Manuel Sánchez: Mexico's reforms progress and economic outlook

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the 2015 Institute of International Finance (IIF) Latin America Economic Forum, Busan, Republic of Korea, 28 March 2015.

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I would like to thank the Institute of International Finance for the invitation to participate in this conference. It is an honor to share the panel with such distinguished speakers and to be in South Korea, an economy that has shown extraordinarily rapid development in the last few decades, achieving the level of an industrialized nation in an amazingly short lapse of time.

Mexico has benefited greatly from economic ties with South Korea. In particular, this country is the second most important source of investment from Asia to Mexico, especially in manufacturing, commerce and mining, and it is also a significant trading partner.

In this talk, I would like to touch first on structural reforms recently undertaken in Mexico and, second, comment on Mexico's economic outlook. As usual, my views are entirely my own and do not necessarily reflect those of the Bank of Mexico or its Governing Board.

Mexico's progress on structural reforms

Mexico has embraced an ample program of structural reforms encompassing labor, education, the financial system, telecommunications, and energy, among other areas. The general aim is to promote greater market flexibility, investment in both human and physical capital, and competition, thereby boosting total factor productivity growth, the stagnation of which has inhibited long-term overall economic expansion.

Legislative changes necessary for the reforms have been passed by Congress, and the country is currently in the process of implementing them. Challenges are inherent in this task. As all of us know, the effectiveness of reforms anywhere in the world rests heavily on the details.

Today, I would like to bring you up to date specifically on the telecommunications and energy reforms, given the essential role these sectors play in the overall economy and consumer wellbeing.

The telecommunications sector has been characterized by limited access and high cost. In both telecoms and broadcasting services competition has been scant, with each sector dominated by one company.

In particular, the privatization of the government telephone operator more than two decades ago transferred exclusive fixed-line rights to one buyer, without adequate regulation favoring serious competition. In the following years, new providers of telecoms services encountered a playing field that was not at all level. While some price reductions occurred thanks to incipient competition, services remained expensive and their quality low by international standards.

The telecommunications reform seeks to remedy these problems by facilitating greater competition and, until an acceptably competitive environment is achieved, by clamping restrictions especially on dominant players, defined as those companies with a market share greater than 50 percent in telecoms or broadcasting, or those judged by the regulatory authority to have significant power in specific market segments.

To promote competition, barriers to the entry of new players were reduced. Now, 100 percent foreign ownership is permitted in telecoms and 49 percent in broadcasting. Also, licenses generally allow operators to offer a broad basket of services, provided that certain non-concentration requirements are met. In broadcasting, two new national digital television networks have recently been granted through a public bidding process.

In the case of telecoms, the new law eases customer mobility across operators. For example, they have to unblock handsets when contracts expire or the consumer pays for the equipment. Also, operators must implement portability for fixed and mobile telephone numbers within 24 hours of receiving the request and free of charge.

To regulate market power in the overall industry, several measures have been undertaken. First, the new Federal Telecommunications Institute has authority that includes the sphere of competition. It will be helped by the fact that some legal recourses previously used by operators to circumvent the former authority's resolutions indefinitely are no longer allowed.

Second, a price restriction has been imposed on all telephony operators in the form of the elimination of national long distance fees, which in a world of digital networks and the internet were increasingly obsolete.

Third, an asymmetric regime containing price and activity caps applies to dominant players, as long as they continue to be deemed as such. Notably, the main fixed and mobile telecoms provider cannot charge other operators for calls and text messages terminating in its network. This mobile operator is not allowed to charge fees to customers when they receive calls while outside their local service areas, nor can it price discriminate when customers call other companies' phone numbers. The dominant player must also allow the sale and resale of mobile services to other concessionaries and the leasing of the last-mile network. It cannot offer TV services.

In broadcasting, the dominant firm must allow competitors the lease of its infrastructure and cannot buy exclusivity for audiovisual content considered significant. This broadcaster is not permitted to own capital in the dominant telecoms provider.

This reform has already yielded benefits. A declining trend in relative telecoms prices has deepened, and service providers have increased the variety of packages offered. In fact, competition between operators focuses increasingly on the speed and quality of data services provided through both fixed and mobile means. Another encouraging sign is the interest of international players in the Mexican market.[1]

To turn to our second focus, the energy sector has also suffered from high prices and frequently, insufficient supply. Crude oil production has been declining continuously since 2004. Inadequate pipeline infrastructure has limited lower-price gas imports, as well as lower-cost, more efficient distribution. Electricity prices in Mexico remain well above those in its key trading partners.[2]

Behind these problems lie decades of state control, with little or no benefit from outside participation. The energy reform seeks to confront this reality by allowing private participation in virtually all aspects of the sector. This includes public bidding for oil and gas exploration and production contracts, and permits for production of oil products and petrochemicals, transport, storage, distribution, and sale of hydrocarbons and hydrocarbon products. Also, permits are to be granted to generate and sell electric power, as well as import electricity using Mexico's National Electric System.[3]

The reform contemplates a wholesale market for the purchase and sale of electricity, with retail operations also possible. Electricity transmission and distribution remain in the hands of the state, with the outsourcing of private contractors permitted.

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1 For an analysis of recent price developments in the telecom services sector, see Banco de México (2015), *Informe Trimestral, Octubre-Diciembre 2014*, Box 1, February.

2 The negative impact of the inadequate infrastructure of the gas pipeline system is illustrated in Banco de México (2013), *Inflation Report, July – September 2013*, Box 2, November.

3 The National Electric System is mainly composed of the national transmission and general distribution networks, the power plants that deliver electricity to the national networks, and the equipment and facilities used to control the system itself.

As to oil and gas exploration and extraction, four different types of contract are on offer, namely licenses, profit-sharing, production-sharing, and services. In the first three, private companies can register the value of the expected profits backed by the contracts on their books.

In the wake of the so-called round zero in which Pemex applied for certain fields and was allocated some of them, the first round of public bidding has begun. Two auctions have been announced, one for exploration and production, and another for production only, both in shallow-water oil fields under production-sharing contracts. The auction allocations are expected in a matter of months. Fiscal and economic conditions in the contracts have been revised according to suggestions by auction participants, and in accordance with recent developments in oil markets. Three additional phases of this round will ensue, with the types of extraction increasing in level of difficulty or cost.

Additionally, contracts have been auctioned and awarded to deliver gas in private pipelines, including a pipe from Texas to Chihuahua and another from Chihuahua to Durango. The first permit granted to a private agent to import electricity from a power station connected exclusively to the National Electric System has also been conceded.

Significant foreign and domestic private investment could potentially materialize in this new environment. The changes should eventually allow more efficient energy-sector production and lower domestic gasoline and electricity prices through competitive markets.

The economic outlook

The Mexican economy shows signs of moderate recovery after a slowdown in 2012. The upturn is driven by industrial production, with manufacturing taking the lead, fueled by exports to the United States. Construction has recently picked up as well, while mining is still faltering, due mainly to oil production, on the decline since 2004.

Domestic spending has also improved somewhat, with private investment showing more strength, and consumption gains unable to obtain traction. Analysts' consensus forecasts for this year and next call for the economy to gradually pick up steam, pulled by positive U.S. performance.[4]

Downside risks to the growth outlook include continued stagnant consumer confidence, the potential impact of social unrest, and possible further reductions in the oil production platform.

Mexican financial markets face two challenges. First, the sharp fall in crude oil prices since last summer has made the country's fiscal position weaker, since oil still accounts for approximately one-third of budgeted public-sector revenue. In view of the most likely scenario that oil prices remain low for some time to come and the decreasing oil production trend, the federal government recently sent investors a sign of fiscal responsibility by announcing cuts to 2015 budgeted spending, amounting to 0.7 percent of GDP, despite the fact that oil revenue for the year is almost fully hedged.[5]

Second, the U.S. Fed is widely expected to begin normalizing monetary policy this year. Volatility has hit the Mexican foreign exchange market, with the peso depreciating significantly, along with most other world currencies. However, the adjustment in Mexico has been orderly, with abundant liquidity prevailing in market operations.

Furthermore, during 2015, holdings of peso-denominated government bonds by nonresidents have remained stable. While somewhat higher than last year, interest rates continue to be relatively low for all terms. Nevertheless, as U.S. monetary policy normalization is around the

[4] See *Blue Chip Economic Indicators*, March 2015, and Banco de México (2014), *Quarterly Report, October-December 2014, Summary*, February.

[5] See SHCP (2015), "La SHCP Anuncia Medidas de Responsabilidad Fiscal para Mantener la Estabilidad." *Press Release* 007/2015, January.

corner, some portfolio adjustment and further bouts of volatility cannot be ruled out. Therefore, financial authorities must remain on watch.

So far in 2015, inflation has returned to a path of convergence with the Bank of Mexico's 3 percent permanent target, after a year of straying due to temporary factors such as tax hikes and agricultural price pressures. The recent decline in inflation has been supported by the disappearance of the effect from last year's tax increases and fading pressures from agricultural prices, along with lower key telecoms and electricity prices.

The better inflation performance must be maintained. Upside risks include more significant pass-through from a weaker peso down the road, as well as the resurgence of spikes in noncore inflation prices and eventual aggregate demand pressures. Close monitoring of these risks is all-important in view of the fact that analysts' long-term inflation expectations remain above the 3 percent target. Sustained convergence with the target must be consolidated.

Final remarks

Mexico is on a path that should help take it to the resolution of fundamental issues obstructing productivity and long-term growth. In particular, recent telecoms and energy reforms seek to foment investment and competition in these sectors, which may boost the efficiency of the economy. The degree of success of these and other reforms should be defined in terms of enhancing the economy's potential. This will depend heavily on the quality of implementation, in the sense that these reforms actually lead to greater market flexibility and investment, and generate substantially effective competition.

Moderate cyclical economic recovery in Mexico is underway on the back of stronger U.S. performance. Persistently lower oil prices and upcoming U.S. monetary policy normalization pose challenges to both Mexico's economic upturn and markets. Further volatility cannot be excluded, and thus the authorities must remain on alert.

Finally, inflation has recently fallen to the Bank of Mexico's target. However, convergence to this objective must be consolidated so that it becomes a permanent phenomenon.