

Manuel Sánchez: Is Mexico different from other emerging economies?

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the University of York, York, United Kingdom, 19 April 2016.

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It is an honor to be with you today in this historic English city to speak at the prestigious University of York. This academic center has received much recognition in its first half-century for its achievements in both research and education, with a distinguished faculty and cosmopolitan student community.

I would like to talk about how Mexico has fared in the present international environment of heightened risk aversion, and some of the challenges that lie ahead. In particular, I would like to examine whether or not Mexico's structural and policy framework has set the country sufficiently apart from other emerging economies.

Differentiation is a highly desirable outcome as it would contribute to better economic conditions. I will argue that Mexico should make further progress in this regard in order to consolidate price stability and enhance potential output growth.

As usual, my remarks are entirely my own and do not necessarily reflect the position of the Bank of Mexico or its Governing Board.

The rise and fall of emerging economies

Starting in 2010, emerging economies enjoyed a favorable financial environment characterized by substantial capital inflows in the search for yield amid extraordinarily lax monetary policies in advanced countries. At the same time, commodity prices rose and remained high, supporting growth in commodity exporters. Also, asset prices in emerging markets tended to increase, including some bouts of currency appreciation vis-à-vis the U. S. dollar.

While the taper tantrum in 2013 sparked a transitory rise in risk aversion, the market mood really changed around mid-2014 as previous trends reversed, including a contraction of portfolio investment inflows in the second half of the following year, something which had not been seen since the global financial crisis. In a few words, emerging economies went from beauty to beast in the eyes of international fund managers.¹

Among factors spurring this turn of events was the apparent perception that the process of U.S. monetary policy normalization was about to begin, given the end of longstanding asset-purchase programs in October 2014, and worries about the health of the Chinese economy and policy measures there.

The result has been an almost continuous decline for commodity and financial asset prices in emerging economies over the last two years, only partly attenuated in recent weeks. Energy prices have been the most affected, but those of metals and agricultural products have also taken a knock. Growth prospects and public finances have been hurt in countries heavily dependent on commodity exports.²

1 See Koepke, R. and S. Farnham (2016). "March 2016 EM Portfolio Flows Tracker and Flows Alert," IIF Portfolio Flows Tracker, March.

2 For an analysis of the impact on and policy responses of commodity-based economies to lower prices, see International Monetary Fund (2015). World Economic Outlook: Adjusting to Lower Commodity Prices,

Simultaneously, external borrowing costs for emerging economies have increased and their currencies have weakened significantly versus the U.S. dollar. Some nations have found themselves in a difficult spot given that fiscal and financial imbalances were built up during the preceding bonanza.

Problems run from high debt in domestic and foreign currencies and deterioration of financial institutions' balance sheets to overly appreciated real estate in some cases. As a result, several economies have been tightening monetary policy in the face of rising inflation and inflation expectations, a development that contrasts with that of advanced nations.

The real impact on Mexico

There are two noticeable avenues through which this adverse external environment has affected Mexico's actual and potential economic activity. One is through lower commodity prices, where the impact can be expected to be milder than that for primarily commodity exporters.

Beginning in the 1980s, Mexico undertook a deep economic transformation by expanding its integration with the rest of the world, tearing down foreign trade and investment barriers. Among other treaties signed by Mexico, the North American Free Trade Agreement of 1993 notably consolidated the country's links with the United States. Throughout these years, manufacturing and services gained substantial share, in trade and economic activity, respectively, while agriculture and mining lost relative weight in both.

The most important commodity produced and exported by Mexico continues to be oil. Currently, oil and gas extraction accounts for roughly five percent of GDP, and crude, only around six percent of total exports. A large part of the reduced size of the sector comes from the shrinking production trend observed since 2004 due to the depletion of high-yield oil fields³

Whereas Mexico now depends much less on commodities for production and trade than several other emerging economies, particularly in Latin America, the possible real effect of low oil prices is not trivial, especially if they are sustained for a long time. Further oil extraction in certain areas may no longer be profitable, and the return on new investments as well as the possibilities for financing may be more limited. Negative spillovers to other production sectors, such as mining-related services, may be considerable⁴

Another real external effect has come from the slowdown of U.S. industrial production, partly due to the downsizing of the oil sector in that country after the price drops. Mexico's GDP is highly correlated with industrial production in the United States, reflecting the vertical integration of processes between the two nations, such as in the automotive and electronic sectors.

The negative impact has been transmitted through a deceleration of Mexico's manufacturing exports to its northern neighbor. Even so, the hit has tended to be smaller than that experienced by many other emerging economies with exports oriented to countries other

Washington, October; and Institute of International Finance (2015). "Living With Less: Oil Exporters' Different Adjustment Paths," December.

3 To appreciate the contrast, it is worth noting that in 1982 oil represented 68 percent of total exports. To confront the declining trend in oil production, the Mexican government has opened the energy sector to private investment, which could have positive impacts over the medium term.

4 The general view of analysts as well as the futures markets point towards a slow recovery for oil prices in the medium-term. For example, the U.S. Energy Information Administration (EIA) forecasts West Texas Intermediate (WTI) crude oil prices to average 35 dollars per barrel in 2016 and 41 in 2017; see U.S. Energy Information Administration (2016). Short-Term Energy Outlook, April.

than the United States, as this economy has shown one of the clearest upturns among advanced nations after the crisis, albeit disappointing in a historical context.

Since 2014, Mexico's GDP has been growing at roughly 2.5 percent, slightly below the average of the previous two decades. The main engine of the ongoing rebound has been the services sector and, on the demand side, private consumption. However, history tells us that unless the external sector eventually supports the upturn, the economy's vitality will not continue.

The outlook for the Mexican economy is one of a gradual recovery along with that of the United States. However, downward risks prevail, including most importantly, less-than-expected U.S. industrial improvement, and secondly, a larger-than-anticipated contraction in oil production. Of course, long-term growth potential depends heavily on adequate implementation of the structural reform agenda, which seeks more efficiency in many sectors such as energy and telecommunications.⁵

The financial impact on Mexico

The adverse international environment has also had financial repercussions on Mexico through two main channels. The first is a slowing in portfolio investment inflows, which nevertheless have tended to remain positive in contrast to those of many other emerging economies, where they have been significantly negative.

As a result, nonresident holdings of peso-denominated government securities, a favorite for fixed-income investors for several years, continued to increase, and since 2015 have remained roughly constant in nominal terms. Hence, the share of these holdings in the total outstanding has recently declined only moderately. However, this proportion is still one of the highest among emerging-market local-currency-denominated government securities.

High and stable exposure to foreign holdings is a sign of strength. The confidence shown by investors in Mexico possibly reflects the depth of the bond and peso markets and the credibility of the economic policy framework. The resilience of foreign portfolio investment has contributed to the relative stability shown by medium- and long-term market interest rates for government bonds. Maintaining the preference of nonresident investors is obviously of paramount importance and can never be taken for granted.

The second route for external impact has been in the public finances, originating, again, in lower oil prices. As with other large oil producers, Pemex, the state-owned oil extracting enterprise, has seen its financial conditions deteriorate significantly. This, along with more than a decade-long decline in oil production, has resulted in a considerable increase in credit-risk perception. The rise for Pemex credit default swap (CDS) spreads has been more acute than for many other major oil-producing firms.

More importantly, lower oil prices have dented the prospects for healthy Mexican public finances. The fragility is due, first, to the fact that because Pemex is state-owned, markets assume the government will back its debt under the pressure of contingencies. Second, public-sector budgeted revenues depend heavily on oil income, which accounts for slightly less than one-third of the total, among the highest ratios in the emerging-market universe.⁶

5 Analysts' forecasts for U.S. industrial production and Mexico's GDP are, respectively, 0.3 and 2.4 percent for 2016, and 2.3 and 2.8 percent for 2017; see Blue Chip Indicators 2016, April. For a discussion of Mexico's structural reforms, see Sánchez, M. (2015). "Mexico's Reforms Progress and Economic Outlook," speech given at the 2015 IIF Latin America Economic Forum, March.

6 See IMF (2015). "Fiscal Monitor: Now Is the Time, Fiscal Policies for Sustainable Growth," p. 2, April. For the classification of emerging markets, see Koepke, R. (2012). "IIF Capital Flows User Guide," IIF Research Note.

These weaknesses are amplified by the fact that during the last few years, the ratio of accumulated total public-sector financial requirements to GDP has consistently increased. For the public finances to be sustainable, this proportion must stop growing and eventually stabilize at lower levels, a goal which has been explicitly stated in federal budget plans.⁷

The resulting vulnerability has been reflected in two ways. One, during the first few weeks of this year, Mexican government CDS spreads increased more rapidly, and have tended to remain higher than those for governments with equivalent credit ratings.

Another is the increasing correlation between the peso-U.S. dollar exchange rate and oil prices. Since mid-2014, the peso tracked the average emerging-market currency in its substantial weakening trend, with nothing to distinguish its performance.

Furthermore, in January and until mid-February this year, the peso depreciated at a faster rate than other emerging-market currencies. This period also overlapped with the worst of the deterioration in CDS spreads. Since then, along with other emerging-market currencies, the peso has recovered somewhat, in tandem with higher oil prices.

In short, Mexico has been affected financially by external circumstances. Furthermore, new financial pressures may emerge as the sources of international volatility have not disappeared and could even resurface. For this reason, Mexico needs to strengthen its macroeconomic fundamentals.

Certainly, in the face of the possible persistence of reduced oil prices, a tight fiscal stance is highly advisable. Appropriately, last February, the federal government announced budget expenditure cuts, especially for Pemex.⁸

Monetary policy and inflation

Since 1994, the Bank of Mexico's primary objective as mandated by the country's constitution is price stability. Like that of other emerging economies, Mexico's monetary policy has formally been implemented within an inflation-targeting framework since 2001. The permanent annual inflation target is 3 percent. Attaining this target has been a long quest.

Recent inflation developments differ from those in other emerging economies in two interrelated ways. First, since 2015, inflation has not only been lower than that in several other emerging economies, especially in Latin America, but it has also been consistently below target for the longest period on record in Mexico. Consequently, inflation struck all-time lows last year.

A second difference, perhaps more noteworthy, is the fact that pass-through from currency depreciation to price changes has been virtually inexistent. While, as expected, currency depreciation has directly affected the prices of particular tradable goods, no second-round effects have occurred either on the generalized price formation process or medium- and long-term inflation expectations.

The absence of pass-through is quite an achievement given Mexico's long history of high correlation between currency devaluation and inflation until the 1990s under successive regimes of predetermined exchange rates. To be sure, under inflation targeting and a flexible exchange rate, pass-through has diminished substantially in the past 15 years, a result that

7 See SHCP (2015). Criterios Generales de Política Económica para la Iniciativa de Ley de Ingresos y el Proyecto de Presupuesto de Egresos de la Federación Correspondientes al Ejercicio Fiscal 2016, p. 139, September.

8 See SHCP (2016). "Preemptive Fiscal Adjustment Strengthens the Commitment to Macroeconomic Stability," Press Release, February.

may be traced to lower and more stable inflation. Furthermore, statistical evidence shows that pass-through has been lower than in other Latin American countries during this century⁹

An interesting question is why pass-through has been muted in the present context. Although the answer still awaits rigorous statistical examination, I would like to put forth three possible reasons for this phenomenon, which could be complementary, though with varying degrees of significance.

First is slack in the economy. While one cannot rule it out as a factor, slack is also present in other Latin American countries, not just Mexico, and they have seen more significant pass-through.

Second, last year saw positive supply shocks, including the elimination of national long-distance telephone charges, a reduction in government-mandated gasoline and electricity price increases, and unusually soft agricultural prices. It is possible that these shocks have given entrepreneurs maneuvering room for delaying price increases stemming from greater import costs. However, some of these bonuses have begun to wane this year, and yet inflation remains benign.

Third, inflation expectations for the medium- and long-term horizons, contained in analysts' surveys, have continued to be stable, although slightly above the target. This is perhaps the most important factor behind the absence of pass-through, possibly reflecting credibility on the commitment to price stability¹⁰

To face the risks posed by the external scenario, Mexico's monetary policy was adjusted twice recently, with a 25-basis-point hike in December and a 50 basis-point hike in February. Considerations behind these measures were consistent with arguments in favor of vigilance emphasized in previous monetary policy communications.

In particular, an important argument supporting the first hike was to maintain the relative stance vis-à-vis the United States in light of the first fed funds rate increase since 2006. The second hike came in conjunction with the government's announcement of expenditure cuts, and sought to prevent contamination of inflation expectations from currency depreciation, as well as to contribute to stronger macroeconomic fundamentals.

Trust gained over years of consistent endeavor, however, can be lost in an instant. Mexico has an unprecedented opportunity to consolidate convergence to the inflation target, given unusually subdued price pressures.

Upward risks to inflation imply that monetary policy must remain particularly on guard. Dangers include further peso depreciation that does lead to second-round effects, despite their past absence; more rapidly rising agricultural prices that may contaminate other prices; and aggregate demand pressures which may eventually arise with the economy's recovery, something particularly relevant in light of uncertainty on the degree of slack in the economy¹¹

9 The observation of lower pass-through resulting from price stabilization was pointed out as a general phenomenon by John Taylor. See, Taylor, J.B. (2000). "Low Inflation, Pass-through, and the Pricing Power of Firms," *European Economic Review*, 44(7). For pass-through estimates, see Banco de México (2015). Quarterly Report, July-September 2015, Box 1, November.

10 See Banco de México (2016). Encuesta sobre las Expectativas de los Especialistas en Economía del Sector Privado: Marzo de 2016, April.

11 For international evidence of non-linearities in pass-through during episodes of significant currency depreciation, see Caselli, F.G. and A. Roitman (2016). "Non-Linear Exchange Rate Pass-Through in Emerging Markets," IMF Working Paper WP/16/1, January. For a recent discussion of slack in the economy, see Palacio, S. and G. Lozano (2016). "Mexico: Potential GDP, Output Gap, and Inflation," *Economic Research Global Data Watch*, April.

Finally, although actions by the U.S. Federal Reserve must continue to be taken into account, the need for further adjustments may arise independently of U.S. policy moves, for example if inflation expectations become misaligned as a result of international volatility.

Concluding remarks

Mexico has set itself apart from other emerging economies in some respects. However, to an extent, markets continue to treat the country as if it were an average case, and sometimes, below the mean in its asset class. This implies that Mexico must make further progress on possible sources of differentiation. These include improvement of macroeconomic fundamentals, with sustainable public finances and timely monetary-policy adjustments to consolidate price stability.

A well-capitalized and highly liquid banking system must continue to be the case. Structural reforms should also be implemented appropriately. Finally, Mexico's potential growth will increase if improvements to the rule of law and public security are attained.