# Manuel Sánchez: An economic outlook and policy update on Mexico

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the United States-Mexico Chamber of Commerce, New York City, 26 September 2014.

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I am honored by the invitation to be here again in the vibrant city of New York. Thank you for the opportunity to share my thoughts with you on the economic outlook and policy challenges we face in Mexico. A few things have changed since the last time we were together, and I hope to bring you up to date on the most important developments.

I would like to talk first, about the current rebound in the Mexican economy and how the financial markets are performing; then, give you some perspective on inflation and monetary policy; and finally, describe the most recent progress on Mexico's structural reform agenda. As usual, my comments are entirely my own and do not necessarily reflect those of the Bank of Mexico or its Governing Board.

### The current economic rebound

At this time last year, Mexico's economy was deteriorating. Today, an incipient upswing is underway. Specifically, in the second quarter, Mexico's economy posted vigorous growth, similar in annualized terms to that of the United States. Data for the third quarter, including the GDP monthly proxy for July, suggest that momentum continues.

Improvement in the industrial sector has included a strong push from manufactured products, with transportation equipment doing particularly well. After six consecutive quarters of contraction or stagnation, construction has seen some rebound.

External demand has played a predominant role in the recovery due to greater manufacturing exports, particularly to the United States. Within that category, automobile exports stand out. In addition, the expansion of services continued, especially those most associated with external demand.

On the domestic side, consumption in the second quarter picked up, and recent sales data suggest that the pace continues. Formal employment is expanding, as has been the case since 2010. However, total employment has been stagnant this year. The previous two facts are consistent with a slight decline in informality. More formal-sector jobs may have provided support for higher consumption. Yet, consumer confidence remains relatively low, indicating some fragility there.

Furthermore, investment in the second quarter kept up a revival, driven by the private sector, and could strengthen even further in the near term. Indeed, this is suggested by the business community's more positive answer to the survey question of whether or not this is the right moment to invest.[1]

The Bank of Mexico estimates that GDP will grow between 2 and 2.8 percent in 2014 and between 3.2 and 4.2 percent in 2015. Consensus analysts' point forecasts fall within these intervals.[2]

The balance of risks for the growth scenario is to the upside. The possibility of higher-than-anticipated economic expansion in the United States, as well as more constructive

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[1] See INEGI and Banco de México (2014), *Encuesta Mensual de Opinión Empresarial del Sector Manufacturero*, September.

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

investment sentiment stemming from progress in the implementation of structural reforms, contributes to this assessment.

## Financial market developments

Since February, international financial market volatility has declined considerably due to expectations that the normalization of U.S. monetary policy will take place later than previously thought, and in a gradual way. A return to the search for yield has implied downward shifts for Mexico's yield curve, together with the long end of the U.S. curve.

Intermittent breaks in the calm since the end of July reflect the swinging of market expectations for the start of U.S. monetary tightening back toward an earlier timeframe, and heightened geopolitical pressures. In this context, the dollar has appreciated, and the prices of some emerging-market financial assets have fallen somewhat.

In Mexico, the recent increase in global risk aversion has fueled a higher term premium for government bonds and along with it, a steeper yield curve. However, the peso has depreciated less than the currencies of many other emerging-market economies. Both markets have behaved in an orderly manner, with traded volumes high and bid-ask spreads tight.

Going forward, greater financial volatility and further downward pressure in asset prices cannot be ruled out. Interest rates on a wide variety of securities in advanced countries, including high-yield bonds, remain close to all-time lows amid market uncertainty and speculative conditions, suggesting that these levels are not sustainable.

In the monetary policy meeting of last July, the U.S. Federal Reserve said that it was within closer reach of its medium-term targets. Also, many FOMC members noted that if convergence to these targets accelerates, it would be appropriate to begin the tightening phase sooner than previously foreseen. In the most recent meeting in September, forecasts by FOMC members for the fed funds rate seem to suggest a faster pace of normalization than previously expected.

In a similar way, the Bank of England has noted that it is nearer to reaching its long-term objectives. Futures markets predict that U.S. and British policy rates will begin to rise next year, although uncertainty still reigns over the exact timing and pace of the tighter policies.

Adding to the mix of unknown factors the markets must consider, the Eurozone and Japan are likely poised to loosen their monetary stances further in the face of disappointing economic performance. Although the net effect in world financial markets is still in the balance, the markets currently appear to give more weight to probable tighter polices in the United States and the United Kingdom.

## Inflation, minimum wages and monetary policy

Since last July, Mexico's annual headline inflation breached the upper limit of the variability interval around the central bank's permanent target of 3 percent. This development, which has surpassed market expectations, reflected pressures in the core component, especially goods prices, as well as the noncore component, driven particularly by livestock prices. The possible persistence of these adverse factors makes it likely that inflation will remain above or near 4 percent during the second half of the year.

Some conditions should contribute to a decrease in inflation next year, such as base effects from the 2014 fiscal reform, lower rises in government-administered gasoline prices, and a possible drop in some telephony charges due to new regulations. However, the impact should be properly assessed. For example, the new gasoline price policy does not mean the absence of annual pressure from this front during the year.

The balance of inflation risks appears to be to the upside due to the following. First, proposals are being considered for substantial rises in minimum wages, which could generate inertia in inflation and second-round effects in the price-formation process.

Second, the possibility of unforeseen additional pressures in agricultural prices persists. Historically, this component has posted a higher average and more volatile annual change than that of energy and government-administered prices. Third, the risk of bouts of high financial volatility remains, and this could push prices higher through the exchange rate channel.

The upside risks are especially significant as annual headline inflation will probably surpass 4 percent most of this year, and analysts' inflation expectations for all time frames remain above the permanent target. These challenges merit careful monitoring.

I would like to add a few comments on possible minimum wage hikes in Mexico. Minimum wages are a feature common to most countries, and Mexico is no exception, with the level set by a national commission for all jurisdictions. What is particular to our country is a notable deterioration of this indicator in the 1980s and 1990s due to high and unstable inflation. This process yielded lower purchasing power for all salaries and underscores the vital necessity of protecting the significant ground gained in the last decade in the battle to control inflation, and of consolidating this progress.

What effects would minimum wage hikes have in Mexico? The economic literature on competitive labor markets suggests that rises in real minimum wages can hurt employment and training, especially of young and unskilled laborers, and promote informality. Also, there may be some pass-through from these increases to prices of final goods and services. The degree of these and other impacts remains an empirical issue.[3]

In the case of Mexico, these effects could be material, for at least two reasons. First, negotiations of private-sector contractual salaries have tended to take into account minimum-wage revisions as a floor reference, although the two are not automatically tied. The wage contagion could reflect partly a substitution effect away from less-skilled workers, a phenomenon observed in many countries.[4]

Second, the minimum wage serves as an index for myriad legal purposes, including fines, tax exemptions, public pensions, government-sponsored mortgages, and many private contracts.

Wage contagion and indexation would broaden the possible negative real effects on the economy. Furthermore, significant minimum wage hikes may contaminate the process of price formation. These adjustments could trigger a chain reaction on inflation expectations, complicating the challenges for the Bank of Mexico in getting inflation to converge to its permanent target. To handle the risk from indexation, complicated legal changes and cumbersome contract revisions would be called for.[5]

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[3] For empirical evidence on the possible effects of minimum wage increases, see, for example, Neumark, D. and W. Wascher (2008), *Minimum Wages*. Cambridge, MA: The MIT Press; Neumark, et al. (2013), "Revisiting the Minimum Wage-Employment Debate: Throwing Out the Baby with the Bathwater?" *NBER Working Paper* 18681; and Meer, J. and J. West (2013), "Effects of the Minimum Wage on Employment Dynamics." *NBER Working Paper* No. 19262.

[4] See, for example, Maloney, W. and J. Mendez (2004), "Measuring the Impact of Minimum Wages: Evidence from Latin America." In Heckman, J.J. and C. Pagés (2004), *Law and Employment: Lessons from Latin American and the Caribbean*. Chicago: University of Chicago Press.

[5] There is evidence that the decline in real minimum wages in Mexico increased employment for less-skilled female workers. See Feliciano, Z.M. (1998), "Does the Minimum Wage Affect Employment in Mexico?" *Eastern Economic Journal*, 24(2).

## An update on structural reforms

As you all know, Mexico has embarked on an ambitious structural reform agenda, encompassing many sectors of the economy, including the labor market, education, the financial sector, telecommunications, and energy. Already this year, the laws that cement and put the finishing touches on the reforms have been finalized.

But the devil, indeed, is in the details. The quality of implementation is of the utmost importance for the transformations to yield their expected benefits.

Reforms are currently in the implementation stage. Some of the changes have come into effect with the mere publication of the new laws, such as the prohibition of bundled sales of products in the financial sector.

Others imply specific actions already contemplated. For example, in education, the first generalized test is in place to qualify a teacher to receive an elementary school post, breaking with a long tradition in which new graduates from teaching schools were automatically hired. In the financial sector, a newly established resolution scheme is being applied to the case of a small bank without incident.

In telecommunications, the arrival of new competitors, drawn by a changed set of rules and conditions in the marketplace, sets the stage for a possible shakeup. Auctions for nationwide television licenses are in the offing.

Much interest is focused on the energy reform. Geographical areas for oil and gas exploration and production have already been allocated to Pemex, and the first round of auctions for the private sector will take place early next year.

These opportunities are generating enthusiasm in the private sector and should draw significant investment from both domestic and foreign companies. Greater competition, in turn, should boost total factor productivity and potential GDP growth in the medium term.

To take full advantage of this situation, Mexico needs to complement the already enacted reforms with changes that would improve the environment for conducting business. These measures should include strengthening the rule of law, investing further in physical infrastructure, and enhancing public security.

## Concluding remarks

Mexico has seen an incipient economic upturn this year, driven by stronger external demand and higher domestic spending. The panorama is favorable given more consistent U.S. economic performance and Mexican structural reforms in the first stages of implementation.

Mexico’s economy has benefited from the continuation of portfolio capital inflows amid benign financial conditions, notwithstanding some recent volatility. However, a change in market sentiment could trigger a reversal of this relative financial bonanza at any moment. Although Mexico enjoys strong macroeconomic fundamentals, financial risks should continue to be monitored.

Continuation of recent upward trends in inflation as well as factors that may generate additional price pressures are risks that must be carefully watched in order to make convergence to the permanent inflation target a reality. Current discussions on recovering the real value of the minimum wage underscore the need to keep the upper hand in the fight against inflation. Finally, progress on structural reform is encouraging, but implementation over time must be adequate for expected benefits to fully materialize.