Mexico formally replaced its policy instrument, moving from a quantitative guideline (the "corto") to the overnight interest rate used in the interbank market. In the middle of that year, to counter pressures from currency depreciation and other supply shocks which had pushed inflation off the convergence path to its permanent target, the Bank of Mexico raised its reference interest rate by 75 basis points.[3]

However, in 2009 when it was clear that those pressures had ceased to threaten price stability, the Bank of Mexico relaxed its monetary policy. Specifically, from January to July of that year the overnight policy interest rate was cut 375 basis points in all, and since then the reference policy rate has been kept at 4.5 percent. The resulting expansionary monetary stance, as reflected in the central bank's Monetary Conditions Index, among other indicators, has helped to mitigate the impact of the global trade and output contraction that led to the severe recession in 2009.[4]

Monetary policy was effective at bringing inflation back to the desired convergence path. Annual inflation fell from 6.5 percent in 2008 to 3.6 percent in 2009 and since then its average has been 3.9 percent. Furthermore, after hitting 3 percent in March of 2011, annual inflation has remained substantially close to, albeit somewhat above, the permanent target.

The fact that inflation has approximated the objective during the last four months is a hopeful sign, since a similar pattern had not been achieved since 2006. This progress should be beneficial to expectations for the sustained feasibility of the inflation target in a context of economic growth. In order to take full advantage of the current benign environment, monetary policy must continue to be geared toward facilitating the anchoring of inflation expectations on the permanent target. A challenge to this goal is the fact that medium- and long-term inflation expectations, as reflected in analyst surveys and the bond markets, still remain above 3 percent, and in the recent past, short-term expectations frequently surpassed this level by a large margin.

Monetary policy should also take into account the fact that certain factors that contributed to the recent decline in inflation could be transitory. These elements include the negative output gap, defined as the difference between observed and estimated potential output, as well as other measures of slack that will continue to tighten as the economy grows; unusually favorable agricultural prices; seasonal reductions of electricity tariffs; and the appreciation of the Mexican peso, which could vanish and even reverse course due to factors outside the country's control.[5]

These challenges notwithstanding, the Bank of Mexico is confident that the future path of inflation will be consistent with its convergence to the permanent target. The Bank of Mexico's Governing Board has repeatedly stated that it will continue to examine all variables that could raise warnings about the emergence of any generalized pressures on prices and that, if such an event happens, it will adjust monetary policy to ensure convergence. According to the central bank's estimates, headline inflation will most likely settle between 3 percent and 4 percent during this year and next, while core inflation will most probably settle in a range between 3 percent and 3.5 percent during 2011, and slightly below 3 percent in 2012.[6]

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[3] The "corto" was defined as the amount in the balance of the commercial banks' accounts with the Bank of Mexico, for which the central bank provided daily liquidity at a price of twice the market interest rate. A higher "corto" signaled a more stringent monetary policy.

[4] The Monetary Conditions Index (MCI) is calculated as the weighted average of the changes in indicators of real interest rate and the real exchange rate with respect to their average level during a certain period. An exchange rate appreciation and/or a real interest rate increase lead to an increase in the MCI. Therefore, an MCI increase suggests relatively more stringent monetary conditions. To review this indicator as applied to Mexico, see Bank of Mexico, *Inflation Report January–March 2011*.

[5] For an analysis of the output gap and other measures of slack, see Governing Board of the Bank of Mexico, *Minuta No. 4*, May 27, 2011.

[6] See the Bank of Mexico, *Inflation Report January–March 2011*.

Let me close by commenting on two recent developments that should strengthen the institutional framework of monetary policy. One is the publication, starting this year, of the minutes of the Board meetings for monetary policy. This action has the purpose of disclosing the reasons individual Board members had for casting their votes, hopefully contributing to a better understanding of the basis of monetary policy decisions in Mexico. The second development centers on the transfer of the responsibility for producing the price indices to the National Geography and Statistics Institute (INEGI) beginning this month. The independence of INEGI from the Bank of Mexico should further support monetary policy credibility.

Finally, I would like to acknowledge the critical role that responsible fiscal policy in Mexico has played in the reduction of inflation. Narrow fiscal deficits and the adequate management of public indebtedness, as expressed in moderate debt-to-GDP ratios, the long duration of public debt, and low foreign-currency exposure, among other indicators, have been notably supportive. Definitively, the deepening of a solid fiscal position will continue to be a prerequisite for sustainable price stability in Mexico.

Concluding remarks

Since the middle of 2009, the Mexican economy has shown clear improvement. Recent indications of moderation notwithstanding, Mexico's economic outlook continues to be one of recovery in which the main risks are external. Relative stability in financial markets has led to substantial capital inflows to the country, without generating any noticeable problems. Future reversals of these flows cannot be ruled out, given free capital mobility, but if they materialize, such events should not harm the functioning of the economy provided that its strong fundamentals are maintained. Finally, monetary policy faces the challenge of perseverance in order to ensure continued progress on the long road to price stability.