Manuel Sánchez: Mexico's economic modernization and outlook

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the 2014 Southwest Economic Summit: The Americas, Global Interdependence Center, Phoenix, AZ, 24 February 2014.

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Thank you for inviting me to participate in the 2014 Southwest Economic Summit, devoted to the discussion of the economic effects of international trade. This conference is timely as we celebrate the 20th anniversary of NAFTA, an accord that has yielded significant benefits to each of the three member countries.

Being a developing nation, Mexico in particular has gained from the opening of the economy and NAFTA, in terms of higher consumer wellbeing, output expansion and efficiency, among other benefits. Yet, in spite of more dynamic foreign trade, the country's economic performance during the last three decades has been far from satisfactory.

Ongoing structural reforms in the country enhance possibilities for progress as they are intended to tackle Mexico's most important drag on long-term economic growth, stagnant productivity. On the other hand, the country is currently undergoing an economic rebound that faces challenges, including those from less favorable external financial conditions.

Today I would like to briefly address these long- and short-term issues for Mexico. Specifically, first I will review the impact of Mexico's economic opening and second, I will highlight some features of the current momentum on structural reform; third, I will discuss the economic outlook; and finally, I will provide a few remarks on monetary policy and inflation.

Mexico's integration in the world economy

Since the middle of the 1980s, Mexico has implemented a strategy of gradual trade liberalization in order to modernize its economy and promote economic growth. The first steps were unilateral, consisting of across-the-board reductions of import tariffs and non-tariff barriers. This policy was strengthened by Mexico's incorporation in the General Agreement on Tariffs and Trade (GATT) in 1986.

External liberalization was later deepened through a number of free trade accords, among which NAFTA stands out. Mexico´s economic opening was mainly in foreign trade, although notable steps in removing obstacles to foreign direct investment (FDI) were also undertaken. The recent lowering of import tariffs for nations with which Mexico does not have any trade agreement widened the country's openness to the world.

Certain effects from more trade seem to be clear in Mexico. By far, the most evident and crucial benefit has been greater consumer welfare, the ultimate end of any economic policy. The reduction of trade barriers has provided the Mexican consumer with a wider variety of higher-quality goods at lower prices, many of them completely unavailable when the economy was closed.

Behind this development has been a considerable expansion of merchandise exchange with the rest of the world. During the last thirty years, total trade value, defined as the sum of exports plus imports, has tripled relative to GDP, to reach approximately 60 percent.

NAFTA seems to have contributed to the enlargement of trade not only with Mexico's North American neighbors, but also with nations from other regions. In fact, there is evidence that trade diversion resulting from this preferential agreement has been relatively low. The observation is confirmed by the fact that during the last ten years, the importance of shipments to the United States relative to Mexico´s total non-oil exports has declined.[1]

At the same time, trade opening resulted in a significant change in the composition of exports, from one based on oil to one made up mainly of manufactured goods. Within this transformation, the share of high-tech products has been gradually increasing.

Growth in exports has occurred in tandem with that of imports. The vertical integration of many firms in the North American region has implied significant growth of intermediate goods imports, which along with capital imports accounts for the majority of purchases from abroad.

Less dramatic but also clear has been the contribution of economic opening to greater FDI. On average during the last 20 years, FDI relative to GDP has been twice as large as the average observed ten years earlier, although this ratio still remains well below those of leading recipient countries. Also, during the more recent past, the proportion of flows coming from the United States has been decreasing.

In addition to the impetus from NAFTA, other factors such as the liberalization of FDI restrictions in several areas, such as the financial and the telecommunication sectors, contribute to explaining the larger inflows. Through FDI, new firms have been established in the country, including those oriented to providing services, and companies have been able to adopt new technologies and modernize their productive processes.

There is some evidence that the sectors more engaged in international trade in Mexico have enjoyed increasing efficiency. This seems to be largely the result of import competition and access to foreign intermediate inputs. Also, some studies suggest that FDI has contributed to an increase in total factor productivity. Greater efficiency, in turn, has tended to support relatively higher wages in the sectors most exposed to international trade.[2]

Mexico's economic integration with the United States has been strengthened with the opening of the economy. This effect, along with Mexico's sounder macroeconomic policies, has resulted in an increased synchronization of its business cycles with those of the United States, thus making the economy relatively more stable than in the past.

Structural reforms

In spite of the benefits from economic liberalization, Mexico's long-term economic performance has been less than stellar. During the last three decades, per capita GDP growth has been below half that of the United States. This is surprising given that Mexico's stage of development should translate into a wide range of profitable opportunities the exploitation of which could presumably increase potential growth rates.[3]

Several analyses of Mexico's per capita GDP growth, based on factor and productivity decomposition, confirm that the main impediment to more dynamic output is stagnant total factor productivity. Moreover, examination of sectorial productivity suggests that common

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1 See, for example, Krueger, A.O. (1999), "Trade creation and trade diversion under NAFTA," *NBER Working Paper*, 7429; and Lederman, D., W.F. Maloney, and L. Serven (2005), Lessons from NAFTA, Stanford University Press and the World Bank.

2 For productivity and wage effects from NAFTA, see De Hoyos, R. and L. Iacovone (2013), "Economic Performance under NAFTA: A Firm-Level Analysis of the Trade-Productivity Linkages," *World Development 44*; and Caliendo, L. and F. Parro (2012), "Estimates of the Trade and Welfare Effects of NAFTA," *NBER Working Paper* 18508. Evidence of the FDI channel of NAFTA is provided by Waldkirch, A. (2010), "The effects of Foreign Direct Investment in Mexico since NAFTA," *The World Economy*, 33(5), 710–745.

3 From 1980 to 2011, annual average PPP-adjusted per capita GDP growth was 1.7 percent in the United States and 0.6 percent in Mexico; based on Feenstra, R.C., R. Inklaar and M.P. Timmer (2013), *The Next Generation of the Penn World Table*.

factors in the lagging segments of the economy include low competition, poor contract enforcement, and burdensome regulation resulting in widespread informality.[4]

Current momentum for structural reform in Mexico is a welcome development as the reforms include some measures that may tackle inhibitors of productivity in key sectors of the economy. The transformation agenda encompasses several areas, including labor, education, financial intermediation, telecommunications, and energy.

The legislative changes incorporate deregulation in the labor market, the protection of creditors' rights, and the exposure of sectors to competition where the entry of private participants is either completely banned, such as in most areas of the energy sector, or restricted to different degrees, such as in telecommunications.

As regulation improves and obstacles to competition diminish, higher efficiency may emerge in related areas, with eventual benefits for the consumer in terms of higher quality and lower prices for goods and services.

It is worth noting, however, that as with any other structural change, the intended benefits depend crucially on the quality of the rules and their adequate implementation, so that participants view the new framework as clear and reliable. In particular, secondary legislation is pending for the energy, telecommunications, and financial system reforms, and these norms need to facilitate participation and competition.

We should also recognize that, although a revival of private investment may occur in sectors such as energy in the not-too-distant future, productivity effects and eventual consumer benefits will likely become evident only over the course of several years.

The economic outlook

In the year beginning in the 2012 third quarter, the Mexican economy underwent a process of deceleration. The main factors behind slowing GDP growth were weaker export demand from all regions, including the United States, and a contraction in domestic investment, largely driven by deterioration in construction. Shrinking construction, in turn, reflected reduced public expenditures associated with the change in administration, and lower private housing investment linked to major developers' financial problems.

Since the middle of 2013, there have been signs of an economic upturn. GDP grew in the third quarter and continued to expand in the fourth, though at a much slower pace. A source of improvement has been more dynamic exports as the U.S. economic recovery has gained steam, and lately the normalization of public expenditures.

Consumption apparently continued to grow in the fourth quarter, as suggested by the performance of service production and retail sales. The labor market provides other encouraging indicators. Formal employment has maintained a positive trend and the unemployment rate has fallen to its lowest level since 2009, even though it remains above pre-crisis averages.

Despite this progress, the rebound remains fragile, as shown by very weak fourth-quarter GDP growth. Investment has extended a declining trend, with deceleration involving not only construction but machinery and equipment purchases as well. Also, consumer confidence has been falling since last year, and recently more sharply.

4 For an analysis of GDP decomposition and sectorial productivity see, for example, Sánchez, M. (2013), "The search for Mexico's economic progress," presentation for Alamos Alliance XX, February.

Analysts' consensus posits a gradual recovery for the Mexican economy this year and next. Elements that may support these forecasts include better expected economic prospects for the United States and the reactivation of government investment.[5]

However, there are downward risks to this scenario, including a further decline in consumer confidence; the time needed to restructure the housing developers market; and less favorable external financial conditions.

Regarding the third factor, expectations of the tapering of U.S. Federal Reserve securities purchases last May brought about an increase in global risk aversion, reducing the prices of many financial assets, especially those of emerging markets, which had been favored in the previous two years. Although volatility declined by the end of 2013, partly as a result of lower uncertainty after the Fed finally did announce its decision to start reducing its asset purchases, risk aversion has returned in 2014.

The recent deterioration of global market sentiment has once again translated into a flight to quality, away from emerging economies. Some countries with significant macroeconomic imbalances, high inflation or political upheavals have been hit severely.

Heightened risk aversion apparently reflects uncertainty on the pace of the future unwinding of monetary stimulus in advanced nations, lower growth prospects for emerging markets, notably China, and the unknown capacity of vulnerable developing countries to undertake needed adjustments.

Although emerging markets as a group have been affected negatively, there has been some differentiation in investors' appetites among specific economies. So far, Mexico's financial asset prices have been relatively less affected, and the availability of foreign financing continues to be ample.

Yet the country cannot take the present situation for granted, since market sentiment can deteriorate further at any time. In the face of such an eventuality, the best strategy for Mexico is to buttress its economic fundamentals, including fiscal discipline, financial and price stability, and productivity-enhancing reforms.

Monetary policy and inflation

For more than a decade, the Bank of Mexico has implemented its monetary policy within an inflation-targeting framework. Since 2003 the permanent objective has been 3 percent annual inflation, with a variability interval of plus or minus one percentage point around this target.

The interval is not an objective or an indifference range, but a reflection of the inherent volatility of the non-core components in the National Consumer Price Index (INPC). Throughout these years, there has been considerable progress in the convergence of general inflation towards the 3 percent target.

In 2013, the Bank of Mexico lowered its policy interest rate by a total of 100 basis points in three cuts, leaving it at its current 3.5 percent. The reasons for these adjustments were previous gains in the reduction of inflation, and the softening of economic activity, viewed as consistent with diminished foreseeable inflation pressures.

After a slight decline in average annual inflation, price growth picked up at the end of 2013 and surpassed the upper limit of the variability interval in January. The main proximate causes of the recent rise in inflation were increases in public transportation prices and tax

[5] Consensus forecasts for Mexico GDP growth are 3.4 and 4.0 percent for 2014 and 2015, respectively. See Consensus Economics (2014), *Latin American Consensus Forecasts*, February.

hikes approved for the present year. Although by nature, these elements will likely exert only transitory effects on inflation, future price developments should be monitored carefully.

In particular, the balance of risks for inflation has deteriorated. Some factors to watch are the fact that analysts' short-term inflation expectations have recently risen, inflation will likely exceed 4 percent for several months this year, and second-round effects cannot be ruled out. Furthermore, additional financial volatility could put pressure on the exchange rate with some pass-through on inflation. These considerations are all the more important as inflation expectations for all terms remain above target.

The Bank of Mexico expects inflation to return to the convergence path towards 3 percent by next year. In any case, the Governing Board has repeatedly stated that it will remain vigilant in order to detect elements that may put convergence at risk and act appropriately.

Concluding remarks

Integration in the world economy through the liberalization of trade and investment has yielded Mexico significant benefits in terms of greater economic activity, efficiency, and especially, consumer wellbeing. However, Mexico's unsatisfactory long-term economic performance points to stagnant productivity related to factors such as excessive regulation and lack of competition in key areas.

Current structural reforms have the potential to tackle some of these problems if the new rules and their implementation provide a reliable framework for better regulation and increased competition. On the other hand, the current economic upturn faces several challenges, including those associated with less favorable external conditions. Finally, a rise in inflation this year poses risks that should be monitored carefully in order to assure that convergence to the permanent inflation target is renewed soon.