Manuel Sánchez: The Mexican economy in difficult times

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the JP Morgan 7th Annual Mexico CEO Conference, Mexico City, 31 July 2012.

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Thank you for inviting me to speak to you today. It is a pleasure to participate in the annual JP Morgan Mexico CEO conference and share my thoughts with you on Mexico's economic outlook and challenges.

As you know, the world economy is going through difficult times, characterized by low growth prospects and financial and fiscal problems in many developed countries. I would like to focus my comments today on how this external scenario is constraining the Mexican economy, and what tasks await on the domestic front. My main message will be twofold. First, although Mexico's ongoing economic recovery from the global financial crisis of 2008 seems to be firmly grounded, its continuation and possible strengthening are highly dependent on future global economic conditions. Second, in order to enhance its growth potential, Mexico should confront its domestic challenges, including those related to the consolidation of price stability. As always, my comments are entirely my own responsibility and do not necessarily reflect the views of the Bank of Mexico or its Governing Board.

Economic developments and outlook

During 2012, Mexico has continued a process of economic recovery which began in the middle of 2009. In the first quarter of this year, GDP increased 4.6 percent versus a year ago, a rate that surpasses the growth observed both in the first and the last quarters of 2011. All major demand components expanded significantly, especially exports of goods and services and domestic investment.

Available data suggest that this upward trend continued during the second quarter. In particular, during April and May, year-over-year growth as measured by the Global Economic Activity Indicator (IGAE), a monthly GDP proxy, averaged 4.4 percent, with its two main components, the industrial and services sectors, showing considerable momentum. Monthly contraction of industrial production in May was mainly due to a slowdown in the production of transportation equipment, as a result of temporary closures of some auto plants for production line retooling. Indeed, auto production in June picked up. Furthermore, the services sector continued to expand year over year.

On the demand side, manufacturing exports since April continued to be a significant source of growth, with shipments increasing both to the United States and to the rest of the world, of both automotive and non-automotive products. Although preliminary figures for June suggest that manufacturing exports may have slowed down somewhat, it is too early to conclude that a change has occurred in the ongoing positive trend.

Domestic consumption remained robust, as reflected by retail sales during the first five months of the year. Sales growth exhibited by self-service and department stores suggests that this expansion probably continued in June. The solid development of consumption has been backed by a high rate of job creation, as measured by the increasing number of people affiliated with the Mexican Social Security Institute (IMSS) across all sectors, and significant consumer loan growth in the banking system.

Moreover, April figures for gross fixed investment exhibited high growth. Capital expansion is consistent with the favorable outlook held by business managers, according to PMI indicators for both the manufacturing and non-manufacturing sectors.

The sustained economic rebound has been possible thanks to the country's macroeconomic fundamentals, which encompass a low fiscal deficit and relatively stable public debt with long average maturities, moderate inflation during recent years, and a well-provisioned, well-capitalized and liquid banking system with a healthy loan portfolio. Additionally, up to now, imports by the United States, Mexico's main trading partner, have provided the economy with significant impetus.

The current growth momentum, the macroeconomic fundamentals, and the expectation that the world economy will continue to expand, although at a moderate pace, underpin the consensus estimate that the Mexican economy will probably grow between 3.5 and 4 percent in 2012 and 2013.[1]

Threats to economic recovery and financial stability

Mexico's outlook is highly dependent on global economic conditions. By far, the most significant external factor is the pace of U.S. economic activity, and particularly, that country's industrial production. As you know, the Mexican economy is closely intertwined with that of its northern neighbor through industrial integration and foreign trade and investment relations. This interconnection is illustrated by the fact that the correlation between the two countries' industrial productions is close to 0.9, and that approximately 80 percent of Mexican manufacturing exports are sent to the United States.

After a moderate economic expansion during the first quarter of this year, the U.S. economy has recently shown signs of deceleration. Disappointing data have included manufacturing production, employment, and retail sales, as well as the recently published advance estimates for GDP during the second quarter. The softening of economic activity in the United States has occurred in spite of the current rebound in bank lending to the private sector and the seemingly incipient upturn from the bottom in the housing market.

The recent data are discouraging, as the U.S. economy has been growing below its secular trend since 2008. The underlying causes of this subpar performance are subject to debate, but they possibly include the time it takes for any economy to recover from a deep financial crisis, the unintended consequences of an environment of increased post-crisis regulation, and the uncertainty regarding measures for avoiding the "fiscal cliff" that would take place in 2013 under current legislation and for attaining long-term sustainability for U.S. public debt. In any event, unless the underlying obstacles to higher economic growth are overcome, the U.S. economy will likely continue to grow at unsatisfactory rates.[2]

As a result, consensus forecasts for the United States have recently been lowered, and if these adjustments continue, it is likely they will affect that country's expected industrial production, with a negative impact on Mexico's manufacturing prospects.

The second most important external factor for the Mexican economic outlook is the evolution of the eurozone. The European Monetary Union continues to face significant challenges stemming from a negative feedback loop between bank fragilities and fiscal weaknesses. These struggles are a consequence of a long period of rising indebtedness on the part of the private and public sectors, especially in the peripheral countries. The number of troubled economies has been increasing since the start of the global financial crisis through a process of contagion which has even threatened the foundations of the Monetary Union.

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[1] For example, Blue Chip estimates Mexico's economic growth at 3.7 percent for both 2012 and 2013. See Blue Chip Economic Indicators, Vol. 37, No. 7, July 10, 2012.

[2] See for example, Reinhart, C. M. and K. Rogoff (2011) *This Time is Different: Eight Centuries of Financial Folly*, Princeton University Press; and Lucas, R.E. (2011) "The U.S. Recession of 2007–201?," *Milliman Lecture*, University of Washington, May 19.

Significant steps have been taken to pursue financial and fiscal stability in the euro area, including support programs for restructuring sovereign debt and recapitalizing banks, more favorable liquidity provision for financial institutions from the European Central Bank, and recent preliminary plans toward fiscal and banking unions. Although this progress is noteworthy, significant challenges remain, including the insufficiency of the measures announced, the difficulties implementing those measures, and the short-term tension between fiscal consolidation programs and economic growth.

Consequently, uncertainty continues to prevail in the eurozone, a situation which over the last two years has contributed substantially to the volatility of international financial markets. Obviously, instability has affected Mexican asset prices and, in particular, the value of the Mexican peso versus the U.S. dollar. The peso market is highly liquid and the floating exchange-rate regime in place since 1995 has functioned as a "shock absorber" for the economy.

The complexity of the problems in the euro area likely means that it will be some time before sufficient solutions are finally implemented. Hence, it is reasonable to expect that the eurozone may continue to fuel recurrent episodes of heightened risk aversion with global financial repercussions.

Also, the euro area will continue to be a drag on the global economic recovery. As the possibility of the occurrence of a tail-event in that area has not sufficiently diminished, additional deterioration of global economic prospects cannot be ruled out. This in turn could further constrain Mexico's economic recovery.

Two comments on external implications for Mexico are in order. First, it is possible that some of the wider variability posted by the Mexican peso relative to other emerging-market currencies during recent months reflected fears of contagion from Europe through banking channels, given that the two largest Spanish banks hold a significant share of assets in the Mexican financial system.

Although caution is always a good strategy for economic policy, sound regulation and the positive performance of foreign bank affiliates give pause to these concerns. Foreign banks can only operate in Mexico as subsidiaries, and hence they have to comply with the same regulatory requirements as domestic banks, including limits for related-party lending and high capitalization standards. Additionally, while many financial institutions in advanced economies are deleveraging, and given the under-banked nature of the Mexican economy, both foreign and domestic banks in Mexico have continued to expand their infrastructures as well as their lending to the private sector.

Second, the increasing monetary accommodation adopted by the U.S. Federal Reserve and other central banks in advanced nations since the global financial crisis may have contributed to the international search for yield that has caused substantial capital inflows to emerging-market economies. In particular, considerable flows have been directed to peso-denominated Mexican government bonds during the last two years, allowing downward shifts of the domestic yield curve in tandem with that of the United States. As a consequence, domestic interest rates have fallen to all-time lows.

Many central banks in advanced economies are obviously navigating unchartered waters. Evidence of the effectiveness of monetary policy as a tool to stimulate economic activity is mixed.[3] Also, the unusually lax monetary stance may have unintended consequences, including lower incentives to correct the underlying obstacles to growth and to finance only efficient investments.

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[3] See for example, Feldstein, M. (2012) "The Impotence of the Federal Reserve," *Project Syndicate,* June; and Taylor, J. B. and Stroebel, J. (2012) "Estimated Impact of the Federal Reserve's Mortgage-Backed Securities Purchase Program," *International Journal of Central Banking* 8(2): 1–42.

Yet growth expectations in developed economies have become highly dependent on successive announcements of further monetary relaxation. Hence, it is likely that additional expansionary measures will be undertaken given the already anemic pace of economic recovery in those countries. The implication for Mexico is that capital inflows will probably continue for some time.

However, as history has taught us time and again, any financial bonanza eventually ends. This lesson should keep us prudent and alert to possible excessive risk-taking in the domestic financial system.

Inflation and monetary policy

After having declined in the previous two years, since the middle of 2011 annual inflation has been rising. Last June, it surpassed the upper limit of the variability interval around the Bank of Mexico's 3 percent target, reaching 4.3 percent. Although the most recent reading was significantly affected by a hike in agricultural prices, the upswing has been underpinned by a gradual increase in core inflation. In fact, on average during the second quarter, core inflation rose while non-core inflation fell.

The most prominent factor pressuring core price changes seems to be some pass-through from the weakened Mexican peso vis-à-vis the U.S. dollar. Although there is no evidence of demand pressures at this moment, available indicators such as the use of manufacturing capacity and the output gap, especially that measured for non-tradable goods whose price changes could better reflect domestic monetary conditions, suggest that slack may already have disappeared.

Furthermore, the outlook for inflation has deteriorated somewhat, as reflected by several factors. Additional volatility in international financial markets may generate further pressures on the exchange rate, with a likely negative impact on inflation. Also, upward pressures on key agricultural prices are probable in the following months due to weather and a chicken pandemic.

An additional element has been a rise of short-term inflation expectations as reflected in analysts' surveys. Moreover, inflation expectations for all time horizons remain above the 3 percent target. This is significant as inflation expectations have never been anchored on the objective, making the task of convergence challenging.

Therefore, monetary policy should be vigilant and actions should be timely in order to prevent supply-price and exchange-rate shocks as well as other factors from contaminating the behavior of other prices and pushing up inflation expectations away from the permanent target. Convergence to price stability is a necessary condition for financial stability and long-term economic growth.

Concluding remarks

To conclude, sustained higher long-term economic growth in Mexico requires consolidated foundations for financial stability. In addition to convergence to price stability, the basic policy agenda includes the strengthening of public finances, especially given significant dependence on oil revenues and the fact that the price of oil in recent years has been unusually high but might not prevail in the future. The agenda also encompasses the deepening of macro-prudential regulation and improved supervision of the Mexican financial system.

Finally, a wide set of possible structural reforms should be considered, including the dismantling of obstacles to private investment and further deregulation of the economy in order to enhance total factor productivity and, hence, promote higher living standards.