Manuel Sánchez: Forces and threats to Mexico's economic recovery

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the United States – Mexico Chamber of Commerce, New York, NY, 28 September 2012.

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It is a great honor to be back at the Northeast Regional Chapter of the United States – Mexico Chamber of Commerce. Thank you for inviting me to share some thoughts with you on the recent evolution and outlook of the Mexican economy.

Since I was here over a year ago, the pace of economic recovery in Mexico has strengthened, even surprising on the upside, slightly exceeding mainstream forecasts. However, some risks that I exposed then still remain today, notably those related to the world economy, while others associated with domestic concerns have surfaced. In this brief overview of Mexican economic conditions, I will focus on both old and new issues, including those regarding inflation and monetary policy in Mexico. As always, my remarks are entirely my own responsibility and do not necessarily reflect the views of the Bank of Mexico or its Governing Board.

Current economic rebound

Since the middle of 2009, Mexico has been experiencing a process of continuous economic recovery. Three characteristics of the upswing are worth mentioning. First, the rebound has proceeded at rates that have been roughly twice as high as those observed during the first decade of the century, before the global crisis.[1] Obviously, high growth is partly explained by adjustment from the deep recession that the country suffered three years ago in the aftermath of the global financial crisis.

However, even after taking the correction into account, recent expansion is noteworthy. Specifically, on average during the first half of this year, GDP increased 4.3 percent in annual terms, which has contributed to bringing the economy back to the level of its long-term trend, as reflected by conventional estimations that the output gap has closed. This progress contrasts with economic underperformance relative to historical standards in many developed nations and, in particular, the United States, Mexico's main trading and investment partner.

Second, the current upturn has been balanced, in the sense that it has included all key components of aggregate demand, notably, domestic fixed investment and consumption. Capital formation has shown substantial rates of growth, surpassing those of consumption, as typically occurs over business cycles. Nevertheless, and despite recent signs of deceleration, during the last two years consumer spending has been increasing at a fairly stable annual rate, close to 4 percent.

In a structural sense, the reactivation of economic activity and domestic absorption in particular has been possible thanks to Mexico's macroeconomic fundamentals, including contained public debt with rising maturities, moderate inflation rates, and a well-capitalized, provisioned and liquid banking system. Indeed, the stable macroeconomic environment has enabled bank lending to firms and households to support dynamic domestic investment and consumption.

In the upswing, a positive feedback loop has emerged between labor market developments and consumer spending. Formal employment has continuously expanded, as measured by

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[1] Average annual GDP growth was 2.3 percent from 2001 to 2007, and 4.6 percent from 2010 to the first half of 2012.

the number of affiliates at the Mexican Social Security Institute (IMSS). Although still moderately higher than pre-crisis levels, the total unemployment rate has been gradually declining. This advancement has occurred while labor force participation has recently expanded, the duration of unemployment has fallen, and transitional indicators of employment and unemployment have improved. As a result, the total wage bill has posted real annual growth during the last three quarters.

A third characteristic of the current upturn, which may explain cyclical developments more than any other factor, is the extraordinary support provided by external conditions, particularly that from advanced countries. On the surface this may sound contradictory, considering the significant difficulties these nations have faced in resolving the fiscal and financial problems that gave rise to or resulted from the global crisis. After all, prolonged uncertainty regarding the effectiveness of corrective measures in those countries has long put a downward bias on output forecasts for many emerging economies, including Mexico, given its close production ties with the United States.

Yet, in spite of this uncertainty and the relatively weak rebound of the U. S. economy, Mexico's actual economic growth has been higher than expected, to a large extent, due to two external factors: solid demand for Mexican exports, and unusually favorable financing conditions.[2] Obviously, these factors are not independent from the economic policies implemented by developed countries. Let me now examine them in more detail.

External supporting factors

Along with the world economy, Mexico is currently in its 13th quarter of economic expansion. Because of Mexico's large degree of openness, the revival of world trade has translated into a significant impetus for Mexican economic activity. Specifically, non-oil exports, which represent approximately 85 percent of the country's total merchandise shipments abroad, have been increasing at double-digit annual rates in dollar terms. Especially vigorous has been the advance of automotive exports, the largest non-oil export item. But sales of other goods have also shown substantial growth.

Non-oil exports have been expanding both to the United States and, even more strongly, to the rest of the world.[3] This development is consistent with the diversification trend registered by Mexican shipments during recent years. Particularly, while in 2000 sales to the U.S. represented approximately 90 percent of total non-oil exports, twelve years later this proportion has fallen to 78 percent.

Several factors seem to be at play in the robustness of exports. External demand has been backed by the resilience of consumer spending abroad, which has been a significant engine of the recovery in the United Sates and other parts of the world. But Mexico's non-oil exports may also have been favored by price competitiveness, as suggested by high productivity gains and declining unit labor costs in the country's manufacturing industry in recent years. Also, the relatively weak Mexican peso vis-à-vis the U.S. dollar could have contributed. All in all, price competitiveness together with the advantage of geographical closeness may help

[2] For example, analysts' average forecast for GDP growth in 2011 was 3.6 percent at the end of 2010 and actual growth was 3.9 percent. Similarly, the average forecast for GDP growth in 2012 was at 3.2 percent at the end of 2011 and is currently at 3.8 percent. See Banco de Mexico Survey of Private-Sector Analysts.

[3] From January 2010 to August 2012, the average annual growth of the dollar value of automotive and non-automotive exports was, respectively, 34.4 percent and 14.2 percent, while that of non-oil shipments to the United States and the rest of the world was, respectively, 17.5 percent and 23.9 percent.

explain the fact that Mexican exports have regained market share in U.S. total manufacturing imports.[4]

A second external driving force stems from extraordinarily favorable financial conditions. Unusually lax monetary policies implemented by many developed countries and in particular by the United States, have resulted in policy and market interest rates currently at or close to all-time lows in those nations. Since Mexico's yield curve has been shifting downward in tandem with that of the United States, domestic yields have also fallen to record-low levels.

As in other emerging markets, a major transmission mechanism of imported monetary easing has been substantial capital flows into the country, driven by the search for yield in equity and fixed income assets. Especially significant have been flows directed to peso-denominated government bonds. Mexico has been attracting an increasing proportion of total capital inflows devoted to emerging-market local bonds. Currently, in Mexico, close to half of all peso-denominated public debt securities with fixed coupons are held by foreign investors.

Factors behind the portfolio inflows may include Mexico's macroeconomic stability, capital account openness, a freely floating exchange-rate regime, and high liquidity enjoyed by the Mexican peso in FX markets. Resulting favorable financial conditions have supported credit to firms and, in general, the recovery of bank lending to the private sector. As financing costs have fallen, so has the required return on capital projects, promoting investment.

It is often said that the main risk associated with buoyant capital inflows is the possibility of a "sudden stop." Indeed, this scenario is likely and it has occurred, on innumerable occasions, for reasons not exclusively related to the recipient country, including several times in Mexico. A sudden stop of capital inflows has frequently implied the need for traumatic adjustments in domestic spending, employment and growth, as has been illustrated by the current collapse of foreign investment in the peripheral countries of the Eurozone.

The most serious risk associated with capital inflows is not the ever-present possibility of a reversal, but rather ignoring the likelihood of the event. To be sure, financial crises typically occur because people assume that easy credit will last forever. As a result, over-borrowing and asset price bubbles emerge, which eventually end in implosions that impair the functioning of the economy, as witnessed in the last global financial meltdown.

Hence, possible capital reversal calls for prudence on the part of economic agents in Mexico. As in any economy, the need to detect financial bubbles poses a challenge for policymakers. Although in accomplishing this task, authorities do not generally have knowledge that is superior to that of market participants, they should have stronger incentives for warning against possible excessive risk-taking. Given the inherent difficulty of measuring systemic risk and the probability of unintended consequences from direct interventions in credit markets, moral suasion could, in principle, be an advisable policy tool.[5]

The base-case scenario for Mexico's economic outlook, as posited by most analysts, assumes the continuation of favorable external conditions. This assumption does not seem unreasonable at this point in light of new rounds of monetary accommodation recently announced by the U.S. Federal Reserve and other central banks. In this environment, the Mexican economy is forecast to continue growing at rates between 3 and 4 percent this year and the next.

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4 For an interesting study of the productivity gains of Mexican manufacturing exports, see Oviedo, M. (2012), "The productivity revolution and the China (manufacturing) syndrome," Barclays, *Emerging Markets Research*, 6 September.

5 For an evaluation of the current state of Mexico's financial system, see Council for Financial Sector Stability (2012), "Informe anual sobre el estado que guarda la estabilidad del sistema financiero en México y sobre las actividades realizadas por el Consejo de Estabilidad del Sistema Financiero," March.

Obviously, the substantive role that external conditions have played in Mexico's economic recovery makes their eventual weakening a fundamental risk. In particular, if U.S. industrial production slows, Mexican manufacturing exports may decelerate notably. Additionally, further difficulties encountered by the euro area countries in implementing measures aimed at an integral solution to their common problems could generate new bouts of financial volatility and engender adverse effects on world economic prospects, affecting Mexico.

Inflation and monetary policy

In recent months, annual inflation has been rising, and since last June, it has surpassed the upper limit of the variability interval of plus or minus one percentage point around the Bank of Mexico's permanent 3 percent target. A central element behind this deterioration has been significant price increases registered by agricultural products, resulting mainly from international drought and the outbreak of bird flu in Mexico. These effects have manifested themselves primarily in the non-core component of the National Consumer Price Index (INPC), which includes those items that tend to exhibit the highest price volatility.

A second, more prolonged trend driving the evolution of inflation are increasing annual changes in the INPC core component since the second half of last year. Among other factors, this tendency has reflected some pass-through from the depreciated Mexican peso vs. the U.S. dollar, as well as significant processed food price increases.

According to private-sector forecasts, annual inflation could remain above 4 percent for the rest of the year. The worsened scenario is worrisome, as inflation imposes a significant cost on society. Given the large weight of food components in the price index, this burden has tended to fall more heavily on the lower-income population. Also, inflation uncertainty may hinder consumption and investment and, hence, the pace of the ongoing economic recovery.

Given these prospects, it is crucial to evaluate whether current price pressures are transitory and will not generate future problems for controlling inflation. Most importantly, monetary policy will have to be adjusted in a timely way if convergence of inflation to the 3 percent permanent target is endangered.

Two sources of risk that will have to be monitored are first, the amplification of second-round effects from international price shocks and foreign exchange volatility, and second, evidence of aggregate demand pressures. It is worth mentioning that, as of last August, close to half of the goods that comprise the INPC basket exhibited annual price changes higher than 4 percent, and some indicators of slack in the economy have already disappeared.

The most essential challenge to Mexican monetary policy remains the anchoring of inflation expectations on the 3 percent permanent target. As reflected in analysts' surveys, inflation expectations for the short term have been increasing, while those for longer terms continue to be relatively stable but stubbornly above the objective.

Concluding remarks

Finally, the encouraging pace of the ongoing economic recovery does not imply that the economy is growing at rates that are sufficient to meet social needs or exploit potential opportunities. In order to enhance living standards more significantly, Mexico has to consolidate macroeconomic stability, by promoting strengthened public finances in preparation for future obligations and difficulties, the convergence of inflation to the permanent target, and further improvement of the regulatory and supervisory framework for financial institutions.

Additionally, total factor productivity growth should be facilitated. Considerable efficiency gains seem possible in the services sector and in non-manufacturing industries, given their size in the economy and the relatively low levels of productivity. This could be accomplished by removing obstacles to the reduction of informality and by facilitating competition.