Manuel Sánchez: Mexico's economic outlook and challenges

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the Conference "Regulatory reform, the global economic outlook, and the implications for Mexico's financial sector", organized by the Institute of International Finance and Banorte, Mexico City, 20 February 2013.

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It is a privilege to speak at the close of this conference devoted to the implications for Mexico of recent regulatory reforms and the global economic outlook. I would like to thank the organizers of this seminar, the Institute of International Finance and Banorte, for the opportunity to share some thoughts with you on Mexico's economic conditions and prospects.

I would like first to review the recent developments in the Mexican economy and its outlook in today's weak world economic environment. Then, I will analyze the implications of currently benign financial conditions. And finally, I will discuss some of the present challenges for monetary policy in Mexico. As usual, my remarks are entirely my own responsibility and do not necessarily reflect the views of the Bank of Mexico or its Governing Board.

The Mexican economy in a weak global environment

The performance of the Mexican economy last year continued to be constrained by a weak global environment. The world economy expanded at a slower pace than the average observed in the two decades before the big financial crisis. In the United States, GDP grew moderately, and for a fifth consecutive year, output remained below its secular trend. Signs of improvement in several variables in the United States are encouraging, including those suggesting the beginning of a turnaround in the housing market and the gradual recovery of bank lending to the private sector. However, the level and characteristics of unemployment as well as the sluggishness of private investment remain sources of concern.

Additionally, U.S. industrial production, which exerts substantial influence on Mexico's production and trade, has lately exhibited a deceleration. The rebound in U.S. output after the crisis has been disappointing, especially in light of significant stimulus provided through previous fiscal packages and the ongoing extraordinarily expansionary stance of monetary policy. Subpar economic performance may be partly explained by uncertainty regarding the speed and distribution of costs in the pursuit of fiscal consolidation. Recent fiscal accords may have reduced the risk of a GDP contraction.

On the other hand, during 2012, the euro area fell into recession with unemployment rates at record highs. To a large extent, the problems in the region stem from institutional limitations of the design of the monetary union that have complicated dealing with the aftermath of national financial crises. Progress in revamping the EMU architecture, bailout programs for troubled economies and, especially, decisive measures undertaken by the ECB have lowered perceived risk for sovereign and bank debt, especially in the peripheral countries. Although further meaningful structural measures will be required to attain a full economic recovery, the financial stabilization achieved may suggest that the worst of the crisis is over in the euro area.

Consistently, the most recent consensus estimates for 2013 and 2014 posit a gradual recovery for the world economy, moderate deceleration followed by higher growth in the United States, and a slight contraction and later an expansion in the Eurozone.[1]

[1] See Consensus Economics (2013), *Consensus Forecasts*, February.

In spite of this challenging environment, last year Mexican economic activity continued to exhibit a positive trend, with a firmer expansion in services than in industry. In the fourth quarter, annual growth was the same as in the previous quarter, although both figures were not as high as in the first half of the year. Annual GDP growth for the full year was 3.9 percent, virtually the same as in 2011; this growth is noteworthy, especially in the present world context, as it is almost one percentage point higher than Mexico's average growth rate during the twenty years prior to the crisis.

On the back of this progress, external demand, as reflected prominently in manufacturing exports, has shown some moderation in growth in the past several months, with a recovery in the most recent quarter. By far, the main source of deceleration came from countries other than the United States, and in particular in automotive exports. This slowdown is partly explained by restrictions imposed by Brazil and Argentina on auto imports from Mexico.

At the same time, domestic demand continued expanding. Private consumption, the largest component of domestic spending, maintained its momentum, as indicated by available data on retail sales up to November. The strength of consumption has been supported by a sustained increase in formal employment, a moderate decline in unemployment, and a significant expansion in consumer lending.

Gross fixed investment kept rising, with machinery and equipment showing higher growth rates than construction. Additionally, measures of business confidence up to January 2013, such as the Manufacturing Orders Indicator (IPM), reveal that business managers foresee that the economy will maintain its expansion.

Given the expected slowdown in the U.S. economy largely due to fiscal consolidation, analysts predict that Mexico's economic growth in 2013 will be slightly lower than that of the previous year, with a recovery occurring in 2014.[2] There are both downside as well as upside risks to this scenario. A fiscal adjustment in the United States applied in a disorderly way or lacking credibility, or a complication in policy implementation in the Eurozone that augments financial uncertainty, stand out as possible negative external factors. However, the recovery in the United States may be faster than forecast, and investor confidence in Mexico could increase as a result of progress on structural reforms favoring long-term growth.

Capital inflows and benign financial conditions

During the last four years, the yield curve in Mexico has successively shifted downward, a process that has continued so far this year, leaving current interest rates for all terms close to or at their all-time lows. Aside from variations due to changes in risk aversion, the main driving force for these shifts has been almost synchronic shifts in the U.S. yield curve, resulting from the different stages of monetary easing there.

The main transmission mechanism for lower interest rates has come from persistent capital inflows. As in other emerging economies, Mexico has received substantial capital flows from foreign investors seeking higher yields in both equity and bond markets. Also, foreign investors may feel more confident about the Mexican economy because of its sound macroeconomic and financial fundamentals, the openness of its capital account, the flexibility and depth of its foreign exchange market, and higher expectations for structural reforms, among other factors.

As a result, from 2009 to 2012, the proportion of non-equity financial assets held by foreigners relative to the broadest monetary aggregate, M4, increased from five to seventeen percent. There are indications that inflows have speeded up during the current year in many emerging economies, including Mexico.

[2] Expected growth is 3.6 percent for 2013 and 4.0 percent for 2014. See Banco de Mexico (2013), "Encuesta sobre las expectativas de los especialistas en economía del sector privado," January.

The abundance of foreign savings was supportive of Mexico's recent economic growth. However, the possibility of a change in the perceived conditions that gave rise to the inflows makes it likely for those flows to stop and even revert. Such reversals have occurred on innumerable occasions in many countries, including Mexico, for reasons not necessarily related to the recipient country, causing substantial financial disturbances. The obvious case at present could be the expectation that the Federal Reserve will start unwinding its expansionary monetary policy.

Before such an eventuality occurs, for whatever reason, and about which only the timing and magnitude are uncertain, it is absolutely necessary for savers and borrowers as well as financial intermediaries to take into account that interest rates will eventually rise. The real danger is to believe that this time will be different and that somehow present favorable conditions will last forever. Such myopic behavior has often led to excessive risk-taking, overleveraging and the formation of bubbles in credit and real estate markets, frequently the prelude to financial crises and painful massive redistributions of wealth.[3]

Fortunately, Mexico's banks have been operating cautiously, thereby maintaining strong balance sheets and healthy loan portfolios. Also, no lending bubble is apparent. However, authorities will have to continue monitoring threats to stability in any part of the financial system, in order to act in a timely way if they emerge.

The challenges to monetary policy

In 2012 annual inflation exhibited a rising trend to a maximum of 4.8 percent in September. During seven months it surpassed the upper limit of the variability interval of plus or minus one percentage point around the permanent target of 3 percent established by the Bank of Mexico. Factors exerting pressure on inflation included the international draught and the domestic bird flu epidemic that resulted in significant agricultural price increases, and some pass-through from peso depreciation to merchandise prices.

In December 2012 and January 2013, inflation fell to below 4 percent, a welcome development in light of the previous considerable deviation from the target. Nevertheless, the recent decline in inflation should be seen with caution. This is because, first, it is based only on two observations, which cannot yet be proven to be the beginning of a new trend.

Second, the drop in inflation depended significantly on sharp declines in telecom prices and moderating agricultural price increases. If one were to exclude the effect of telecom prices on inflation in December and January, inflation would have been above and practically on the upper limit of the variability interval, respectively. Also, as occurs with negative disturbances, positive shocks like the recent ones sooner or later die out and could be followed in their own turn by adverse shocks.

Third, the proportion of the components of the National Consumer Price Index (INPC) basket with annual increments higher than 4 percent is still substantial. Fourth, the two most recent inflation prints exceed the target and do not even correspond to the lowest inflation rates observed in Mexico during recent years.

These caveats are all the more important as the target has not been achieved in the past, in the sense that inflation has not been fluctuating around 3 percent. In fact, since the end of 2003 when this objective became effective, inflation has varied around a mean of 4.3 percent. Moreover, during the nine years after the establishment of the target, inflation has not exhibited any clear path of convergence towards it. This lack of convergence may

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[3] For an excellent account of the persistence of financial crises and their common causes see Reinhart, C. and K. Rogoff (2012), *This Time Is Different: Eight Centuries of Financial Folly*, Princeton University Press.

partially explain why inflation expectations for the short and medium terms, as reflected in analysts' surveys, have long remained stubbornly above the target.[4]

These considerations call for vigilance in monetary policy. The target is the principal guide and has not been attained. Furthermore, negative shocks could easily complicate convergence. Risks include the following: weather and animal health problems could fuel agricultural price rises; new episodes of heightened risk aversion could trigger currency depreciation with some effects on inflation; public-sector prices could be higher than anticipated; and finally, some aggregate demand pressures may arise in light of conventional measures suggesting that slack in the economy has disappeared.

Concluding remarks

In spite of a weak global environment, Mexico's GDP kept growing at rates surpassing historical records. Analysts' outlook for the Mexican economy posits a slight deceleration in 2013 and a recovery the following year. There are both downside and upside risks to this scenario, including on the positive side, further progress on structural reforms.

Substantial capital inflows resulting in unusually favorable financial conditions in Mexico have been supportive of economic activity. However, economic agents should remain prudent as these flows, for many reasons, could stop and even revert. Finally, the short period of recent improvement in inflation, the extraordinary factors that explain it, and the absence of convergence toward the inflation target, require a vigilant monetary policy. Convergence of inflation to the permanent target demands more than a few months of good results.

[4] For empirical evidence of the lack of anchoring of inflation expectations on the target, see Carrasco, C. and J. Ferreiro (2012), "Inflation targeting and inflation expectations in Mexico," *Applied Economics*, July.