Manuel Sánchez: Mexico's prospects for economic growth

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the United States-Mexico Chamber of Commerce, New York City, 18 October 2013.

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I am grateful to the United States-Mexico Chamber of Commerce in New York for the opportunity to speak to you today. Your invitation is especially gratifying as members of your organization are indispensable in promoting investment in both our countries.

My remarks will focus on Mexico's prospects for economic growth. The subject is timely and important as the Mexican economy is currently in a slowing phase. Also, perhaps more crucially, for many years the country's economic performance has been disappointing relative to its own history as well as to that of other emerging economies. It is natural to ask: Are there any indications of possible improvement for the immediate and longer-term horizons?

In order to address this issue, first, I would like to comment on the ongoing downturn and immediate outlook for the Mexican economy; second, I will examine the implications of recent developments in international financial markets for the country; third, I would like to take a longer view and examine the agenda for structural reforms; and, finally, I will make a few observations on monetary policy and inflation in Mexico.

The economic downturn and outlook

Since the middle of last year, Mexico's economic activity has been decelerating significantly. The slowdown has been deeper and faster in 2013, with virtually no growth during the first quarter and a contraction in the second quarter. Recent GDP shrinkage coincided with the first reduction in both the services sector and consumer expenditures observed during the post-crisis recovery.

The origin of the current downturn can be traced back to two negative shocks that began roughly at the same time. The first has to do with the softening of external demand during the second half of 2012, and in particular, of manufacturing exports, which account for around 80 percent of the country's total shipments abroad and fueled a considerable slowdown in manufacturing production. However, exports have gradually gained steam during the present year, reducing the negative impact on the economy. The fact that manufacturing output has been expanding since last May could be a reflection of the external improvement.

The second shock has been domestic and more enduring, expressed in a continuous contraction of public investment since the third quarter of 2012 and weak private investment. Behind this development lie declining public works expenditures and the worsening of an already decreasing trend in private housing construction. Expansion in investment in machinery and equipment has been insufficient to compensate for a fall in total construction spending.

A recent drop in consumption was preceded by lower consumer confidence, which may have resulted from a stagnant real wage bill and low growth in total employment, both connected with the described shocks.

Available data suggest that economic growth may have picked up in the third quarter. Encouraging information includes the strengthening of manufacturing production, exports, and PMIs. Additionally, services output and investment spending grew in July, while retail and wholesale sales have been increasing since May.

Prominent concerns center on the deterioration in construction. As in any economy, an upsurge in this sector is essential for a sustainable recovery. So far there is no indication that improvement in output is forthcoming, although public construction may soon bounce back as government expenditures align with budgeted outlays. On the other hand, a revival of private construction may not be immediate. Housing has been on a weakening path since 2008, major developers now face solvency problems, and the restructuring of the industry will likely take time.

On the other hand, the U.S. economy has continued to show signs of strength, in particular in industrial production, which may have a positive impact on Mexico's economic activity. Thus, most analysts estimate that the current downturn will be short-lived with a clear rebound coming next year. However, downside risks to this scenario seem to prevail, including a pause in the U. S. economic recovery, which may limit the expansion of Mexican exports, and a deeper deterioration of the domestic construction industry.[1]

The impact of international financial conditions

As in other emerging economies, Mexico's financial markets have been affected by the extraordinary monetary expansions undertaken during the last five years by major central banks, most prominently the U.S. Federal Reserve. Until last April, these policies constituted an important factor behind substantial capital flows directed to emerging markets in the search for higher yields.

Obviously, greater capital availability benefits recipient countries, potentially providing additional and cheaper means for financing investment. Nevertheless, significant portfolio inflows may also pose risk if they result in macroeconomic imbalances or financial asset price rises that depart considerably from underlying fundamentals.

Although symptoms of overheating and macroeconomic imbalances have surfaced in several countries, other emerging economies seem to have fared well in the midst of the recent capital bonanza. In particular, Mexico was one of the preferred destinations of portfolio capital inflows, as reflected by unprecedentedly high levels of peso-denominated government bonds held by foreigners.

There are no clear signs of financial disequilibria in Mexico that might have arisen as a consequence of portfolio capital inflows, given the relative stability of indebtedness indicators such as the ratios of the current account balance, public-sector liabilities, and total external debt to GDP. Additionally, growth in lending to the private sector was hardly affected by the capital inflows, as most were des-intermediated and, in any case, banks have shown prudent risk-taking while also complying with stringent regulatory requirements.

Nor has the Mexican peso appreciated consistently, thereby harming export competitiveness. Other factors, such as recurrent pessimism surrounding the U.S. economic recovery, have often pushed the peso in the opposite direction.

By far, the financial asset price most influenced by capital inflows has been that of government bonds, as shown by substantial downward shifts in the Mexican yield curve occurring since 2010 in tandem with U.S. yield-curve shifts. In turn, lower real long-term interest rates and foreign appetite for higher risk-adjusted returns provided favorable conditions for corporate financing in Mexico and abroad.

Since May, market anticipation that the Fed would soon start tapering its monetary stimulus has translated into lower prices for many financial assets, hitting those of emerging markets, previously considered darling destinations for international capital flows, especially hard.

Mexico's financial adjustments to this change in market sentiment, though significant, have occurred in an orderly way. From May to mid-September of this year, ten-year government

[1] From June to September of this year, the median analysts' estimate of GDP growth for 2013 fell from 2.8 to 1.5 percent, while for 2014 it decreased only from 4.0 to 3.7 percent. See Banco de México, *Encuesta sobre las expectativas de los especialistas en economía del sector privado*, June and September.

bond yields increased by more than 160 basis points, financial volatility widened considerably, and the Mexican peso depreciated vs. the U.S. dollar. However, capital outflows were not extraordinary, foreign holdings of government bonds declined only modestly, and the foreign-exchange market remained highly liquid.

The Fed's decision in September to postpone tapering, needless to say, came as a surprise. This development has reduced market pressures somewhat. However, given uncertainty over the future course of U.S. monetary policy, new bouts of volatility cannot be ruled out. Additionally, tapering may pose some risks to Mexico's economic rebound if the effect of less benign international financial conditions is not sufficiently offset by that of a stronger U.S. economic outlook.

A long view on structural reforms

During the last few months, Mexico has seen significant momentum on a structural reform agenda, a phenomenon that has not occurred in about two decades. The scope of the initiatives is wide and progress already achieved, noteworthy.

The ongoing reform movement is a fortunate development as the pursued transformations seek to tackle the most important underlying problem behind the disappointing performance of the Mexican economy during the last three decades: stagnant productivity.

Indeed, the objectives of the reforms, which involve many sectors of the economy, center on fostering competition and market flexibility, thereby allowing for a more efficient allocation of resources as well as lower prices of productive inputs and of final goods and services. The welfare gains from these changes, if fully implemented, could be significant.

Without attempting to provide a complete picture of the reforms, I would like to highlight some of the salient features of three new legislative changes and a bill recently submitted to the Mexican Congress, all of which seem particularly promising in terms of potential benefits.

A first reform, approved in November 2012, seeks to make labor relations more flexible by reducing obstacles to job mobility and labor market efficiency. In particular, the new legislation allows for new hiring practices such as trial, training, and temporary contracts, and the possibility of part-time employment and hourly wages. Also, it prohibits a union membership requirement for hiring, and promotes wage increases based on productivity rather than seniority.

At the same time, the approved legislation reduces wage compensation after labor disputes. Greater ease in hiring and dismissal is expected to increase formal employment, which is typically more productive than informal work. The combination of these measures may increase not only formal employment, but also potential GDP growth as well.[2]

A second reform, approved in 2013, aims at improving the skills and commitment of teachers in public schools for all levels of pre-college education. The reform establishes new conditions for teachers to be hired, keep their jobs and become promoted. In particular, admission to the field will be granted through competitive exams, thereby eliminating the practice of guaranteeing automatic job placements to graduates of public teaching schools, and the inheritance or sale of teaching positions.

An independent institution will be in charge of evaluating teacher performance in order to keep a position. Also, conditions are established on salaries and penalties in case of lack of fulfillment of duties. These basic changes point in the direction of improving the quality of education, a highly necessary step given the importance of investment in human capital to

[2] For an estimation of possible medium- and long-term effects of the labor reform on potential growth and formal employment, see Banco de México (2013), *Inflation Report: October–December 2012*, February.

enhance productivity and the worrisome results obtained in educational achievement tests and evaluations in Mexico.[3]

A third reform, also approved this year, pursues greater competition in key economic areas, with a special emphasis on telecommunications. The reform strengthens the institutional framework of the Federal Economic Competition Commission in order for it to effectively monitor and take legal action against possible anticompetitive practices in all areas except telecommunications, over which a separate authority will preside.

Particular focus is placed on eliminating barriers to competition in telecommunications. The legislation opens the door to new operators interested in all types of services, and to current players seeking to offer additional, previously excluded services, provided that certain market non-concentration requirements are satisfied. Limits to foreign direct investment in telecom, satellite, and radio communications are reduced. Additionally, new national television networks will be auctioned.

A more competitive telecommunications industry is expected to generate wider and cheaper access to efficient communications, potentially improving productivity, while at the same time providing the consumer with more choice.

A significant initiative recently submitted to Congress concerns the energy sector. For oil and hydrocarbons, the proposal envisions private participation in exploration and extraction through contracts based on result sharing. Additionally, it opens the possibility of permits to private participants in gas processing and oil refining, as well as transportation, storage, distribution, and commercialization.

For electricity, the bill proposes allowing private participation in generation and sale to third parties through access to the public transmission network. If approved, this reform may substantially boost investment for several years and reduce the costs of basic productive inputs, yielding wide benefits to the economy.

Inflation and monetary policy

During the last decade, monetary policy has been oriented towards achieving a three percent permanent inflation target. A variability interval of plus or minus one percentage point around this objective accounts for price fluctuations which could mainly arise from the non-core components of the National Consumer Price Index.

Focused on its constitutionally mandated primary objective of price stability, the Bank of Mexico has set its policy interest rate taking into account, among other factors, how the cyclical phase of the economy may affect future inflation. Hence, in the midst of the big contraction of 2009, the central bank lowered its policy interest rate from 8.25 to 4.50 percent, and in 2013 it has further reduced it to 3.75 percent.

In the last ten years, annual inflation has remained much lower than historical levels. This has been possible thanks to the support of a prudent fiscal stance, a prerequisite for the credibility of monetary policy in any country and, hence, something which should continue to be safeguarded in the future.

In 2013, after a spike resulting from agricultural price shocks, annual inflation has recently fallen, reaching 3.4 percent in September. As in previous years, medium- and long-term inflation expectations have remained relatively stable, though above the permanent target.

In the future, several risks need to be assessed for maintaining inflation under control, including possible pressures from renewed financial volatility and new shocks from non-core price components. In any case, the Governing Board of the Bank of Mexico has repeatedly

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[3] See, for example, OECD (2010), *PISA 2009 at a Glance*, OECD Publishing.

stated that it will continue to be vigilant, acting in a timely way if shocks to relative prices could potentially contaminate inflation expectations and put convergence to the permanent inflation target at risk.

Concluding remarks

To conclude, after a year of economic slowing, the 2013 third quarter has seen encouraging signs of improvement. The outlook for the Mexican economy includes a recovery next year, although downside risks prevail, including an adverse external scenario and protracted difficulties for construction-sector restructuring.

Although domestic financial markets have operated in an orderly way in the face of changing international sentiment toward emerging economies, further bouts of volatility may pose some challenges to both inflation control and the strengthening of a recovery in the short term. Finally, Mexico's current momentum in structural reform is highly promising, as both the changes approved and those under discussion seek to enhance productivity growth, a key element for underpinning greater long-term economic expansion.