Manuel Sánchez: Mexico in a weak global environment

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at Morgan Stanley's Mexico's Moment Investor Conference, Mexico City, 17 June 2013.

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It is a privilege to participate in this conference dedicated to examining investment opportunities in the Mexican economy. I appreciate Morgan Stanley's invitation to share a few thoughts with you on the economic situation and outlook in Mexico.

My remarks will be divided in three parts. First, I will briefly review the status of the Mexican economy in the current context of global economic softness; second, I will analyze recent developments in Mexican financial markets in connection with the monetary policies of developed countries; and third, I will describe some challenges to monetary policy and inflation in Mexico.

Developments in the Mexican economy

Mexico's economic performance of this year has been limited by the weakness of the world economy. On the one hand, the United States has shown signs of recovery, confirmed by indicators such as those related to personal consumption, the housing sector, lending, and the labor market. Yet, growth has been dampened by a contraction in public spending, reflecting fiscal consolidation efforts, as well as by a recently lower contribution from net exports.

Forward-looking indicators reveal that economic activity in the United States may continue to strengthen. So far this year, analysts' consensus forecasts posit GDP expansion higher in 2014 than for this year. However, this expected growth is still insufficient for the U.S. economy to return to its secular trend, something that continues to challenge current economic policy.

On the other hand, the euro zone remains in recession, despite progress on financial stability. In addition, emerging economies appear to be slowing, as shown by the performance of industrial production and exports. Even if PMIs from the manufacturing and services sectors imply that expansion in these economies will continue, both indicators exhibit a declining trend.

In short, global growth forecasts for 2013 have been revised slightly downward, and those for 2014 are unchanged, all remaining below the average rates seen before the crisis.[1]

So far in 2013, Mexico's economic output has continued the upturn begun four years ago, although at a slower pace. Moderation in the Global Economic Activity Indicator (IGAE) stems from stagnation in industry and a contraction in agriculture, the latter largely resulting from March frosts. The lack of strength in manufacturing reflects weakness in the sector's exports, both those directed to the United States and especially those to other markets.

In contrast, the services sector has remained highly dynamic. Lending to the private sector, in particular consumer lending, has kept growing, albeit at lower rates. Additionally, the number of formally employed workers has continued to increase, but the unemployment rate remains somewhat above the historic average.

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1 Consensus forecasts for U.S. GDP growth are 1.9 and 2.7 percent for 2013 and 2014, respectively. The world economic growth forecast for 2013 dropped from 2.6 to 2.5 percent between January and June 2013, while estimates for 2014 have remained at 3.2 percent during the same period. See Consensus Economics (2013), *Consensus Forecasts*, January and June.

Some indicators imply that lower external demand has likely had negative repercussions for domestic spending. Retail sales have lost momentum and gross fixed investment has recently slowed.

Nevertheless, most prospective indicators, including the manufacturing and non-manufacturing PMIs and other leading indicators, still suggest that economic performance may improve. Consistently, analysts have revised their forecasts for Mexican GDP growth downward for the current year but, in general, they have kept their forecasts the same for 2014.[2]

Even though downside risks to near-term growth forecasts appear to have increased for this year, for next year upside risks may remain. In particular, if the recovery in U.S. manufacturing consolidates in the following months, the upswing could fuel manufacturing in Mexico, with favorable effects on other sectors of the economy.

In the medium term, economic expansion in Mexico will continue to depend on productivity growth, the lack of which has been the biggest drag on income improvement. Progress on the nation's structural reform agenda is encouraging, including changes affecting the labor market, government accounting, education, and competition and telecommunications. Finally, approval of a financial reform initiative submitted recently to Congress could yield additional benefits.

Capital inflows and financial markets

During the last three years, emerging markets saw significant capital inflows, which appear to have accelerated during the first four months of 2013. In Mexico, the largest proportion of flows went to peso-denominated government bonds.

The relative abundance of external funds for emerging markets seems to reflect three fundamental factors. First, loose monetary policy in developed nations, which in the case of the United States has implied policy interest rates cut to near zero and significant quantitative easing, has triggered a search for higher yields.

Second and not completely unrelated to the preceding factor, global risk aversion has remained relatively tame since 2010.

Third, individual characteristics of different countries contribute to explaining why capital inflows have not been equal in all emerging economies. In particular, Mexico's attractiveness could involve factors such as the openness of the capital account, the free-floating exchange rate regime, the certainty of no discretionary intervention in the markets, moderate country risk, and positive prospects for structural reforms.[3]

During the last few weeks, sentiment has changed in global financial markets. Favorable U.S. economic data and various Federal Reserve officials' statements have fueled market and analysts' expectations for an imminent start to the tapering of quantitative easing in the United States.

Hence, the April employment report published in May approximately coincided with the beginning of a rising trend in long-term government bond rates in the United States and other nations. At the same time, the U.S. dollar has been appreciating with respect to many currencies.

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[2] Economic growth expectations for Mexico in 2013 dropped from 3.6 to 3.0 percent between January and May 2013, while those for 2014 have remained at 4.0 percent during the same period. See Banco de México (2013), *Survey of Private-Sector Economic Analysts' Expectations*, May.

[3] Two empirical analyses of factors that explain capital flows, including idiosyncratic factors, are Ghosh, A.R., *et al.* (2012), "Surges," *IMF Working Paper*, WP/12/22, January; and Fratzscher, M. (2011), "Capital flows, push versus pull factors and the global financial crisis," *ECB Working Paper Series*, No. 1364, July.

The resulting volatility in global financial markets has brought about considerable increases in Mexican government bond yields. For some maturities, the upward shift in the yield curve has offset the downward shifts seen in the first four months of the year. Like other emerging-market currencies, the peso has been depreciating against the dollar.

Adjustments in Mexico's financial markets have occurred in an orderly way. FX market volumes have continued to be high, bid-ask spreads have remained slim, and foreign holdings of peso-denominated bonds are still near record highs, although portfolio duration has been declining throughout the year.

Recent global financial volatility is a foretaste of what could happen when the process of U.S. monetary policy unwinding begins in earnest. Hence, it is likely that some turbulence may continue.

Given this scenario, the Mexican economy is expected to confront any new episode of uncertainty in a solid manner. However, it is important that creditors as well as debtors remain wary of their FX and interest-rate risk exposures. At the same time, authorities need to remain vigilant in order to ensure that financial markets operate normally at all times.

Inflation and monetary policy

In the last decade, monetary policy in Mexico has sought the convergence of inflation toward the 3 percent permanent target. Progress in price stability over the same time has been considerable.

Nevertheless, during the current year, inflation has posted somewhat higher levels, since March surpassing the Bank of Mexico's upper limit in the variability interval of plus or minus one percentage point around its inflation target. Higher inflation mainly reflects pressures in the noncore component of the CPI, from agricultural prices as well as energy prices and government tariffs.

However, the negative supply shock is expected to be transitory. At the same time, moderation in core inflation continues to depend, to some degree, on a positive shock from certain services prices. Nevertheless, core inflation has remained around 3 percent during the last few months and is expected to stay around this level during the rest of this year and next.

Up to now, there is no evidence of secondary effects from recent changes in relative prices. Analysts' short-term inflation expectations have increased somewhat, but expectations for the medium and long terms have remained stable, albeit above 3 percent. The Bank of Mexico expects inflation to return to the variability interval in the second half of this year, and to be very close to the permanent target in 2014.

Upside risks to inflation prevail, including greater-than-expected hikes to transportation prices, additional agricultural price pressures, given avian flu, low precipitation and reduced water levels in dams, and greater volatility due to uncertainty over U.S. monetary policy normalization.

The persistence of higher inflation carries the risk of fueling second-round effects that may contaminate the price and wage formation process. Thus, the Bank of Mexico Governing Board has warned that it will remain alert to adverse supply shocks in order to keep them from producing these effects so that the process of convergence to the permanent inflation target remains on track.[4]

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4 See the Bank of Mexico's monetary policy announcement, June 7, 2013.

Concluding remarks

Recent indicators highlight slower expansion in the Mexican economy, largely caused by global economic weakness. By next year, as the external environment improves, Mexico's economic activity is expected to post a healthier pace. Also, in the medium term, structural reforms could enhance productivity.

The financial volatility of the last few weeks has had significant implications for emerging markets. Adjustments in Mexico have been orderly. In the face of the possibility that uncertainty may continue, prudence should prevail on the part of creditors and debtors, and the authorities should remain alert in order to ensure that at all times financial markets operate normally.

Finally, an increase in annual inflation so far this year is due to negative supply shocks, reflected especially in the noncore component of the CPI. Given the temporary nature of recent pressures, it is likely that inflation will soon resume a downward trend toward the 3 percent permanent target.