Manuel Sánchez: Mexican structural reforms and the binational relationship

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the Latino Business and Community Leader Luncheon, Federal Reserve Bank of San Francisco, Los Angeles, California, 9 September 2014.

* * *

I would like to thank the Federal Reserve Bank of San Francisco for inviting me to participate in this luncheon with the business and community leaders of the great city of Los Angeles. It is an honor to speak on Mexico's structural reforms and how they will enhance the economic ties between our countries.

Today I would like to organize my comments in three parts: first, the binational economic relationship; second, the opportunities stemming from Mexico's ambitious structural reform agenda; and, third, recent developments and the outlook for the economy. As usual, my comments are entirely my own and do not necessarily reflect those of the Bank of Mexico or its Governing Board.

The binational economic relationship

The United States and Mexico have long had strong economic ties, which have grown tighter in recent years. The relationship encompasses trade in goods and services as well as labor migration.

In the last two decades, the annual dollar value of Mexican merchandise exports to the United States has almost sextupled, while U.S. sales to Mexico have more than tripled. California has been a significant destination and origin for these trade flows.

Both countries have clearly exploited their comparative advantages. The abundance of labor in Mexico has combined with new technologies and know-how from the United States and other advanced nations to allow the country to produce a host of products of increasing sophistication at low cost. At the same time, Mexico has enjoyed a considerable degree of specialization in products such as autos.

Economic engagement has been facilitated by geographic proximity, as well as two decades of life with the North American Free Trade Agreement (NAFTA). Furthermore, integration between the two countries has occurred in a context of ever-deepening globalization.

The effects of increased trade due to NAFTA seem to have overridden any potential trade diversion from the preferential trade agreement. In fact, during recent years, Mexican exports have seen geographic diversification. While at the turn of this century, approximately 90 percent of Mexico's total nonoil exports went to the United States, currently this proportion is roughly ten basis points lower.

In services, exchange between the two countries has been significant in tourism and finance. In particular, major direct and portfolio investments come from and go to the United States.

Additionally, net migration to the United States has been considerable for a long time. A few facts of note include the following. The migration corridor from Mexico to the United States, by number of immigrants, is by far the most important in the world. The largest demographic minority in the United States is now comprised of the Hispanic population, with families of Mexican heritage forming the largest bloc in that group.[1]

---

[1] The Hispanic or Latino ethnic group refers to people of Cuban, Mexican, Puerto Rican, South or Central American, or other Spanish culture or origin regardless of race. See United States Census Bureau.

California, with an economy almost twice as large as that of Mexico, is the state that absorbs the most Mexican migrants. This is a significant reason Mexico and California are becoming more and more intertwined. But Mexico's influence in the United States has become ever broader as immigration has spread to areas that are far away from the immigration corridor, such as small towns in North Carolina and ranches in Northern Colorado.

Also, Mexican immigrants in the United States tend to get attached to this country, as suggested by the relatively high proportion of immigrants owning a house and the low fraction of total earned income sent in the form of remittances to Mexico.[2]

During this century, annual net migration flows to the United States have, on average, declined, and since 2008 they have been slightly negative.[3] There are several explanations for this phenomenon, the most important being a combination of demographic factors stemming from a previous decline in the fertility rate, and the aftermath of the big financial crisis.

Indeed, Mexican immigrants living in the United States were likely hit hard by lower economic growth, especially in sectors with high concentrations of Mexican labor, such as construction. Remittances to Mexico from abroad have declined since the crisis, and economic recovery has been weak, thus affecting the incomes of Mexican families back home.

It is reasonable to expect that, as the U.S. economy recovers ground, migration may increase. However, the aforementioned demographic trends and new labor opportunities in Mexico, derived from higher economic growth and structural reforms, may result in lower migration flows than those of the 1990s.[4]

Empirical evidence suggests that immigration has not hurt job creation in the United States and has contributed to output and productivity. Other studies posit that legalization of immigrants in the United States could increase economic efficiency through channels such as higher labor mobility, better matches between wages and skill levels, and investment in training and education.[5]

Structural reforms

The Mexican government has embarked on an ambitious reform agenda encompassing many sectors of the economy. The broad array of reforms is likely to yield benefits in terms of greater investment and productivity, thus enhancing potential long-term economic growth and the general well-being of Mexicans.

A stronger economy south of the border should, in turn, have spill-over effects in the United States, with greater demand for U.S. products, and further deepening integrated production processes, such as in software and high-tech industries.

Mexico's reforms have changed the rules of the game and the legal frameworks affecting the labor markets, education, the telecommunications sector, the financial system and the

---

2 See, for example, Cervantes, J.A., and A. Rodríguez (2014), "Propiedad de la vivienda en Estados Unidos de la población inmigrante de origen Latinoamericano y del Caribe." CEMLA, *Documentos de Remesas, 2*; Cervantes, J.A. (2014), "El perfil de la población de origen guatemalteco en Estados Unidos." *Programa de aplicación de los principios generales para los mercados de remesas de América Latina y el Caribe*, CEMLA-BID, July.

3 See Cervantes, J.A (2014), "Indicadores sobre migración Mexicana hacia Estados Unidos." *CEMLA*, August.

4 A similar argument was advanced by Gary Becker. See Becker, G.S. (2013), "The decline in illegal immigration from Mexico." http://www.becker-posner-blog.com/2013/03/the-decline-in-illegal-immigration-from-mexico-becker.html

5 See Peri, G. (2012), "The effect of immigration on productivity: evidence from U.S. states." *The Review of Economics and Statistics*, 94(1): 348–358; Hinojosa-Ojeda, R. (2012), "The economic benefits of comprehensive immigration reform." *Cato Journal*, 32(1).

energy sector, among others. The general aim has been towards making markets operate more freely, reducing obstacles to private investment and increasing competition.[6]

Among other changes, with the new labor legislation, temporary hiring is allowed, and wages can be determined by productivity rather than seniority. Also, mandatory back wages after labor disputes have been capped, and the "closed shop clause" for unions was repealed, meaning that if a worker leaves a union, the employer does not have to terminate the labor relationship anymore.

The education reform enforces hiring and promotion based on qualifications and performance for teachers in public education at all levels before college. An autonomous evaluation institute is in charge of the process, open not only to candidates from teachers' schools.

In telecommunications all operators are allowed to provide triple play services subject to restrictions for dominant firms, and limits on foreign direct investment (FDI) are reduced. New licenses for TV frequencies will be auctioned to form at least two new national-coverage TV companies. A new regulatory authority is now in place.

The financial reform pursues stronger protection for creditors' property rights, by closing legal loopholes used by debtors to prolong the debt resolution process, and reducing obstacles to expediency in the judicial process to recover collateral. More competition is encouraged through the facilitation of loan substitution by debtors across banks and the prohibition of bundled sales of financial products. Regulation and supervision are strengthened, and a new banking resolution mechanism has been established.

Of particular interest is the energy reform. Before the reform, production and most other activities in this sector were open only to government monopolies. The reform has modified the Mexican Constitution to allow wide access to the energy sector to private participants.

Major changes include contracts in exploration and extraction for oil and hydrocarbons; permits in gas processing and oil refining, transportation, storage, distribution, and commercialization; and participation in electricity generation and sales.

The depth of the benefits the reforms could eventually bring depends greatly on how they are implemented. Additionally, to more profoundly transform Mexico's economy, other policy measures would help, such as strengthening the rule of law, enhancing physical infrastructure, and improving public security.

Meanwhile, the reforms undertaken offer great scope for further U.S. investment in Mexico, thus further binding the two economies.

Mexico's economic outlook

After a year and a half of deceleration, during 2014 Mexico's economy has been gaining steam. Higher momentum has been supported by stronger manufacturing output which, in turn, has been linked to increasing external demand, notably from the United States. Auto exports to this country, in particular, have posted a significant rise since February.

Following six quarters of decline and stagnation, mainly reflecting lower public spending and the bankruptcy of the three major housing developers, construction picked up in the second quarter. Domestic spending also has begun showing signs of recovery. Both private consumption and total investment have rebounded, although the latter remains below the

---

[6] For an identification of obstacles to productivity growth in Mexico and the potential of reforms, see Hanson, G.H. (2011), *Understanding Mexico's economic underperformance*. Washington, DC: Migration Institute Policy; Arias, J., et al. (2010), "Policies to promote growth and economic efficiency in Mexico." *Institute for the Study of Labor Discussion Paper 4740*.

levels prevailing two years ago. Unfortunately, consumer and producer confidence indexes remain relatively low.

Notwithstanding some recent pressure partly from geopolitical risks, international financial volatility has declined so far this year, largely reflecting the market's perception that the normalization of monetary policy in the United States is not imminent and will be gradual. Declining international risk aversion has fueled some appreciation of Mexican financial assets. The yield curve has shifted downward in tandem with that of the United States.

As in many other emerging-market economies, the proportion of nonresidents' holdings of Mexican government peso securities has remained relatively stable since 2013. This may attenuate concerns about possibly ever-increasing financial risk in the economy.

However, as experience confirms, portfolio capital flows can easily stop and even revert following a change in market sentiment. Due to longstanding, extraordinarily accommodative monetary policies in advanced nations, international markets have tended to react negatively to good news from those economies and vice versa. This apparently awkward behavior seems to reflect the search for yield facilitated by those policies.

Mexico's strong fundamentals have drawn players with long-term investment profiles. Yet, Mexico is not immune to spillover effects from factors unrelated to fundamentals, such as anticipation of the path of U.S. interest rates, which could induce a redirection of capital flows away from emerging markets. Hence, domestic financial risks should be monitored.

On the back of expected higher U.S. growth, a gradual recovery of the Mexican economy this year and next is predicted. The Bank of Mexico's GDP interval forecast is for 2- to 2.8-percent growth in 2014, and 3.2- to 4.2-percent growth for next year. Analysts' consensus point forecasts currently fall within these ranges.[7]

Some risks to these forecasts persist. To the upside, faster U.S. output growth and a greater-than-foreseen positive impact from structural reforms could occur. To the downside, insufficient improvement in consumer and producer confidence is also a possibility.

In the context of slower GDP growth, since March 2013, monetary policy accommodation has been successively broadened. The objective for the policy interest rate, which is the interbank overnight rate, has accumulated a reduction of 150 basis points during this period.

On the other hand, since July, annual headline inflation has breached the upper limit of the variability interval around the 3 percent permanent target. Pressures from both the core and noncore components of the National Consumer Price Index have contributed.

Going forward, some inflation risks should be watched. Second-round effects from possible minimum wage hikes, unfavorable shocks to noncore inflation and volatility in global financial markets may make convergence of inflation to the 3 percent permanent target challenging.

Concluding remarks

Mexico and the United States have been growing closer in recent years, both economically and culturally. Trade in goods and services, as well as labor migration, have benefitted both countries. In this connection, California, the state with the largest Mexican population, has played an important role.

An ambitious Mexican reform agenda opens up a great variety of business opportunities to U.S. investors. While potential gains from the reforms may be to the advantage of the entire Mexican economy, certain sectors such as energy and telecommunications are likely to emerge as highly attractive destinations for FDI.

---

[7] See Banco de México (2014), *Quarterly Report, April – June 2014, Summary*, August; and *Blue Chip Economic Indicators*, September 2014.

Finally, recent developments reveal that the Mexican economy has begun to rebound, and higher expected growth in the United States provides a foundation for the widely held forecast of Mexico's gradual economic recovery. Some inflation risks should be watched, since if they materialize, they could make convergence to the 3 percent permanent target difficult.