Manuel Sánchez: Structural challenges for the Mexican economy

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the Hong Kong University of Science and Technology, Hong Kong, 14 November 2014.

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It is an honor to be at such a prestigious university in Hong Kong, one of the world's most emblematic centers of impressive economic growth. Thank you for the invitation to share my thoughts with you on challenges faced by the Mexican economy.

I will touch on three themes, starting with the Mexican economy's modernization over the last few decades. Second, I would like to describe how the current structural reform agenda and other policies could foster higher long-term growth. Third, I will talk about the economy's recent developments and outlook. As always, these views are entirely my own and do not necessarily reflect those of the Bank of Mexico or its Governing Board.

Structural transformation

Since the 1980s, Mexico has undergone a profound transformation toward a more market-oriented economy. Measures implemented include the privatization of many public-sector enterprises, deregulation, improved public finances, and notably, the opening of the economy to trade and investment with the rest of the world.

As of 2013, adjusted for purchasing power parity, Mexico is the world's eleventh-largest economy, with an income per capita above US$17,000. Its population approaches 120 million, with almost half younger than 25, and most living in urban areas.[1]

The dynamics of fertility and mortality rates have led to a decrease in the dependency ratio, with a wider base of working-age people, yielding benefits in terms of total employment. This demographic bonus will likely remain in place for more than another ten years.

The economy is largely concentrated in services, which account for more than 60 percent of total production, while industry represents more than one-third, and agriculture around 3 percent. Competition through foreign trade has made many sectors, especially manufacturing, more efficient. In addition, thanks to foreign direct investment (FDI), companies operating in Mexico have imported significant know-how and new technologies.

Total trade of goods and services amounts to almost two-thirds of GDP, and more than 80 percent of total merchandise exports are manufacturing products. Making up a substantial fraction of the total, high-tech shipments, such as computers and telecom equipment, have seen the highest growth of all segments in the last two decades.

Mexico has gradually diversified its export destinations. For example, sales to the United States have been decreasing from almost 90 percent in 2000 to nearly 80 percent in 2014. At the same time, China and Mexico have both gained share in the U.S. market.

Most merchandise imports are intermediate and capital goods, and the origin of total imports is more diversified than the destination of exports. Purchases from the United States are about half of the total, while imports from China have increased from less than 2 percent of the total in 2000 to more than 16 percent in 2014.

FDI has increased significantly in recent years. A large proportion has come from North America, especially after the North American Free Trade Agreement, Europe and Asia, which have invested in sectors such as transport equipment and finance. Magnets for these

1 Based on estimates from the World Economic Outlook (2014), IMF and Mexico's National Population Council (CONAPO).

funds include Mexico's prime location on the southern border of the world's largest economy, an abundance of labor, and a growing consumer base.

Mexico has made considerable progress in building solid macroeconomic foundations. It has achieved relatively stable, low public debt ratios, moderate inflation, and a sound financial regulatory framework.

Since 1994, the central bank has enjoyed autonomy, with its primary objective being that of price stability. Since 2003, it seeks to meet a permanent annual inflation target of 3 percent, with a variability interval of plus or minus one percentage point around this objective.

Privately managed, individual pension accounts have been in place since 1997, replacing a state-run pay-as-you-go scheme. The financial system is dominated by banks, although nonbank entities account for about 40 percent of total assets. Openness to investment has led to foreign control over approximately 70 percent of total bank assets. Financial intermediaries have healthy balance sheets, with strong capital and provisioning ratios, and most meet high liquidity standards.

Increasingly credible economic policy has undergirded the development of the financial markets. Since 1995, the currency has been under a floating exchange-rate regime. The Mexican peso trades 24 hours a day and is the most traded among emerging-economy currencies. Two-thirds of this trading is carried out offshore. Also, Mexico's domestic yield curve includes maturities for up to 30 years, and more than one-third of total peso-denominated government securities are held by foreigners.

These economic changes have led to higher standards of living, significant benefits for consumers, and a much broader middle income class.

Long-term productivity challenges

In spite of this progress, Mexico's long-term economic performance has been less than stellar. From 1951 to 2013, average annual per capita GDP growth was 2.4 percent. This average growth rate includes a slowdown to 0.8 percent since 1981. At this latter rate, it would take about 92 years to double income per head. This contrasts with the extraordinary performance of the leading Asian economies.

Growth accounting reveals that slow growth since the 1980s has not been mainly a problem of lack of employment or investment. In fact, positive contributions to the expansion of per capita income have come from both labor and capital. Favorable demographics largely explain the contribution of labor to per capita income growth.[2]

By far, the most serious problem has been one of stagnant total factor productivity (TFP). A comparison with China is rather telling. While TFP in Mexico has remained basically flat, Chinese TFP has increased dramatically.[3]

The Mexican productivity conundrum is not easily explained. However, many studies pinpoint the following as possible explanations for low productivity growth at an international level: poorly functioning institutions, deficient infrastructure, burdensome regulation, and lack of competition in key areas, among other factors.[4]

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2 For a breakdown of per capita GDP growth accounting, see Sánchez, M. (2014), "What Mexico's economy confronts." Presented at *Adam Smith Seminar*, July, p. 32.

3 Kehoe, T.J. and K.J. Ruhl (2010), "Why Have Economic Reforms in Mexico not Generated Growth?" *NBER Working Paper Series*, N° 16580.

4 See, for example, Lewis, W. (2004), *The Power of Productivity: Wealth, Poverty, and the Threat to Global Stability*. Chicago, University of Chicago Press; and Restuccia, D. (2008), "The Latin American Development Problem." *University of Toronto Department of Economics Working Paper* No. 318.

In Mexico's case, sectorial research on labor productivity finds that declining productivity is clear in services and nonmanufacturing industrial output, which encompasses mining, utilities, and construction. Here, large sub-segments such as commerce and construction are characterized by widespread informality, possibly a result of onerous regulation.

Services such as education, health, and finance face limited competition. Also, poor contract enforcement contributes to low bank penetration. Total domestic financing granted to the private sector in Mexico amounts to about 27 percent of GDP, one of the lowest ratios among emerging markets.

Surprisingly, manufacturing makes a stagnant contribution to growth in aggregate productivity. Inadequate infrastructure may help explain this. Finally, labor productivity gains in agriculture, given emigration, are lower than expected. Institutional rigidities which inhibit scale and technological adoption could play a role.[5]

The negative implications of the absence of competition are evident in the energy sector, which until recently was the exclusive terrain of government-owned enterprises. In the last few years, despite ample natural fields, Mexican crude oil and natural gas production has been declining. This contrasts with a revolution in production in countries such as the United States.

Even further, Mexico cannot import enough natural gas cheaply because of a limited pipeline network. Due in part to lack of availability of cheap natural gas supplies, Mexican electricity prices, on average, approach twice U.S. rates.[6]

Another example is the telecoms sector, which has faced limited competition. As a result, the penetration of fixed-line and mobile phone services is still low by international standards. Additionally, indicators for internet services suggest that the services are inferior to those available in many nations.

Mexico's current reform agenda seeks to tackle many of these inefficiencies. The agenda covers a wide range of sectors, including labor, education, finance, telecoms, and energy.

Generating the most interest for investors are the changes in the telecommunications and energy sectors. In telecoms, reforms now allow players to offer triple-play services, provided market non-concentration requirements are met. Limits on FDI have been reduced.

In energy, the gates are now open to private agents, with contracts in exploration and extraction for oil and hydrocarbons allowed. Permits in gas processing and oil refining, transportation, storage, distribution, and commercialization are also provided for, as is participation in electricity generation and sales.

Well implemented, these reforms could boost productivity in laggard sectors in the medium term. To the extent that some of them provide essential inputs to the economy as a whole, overall efficiency gains may be realized. To reap the full benefits from the reforms, other complementary measures should be taken, such as strengthening the rule of law, improving public security, and fortifying infrastructure.

Economic developments and outlook

After a year and a half of weakness, the Mexican economy started to pick up this year. Second-quarter figures were strong, and several recent indicators suggest momentum is

5 Sánchez, M. (2013), "The search for Mexico's economic progress." Presented at *Alamos Alliance XX*, February.

6 Based on PPP-adjusted data from the Energy Information Administration, the Mexican Energy Secretariat (SENER) and the OECD, including residential, commercial, services and agricultural.

unbroken. The monthly proxy for GDP gained ground four consecutive months starting in April, tracing a continued upward trend despite a moderate decrease in August.

Industrial production shows an increase in manufacturing and construction, although not mining, which has been affected by lower petroleum output. Hampered by a contracting pace of public-sector projects, construction is still driven almost exclusively by the private sector.

In the third quarter, manufacturing exports kept up a significant growth rate, mainly to a strongly performing United States. Additionally, improvement in consumption and an upturn in private investment have been prolonged.

Pulled by the U.S. economy, Mexico is expected to post a gradual economic recovery during this and the next two years. The main risks to this scenario seem to be to the upside. A more robust rebound than foreseen for the United States, the lagged effect of high government outlays on output, and the probable impact of structural reforms, could contribute to this outcome.[7]

As with other emerging economies, international volatility has affected financial assets in Mexico. Over the year, the yield curve shifted downward along with that of the United States, reflecting the perception that U.S. monetary normalization would be gradual and not imminent. Since the end of July, however, market sentiment has been moving in the opposite direction, thus reversing some of the flattening of the yield curve. The Fed has stated that the normalization process will be data dependent, thus making for more uncertainty ahead.

Indeed, in recent weeks, magnified global risk aversion has resulted in increases in long-term rates, widening the spread over U.S. yields. Additionally, the peso has depreciated, reaching its weakest level so far this year in November. However, the peso has depreciated less than the currencies of many other emerging economies, and markets have been orderly, operating with more than sufficient liquidity.

Risks of new bouts of volatility remain. Further pressure on emerging-market asset prices could occur. Interest rates on many developed-market securities, such as high-yield bonds, trade at near all-time lows in the face of uncertainty and wide-spread speculation, implying unsustainable price levels. Thus, it is appropriate for Mexico to fortify its economic fundamentals, and the authorities should keep close watch over financial risks.

In the context of slower GDP growth, monetary policy accommodation in the last couple of years has broadened. Since March 2013, the policy interest rate has been cut by a total of 150 basis points leaving it at 3 percent.

Since July, due mainly to transitory adverse factors, annual inflation has breached the upper limit of the variability interval around the permanent 3 percent inflation target. Inflation has largely reflected pressures from the effect over the year of tax hikes, and the noncore component of the National Consumer Price Index, especially livestock prices.

It is essential that inflation converge to the 3 percent target next year, especially in view of the need for monetary fundamentals to help shield the economy against financial volatility. Favorable factors exist, especially base effects from the tax hikes and lower changes in gasoline prices announced by the government.

However, significant risks to the upside stand out, among them further exchange rate depreciation stemming from financial market volatility, additional pressure on noncore inflation, and significant hikes to minimum wages.

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7 Analysts estimate that GDP for Mexico will grow 2.3 percent in 2014, 3.7 percent in 2015 and 4.1 percent in 2016. See Banco de México (2014), *Encuesta sobre las Expectativas de los Especialistas en Economía del Sector Privado: Octubre de 2014*, November.

Risks to the upside are always important, but especially so at the present moment. Inflation will likely post levels above 4 percent during most of the current year. In addition, analysts' inflation expectations for all periods, although stable, remain above the Bank of Mexico's permanent target.

Concluding remarks

Policies implemented in the last few decades have set the stage for the Mexican economy's modernization. The change has yielded many fruits, including an enlarged middle class, greater consumer choice, and higher living standards. Even so, Mexico's economic growth has not completely lived up to expectations in the recent past.

Key obstacles to achieving greater expansion center on productivity. Barriers to higher productivity, in turn, follow from limited competition and excessive regulation in key sectors of the economy. Mexico's current reform agenda seeks to reduce these obstacles. Energy and telecoms reforms are particularly important to investors, with these sectors enjoying openness to private participation not seen in generations.

The Mexican economy's current upturn is consolidating in a context of solidifying U.S. growth. Market volatility, however, may continue to pose short-term challenges. The expected convergence of inflation to the 3 percent permanent target should contribute to the strong fundamentals needed for the country to face a potentially more difficult financial environment ahead.