Manuel Sánchez: Expectations for the Mexican economy

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the 2015 Business Forecast, Chicago Booth Alumni Club of Mexico, Mexico City, 22 January 2015.

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Thank you for the invitation to participate in Mexico's 2015 Business Forecast meeting, organized by the University of Chicago Booth Alumni Club of Mexico. As a fellow Chicago alumnus, I feel particularly privileged to speak at this event.

While forecasts are a time-honored tradition among economists, it is well-known that none of us have crystal-ball insight, particularly on short-term economic developments. The only thing I can promise in this regard is to make my best effort at reading the tea leaves that could give us an idea of our near-term economic future.

I will organize my comments in two sections, talking first about the external scenario and second, about possible domestic conditions. As usual, my opinions are entirely my own and do not necessarily reflect those of the Bank of Mexico or its Governing Board.

The external scenario

Three main issues will likely define the external context for the Mexican economy in the near term. The first, as usual, is the outlook for our country's most important trading partner, the United States. The U.S. economy continues to gain steam, with GDP in the second and third quarters of last year posting significant growth, to 4.6 and 5 percent respectively, in annualized terms. Year-on-year growth since mid-2011 has been averaging about 2 percent. Available data for the fourth quarter 2014 and some leading indicators suggest momentum is in place for improvement in 2015.

Consensus analysts' forecasts are for the U.S. economy to expand around 3 percent this year and next. The main drivers are expected higher consumption and investment due to personal income gains and improved expectations, and a sustained recovery in the housing construction sector.[1]

This scenario faces some potential challenges. The most significant downside risks stem from the possibility of a greater slowdown in the world economy, particularly in the euro zone, Japan, and China and its impact on the United States.

Along with continuous, moderate growth, the U.S. economy has seen a persistent decline in the unemployment rate, which has fallen from the 10 percent peak of the financial crisis, most recently to 5.6 percent. FOMC-member unemployment forecasts during the last four years have been revised downward successively. Reality has persistently surpassed the improving forecasts as the variable has dropped at an even faster-than-foreseen pace.

An extrapolation of this trend would suggest that unemployment may approach 5 percent, a rate consistent with long-term trends, perhaps as early as this year. The firmness of the labor market, however, is open to debate, especially given a diminished labor-force participation rate and seemingly low growth in overall labor compensation.

In view of progress on reduction of unemployment, it is not surprising that FOMC members and markets alike anticipate the first Fed funds rate hike also this year. On that note, a second external factor for Mexico is the expectation that the beginning of a gradual normalization of U.S. monetary policy is close, as suggested by the statement and the

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1 See Blue Chip Economic Indicators (2015), *Top Analysts' Forecasts of the U.S. Economic Outlook for the Year Ahead*, January.

minutes from the most recent FOMC meeting. The minutes acknowledge that the economy is gaining force and that low inflation, affected by falling oil prices, may not be a factor against keeping the rate hike on the table.[2]

Consistently, the majority of participants in the December FOMC meetings of 2013 and 2014 have forecast that the first hike will occur in 2015. A similar message can be drawn from the futures markets, which, assuming that the first hike is 25 basis points, direct us to the second half of the year. Timing, however, still remains an open question, especially in light of subdued inflation.

Superior U.S. economic performance and expected monetary tightening contribute to current, generalized dollar strength. The dollar has appreciated since last year, recently reaching its strongest level in the last eleven years according to the DXY, a measure of the dollar's value relative to six major currencies. The dollar is poised to keep appreciating for some time, supported by a continued favorable outlook for U.S. growth this year and growing divergence in monetary policy among key central banks.

A third important external factor for Mexico is the sharp drop in oil prices, which have fallen to levels not seen in almost six years. In contrast to 2009, the oil shock this time around is mainly supply-driven. Factors behind swooning prices include a major oil production boom starting in the United States in 2008.

Also, increased competition among oil producers since the middle of 2014 has been triggered by factors such as price cuts by Saudi Arabia in the U.S. market, the opening of Libyan oil-export terminals, and lack of an OPEC agreement to reduce production. Finally, on the demand side, an overall decline in economic growth in major importing countries preceded the oil price drop.

Oil prices are expected to continue low for some time or fall even further. Many high-cost producers dedicated to nonconventional sources such as shale are highly leveraged or have hedged their prices to varying degrees, so that they will keep producing for some time. That said, the prospect of lower prices will make oil and gas firms start to cut investment projects and eventually slow production, allowing supply and demand to adjust and prices to recover to some extent. However, relatively low oil prices could be a new normal for the world economy for some time to come.[3]

The plunge was obviously a negative shock for oil-exporting countries, with implications for public finances that could be significant. In the meantime, low oil prices will assist the global economy overall, particularly the United States and other large oil importers, including Europe, Japan, and China.[4]

The Mexican economy on the mend

Let me now turn to the Mexican economy, touching on three major themes. The first is economic activity. Growth has been rather disappointing. Since mid-2012, it has been declining. From that time, annual GDP expansion has been slightly above 2 percent on average, but the pace until the 2014 first quarter was slowing.

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2 See the Board of Governors of the Federal Reserve System (2014), Policy Statement, December; and the Board of Governors of the Federal Reserve System (2014), *Minutes of the Federal Open Market Committee*, December.

3 For an outlook of oil prices, see for example Goldman Sachs (2015), "The new oil order: Lower for longer to keep capital sidelined." *Commodities Research*, January.

4 For an analysis of the possible economic implications of lower oil prices, see Institute of International Finance (2014), *After the fall – Consequences of lower oil prices*, December.

Since the second quarter of 2014, moderate improvement has occurred, but with some softening in the third quarter. Available data for the fourth quarter imply a slightly better performance. However, on a net basis, the conclusion is that the economic rebound has not consolidated.

Consensus analysts' forecasts suggest that along with the United States, Mexico will see a gradual economic recovery this year and next. The Bank of Mexico forecasts growth of 3 to 4 percent for 2015, and 3.2 to 4.2 percent for 2016.[5]

The main growth engines are sustained exports on the back of robust U.S. economic performance and a pickup in domestic private spending. Greater manufacturing exports to the United States should continue to drive an all-important sector of the Mexican economy, manufactured goods, particularly the automotive industry. Lower gasoline prices in the United States could provide an even greater boost to demand in this sector.

In addition, recovery of the Mexican construction sector should continue in the wake of the restructuring of the private-sector housing industry. The consumer in Mexico is not overly indebted, another factor which should further aid housing-sector recuperation.

As growth continues, employment and the real wage bill will likely expand, boosting domestic consumption. Finally, Mexican banks are in a solid position overall, from which they are ready to support private-sector expansion.

There are downside risks to this scenario. First, relatively low levels of consumer and producer confidence could remain stagnant. Second, social unrest may have negative effects on economic activity. Third, continued declines in oil production would further dampen the mining sector, with negative implications for overall GDP. Lower oil prices would also put stress on the public finances.

It is worth noting that the importance of oil in the Mexican economy continues to diminish. The county's oil production platform has been declining since 2004. While oil exports account for a low, decreasing fraction of total exports, currently the oil trade balance is relatively small. The direct negative impact of cheaper oil is on Mexico's public finances, since the government-owned oil producer (Pemex) is a net oil exporter. For 2015, the government's exposure to price fluctuations is hedged.[6]

On the upside, U.S. economic strength could gain more force, and greater-than-currently expected benefits from Mexican structural reforms could start to kick in.

My second focus for Mexico is on the financial markets. Global volatility has certainly hit domestic markets, but they have operated with ample liquidity and without disruption.

In particular, the weakening of the peso since mid-2014 largely reflects global factors such as generalized dollar appreciation and the drop in oil prices. Foreign-exchange (FX) adjustment has been orderly, as reflected by high trade volumes and low bid-ask spreads. Also, the derivative markets have allowed investors to hedge FX risks, as evidenced by the short peso position recently seen in the Chicago peso-dollar futures markets.[7]

However, the share of peso-denominated government bond holdings by nonresidents remains high and has even increased recently to reach new records. Also, Mexico's yield

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[5] See Blue Chip Economic Indicators (2015), *Top Analysts' Forecasts of the U.S. Economic Outlook for the Year Ahead*, January; and Banco de México (2014), *Quarterly Report, July-September 2014, Summary*, November.

[6] For details on the Mexican government's oil hedge, see SHCP (2014), "El Gobierno Federal cubrió la totalidad de los ingresos petroleros para 2015." *Comunicado de Prensa* 097/2014.

[7] For an outlook of real and financial variables see, for example Banco de México (2014), *Encuesta sobre las expectativas de los especialistas en economía del sector privado: diciembre 2014*, December.

curve has shifted downward and flattened in the last year. In other words, the peso has depreciated, but interest rates remain not too far from their all-time lows.

The relative resilience of the domestic financial markets during recent months does not mean that the economy is immune to future shocks. Uncertainty on the timing and pace of U.S. monetary normalization still looms, making it likely the ride in financial markets will be bumpy and posing challenges for the management of long-term fixed-income positions, among others.

In this context, authorities must take a proactive stance, first by fortifying macroeconomic fundamentals in order to provide a shield against external forces. Second, they must remain on alert, identifying possible systemic financial risks in time to make adjustments.

One final point concerns monetary policy and inflation. As you know, from March 2013 to June 2014, the Bank of Mexico cut its policy interest rate target by 150 basis points in the context of weak economic activity.

During 2014, inflation tended to remain above the upper limit of the variability interval around the permanent target of 3 percent. Major factors for these pressures came from tax hikes implemented since the beginning of the year, and certain agricultural price increases.

Inflation will likely be lower during 2015 given favorable base tax effects, more moderate gasoline and electricity price adjustments, and the elimination of national long-distance phone charges. In fact, January first-half inflation was 3.1 percent year-over-year, compared to 4.6 percent in the same time period of 2014. The Bank of Mexico expects inflation to approach 3 percent throughout this year.[8]

However, there are risks to this scenario. These include a potentially weaker peso for a prolonged period of time, which, despite low pass-through in recent years, may have an impact on inflation. Other risks are renewed substantial rises in noncore price components and eventual aggregate demand pressures.[9]

Concluding remarks

Three external issues will be key determinants of Mexico’s near-term economic performance. The first is sustainable U.S. economic strength. The second is uncertainty on the timing and pace of U.S. monetary policy normalization. Third, lower oil prices appear to be here to stay for a while, and prices could even fall further before the trend reverses.

On the domestic side, three issues are also predominant. Mexican economic growth has disappointed but is expected to pick up to above 3 percent over the next two years. Downside risks are still present, including a possibly fragile recovery of domestic spending.

Financial markets are likely to continue to face volatility. Relative resilience in recent months is no guarantee that Mexico is immune to future shocks. Thus, the authorities need to remain vigilant, as they have done to date. On the monetary policy front, inflation is expected to approach the Bank of Mexico’s 3 percent permanent target throughout this year. Going forward, risks to inflation should be carefully monitored so that attainment of the objective is sustainable.

Finally, amid solid macroeconomic fundamentals, new business opportunities should begin to blossom. In spite of what could be adverse external conditions this year, Mexico could very well turn out to be a relatively attractive spot on the emerging-market horizon.

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[8] See Banco de México (2014), *Quarterly Report, July-September 2014, Summary*, November.

[9] For an analysis of FX pass-through to inflation, see Banco de México (2012), *Inflation Report, July–September 2012*, November, Box 1.