Manuel Sánchez: Mexico and Texas – Ties and mutual benefits

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at The Centennial Lecture Series, The University of Texas, El Paso, Texas, 10 September 2015.

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I would like to thank you for the opportunity to participate in the Centennial Lecture Series of the University of Texas at El Paso. It is a great honor to speak in this distinguished academic center, which has contributed considerably to closer relations between Mexico and the United States. I congratulate those of you who have been an essential part of the success story of this institution.

The University of Texas at El Paso has grown at an impressive pace during its first century. After starting out as a small school specialized in mining and metallurgy in 1914, today it is a full-fledged branch of the University of Texas, offering a wide range of degrees. El Paso now leads in programs on border issues and the relationship between the United States and Mexico. Enrollment has increased notably over the years, with the Hispanic community accounting for a large majority of the student body.

Today, I would like to focus on Mexico and Texas as two increasingly integrated economies. I will begin with a review of how their links have expanded over time, yielding significant mutual benefits. I will then briefly describe recent developments in and the outlook for the Mexican economy, in a context in which the United States and Texas play important roles. Finally, I will discuss monetary policy and inflation in Mexico.

As usual, my remarks are entirely my own and do not necessarily reflect the views of the Bank of Mexico or its Governing Board.

Mexico and Texas

Mexico and Texas have a deeply interconnected history of growth. The state of Texas can be rightly viewed as one of the largest economies in the world, and its geographic proximity to Mexico makes it all the more logical for the two to exploit mutually advantageous opportunities. Their symbiosis is a natural consequence of a common cultural heritage, and, in economic terms, includes trade, investment, human capital, and many other areas.

In particular, Texas is Mexico's main trading partner within the United States, and Mexico is the state's main partner as well. In fact, Texas accounts for more than twice as much of total Mexican trade volume as China. As with the United States as a whole, commercial linkages were deepened by the North American Free Trade Agreement, perhaps the most profound structural change ever undertaken by Mexico.[1]

Mexico purchases many goods from Texas, with computers and electronics, petroleum and coal products, and transportation equipment making up the largest share. Gains for Mexico have been seen in terms of competition and pressure for efficiency on domestic production lines, as well as greater variety and lower prices for consumers.[2]

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1 For an examination of the benefits of NAFTA for Texas, see Aguilar Barajas, I. et al. (2014). "Trade Flows Between the United States and Mexico: NAFTA and the Border Region," *Journal of Urban Resources*, 10/2014.

2 For details on Texas exports to Mexico, see Wilson, C.E. (2011). *Working Together: Economic Ties between the United States and Mexico*, Woodrow Wilson International Center for Scholars, p.45.

The role of Texas in U.S. and Mexican trade supersedes Texan borders, as it is the state with the largest terrestrial ports of entry between the two countries. This is especially important given the fact that roughly four-fifths of U.S. trade with Mexico is by land.[3]

Direct investment from Texas has greatly helped Mexico, which is on the receiving end of knowhow and advanced production technology. Many Mexican companies, for their part, do business in Texas.

Furthermore, a great many trade-related jobs have emerged on both sides of the border. In fact, the Lone-Star State is that with the greatest number of exports-related jobs in the United States.[4]

Additionally, Texas is the second most important state in terms of labor migration from Mexico. For a long time, as we all know, our migrants have found opportunities to contribute to this vibrant economy with great dedication and efficiency. Remittances, in turn, have allowed families in Mexico to increase schooling and build better housing.

During the last few years, net Mexican migration to the United States has decreased significantly, to levels that recently became negative. This trend seems to reflect the slow rebound since 2009 of U.S. economic sectors such as construction, which have traditionally absorbed Mexican labor. Lower fertility rates in Mexico since the 1980s might also be a part of the explanation.[5]

Finally, Texas provides a rich supply of schools and universities such as your own, which many Mexicans have chosen for all levels of education.

Mexican economic developments and outlook

Like other emerging economies during the last couple of years, Mexico has been hit by turbulence in international financial markets. Two sources of fear dominate on the world stage.

The first is uncertainty surrounding the beginning of U.S. monetary normalization. Speculation regarding the possible date of the Federal Reserve's first hike is great in spite of efforts to confirm intentions to make the process gradual.

The second stems from the recent slowdown of China's economy, with leading indicators suggesting that this trend may continue. Potentially unsustainable financial imbalances in that country have also raised concerns.

As a result, since the middle of 2014, net capital flows to emerging markets have declined, commodity prices have fallen sharply, and most currencies have depreciated against the U.S. dollar. In this scenario, the Mexican peso has weakened significantly, stressed in particular by faltering oil prices and production, while the yield curve has seen a moderate upward shift, probably in anticipation of the start of U.S. monetary normalization. The share of nonresident holdings of peso-denominated government securities in the total outstanding

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3 See Texas Department of Transportation (2013). *North American Free Trade Agreement: Is it Important for Texas?* Austin TX, Texas Department of Transportation.

4 For an estimation of jobs supported by exports from individual U.S. states, see Hall, J. and C. Rasmussen (2015). *Jobs Supported by State Exports 2014*, Office of Trade and Economic Analysis, International Trade Administration, the U.S. Department of Commerce.

5 Estimation of net Mexican migration to the United States based on the Current Population Survey by the U.S. Census Bureau and the U.S. Bureau of Labor Statistics.

has dipped only slightly. However, a potential portfolio adjustment with significant pressures on domestic financial markets cannot be ruled out.[6]

To cope with possibly rising uncertainty and risk, Mexico should distinguish itself from other emerging economies by strengthening its growth prospects and macroeconomic policy framework. Steps to favor greater growth include deep structural changes and improvements to the rule of law and public security. Especially important to financial stability are actions to ensure the sustainability of the path of the public-debt-to-GDP ratio, and timely adjustment of monetary policy, with the relative stance vis-à-vis the United States taken into account, among other factors.[7]

Since 2014, Mexico's economy has been recovering, growing in the first half of 2015 at an annual rate of 2.4 percent. This pace is slightly below the yearly average of the previous two decades, and is held back by at least three drags. The first is a slowdown in industrial production, which has resulted mainly from persistent contraction in mining, dominated by falling oil output.

Second, the manufacturing sector has been deterred largely by a deceleration in U.S. industry in 2015, affected by another severe winter and declining energy investment in the face of significantly lower energy prices. Modest Mexican manufacturing activity is in line with less vigorous exports to the United States in spite of substantial real peso depreciation. We expect these factors to be transitory and momentum for Mexican exports to pick up once again.

Third, domestic spending has remained tepid, as indicated by damp investment growth and a measured pace for recovering private consumption. The main weight on domestic spending does not seem to come from the labor market, where unemployment continues to drop and labor force participation remains stable. Nor does it seem to stem from a lack of domestic financing, the growth of which has been gaining steam.

More likely causes are disappointing trends in consumer confidence, which has not seen a previously hoped-for rebound, and in producer confidence, which keeps on declining.

Analysts' consensus is for a moderate and gradual Mexican economic upturn in tandem with that of the United States. The Bank of Mexico forecasts growth of 1.7 to 2.5 percent this year, and 2.5 to 3.5 percent in 2016.[8]

Downside risks to growth likely predominate. These include further reductions in oil extraction, less robust-than-expected U.S. industrial production, and continued fragile consumer and producer sentiment.

Structural reforms currently underway in Mexico could enhance long-term productivity growth. However, eventual benefits will take time to show-up, and success crucially depends on careful and deep implementation. Changes in the energy sector may prove particularly attractive to Texan investors. New possibilities in oil extraction, as well as opportunities in natural gas transportation and electricity generation, among others, provide for tantalizing potential investments.

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6 For an analysis of net capital flows to emerging economies, see Institute of International Finance (2015). "Don't Panic! EM Capital Flows Have Weakened, but NOT Collapsed," *IIF Report*, August.

7 For a brief overview of ongoing Mexican structural reforms, see Sánchez, M. (2015). "Mexico's Reforms Progress and Economic Outlook," speech given at the *2015 IIF Latin America Economic Forum*, Busan, Republic of Korea, March.

8 See *Blue Chip Economic Indicators*, September 2015, and Banco de México (2015), *Informe Trimestral, Abril – Junio 2015*, August.

Inflation and monetary policy

Monetary policy in Mexico has been guided by the priority aim of attaining price stability, which, within an inflation-targeting approach, means a permanent objective of 3 percent annual inflation. The conduct of monetary policy has taken into account the cyclical phase of the economy. In the last two and a half years, the policy interest rate was cut by 150 basis points to accommodate sluggish economic activity.

After some price pressures in 2014 coming mainly from tax hikes, annual inflation in 2015 has remained on target, even reaching historically low levels below the objective. This achievement is noteworthy, given the fact that until only a few years ago, Mexico had a long history of high and unstable inflation. Therefore, it is imperative to consolidate the record, recognizing that price stability demands continuous attention to prevent a reversal of the trend.

Some factors call for vigilance. Recent performance has been aided by positive shocks such as favorable base effects related to last year's tax hikes, the elimination of domestic long-distance telephone charges, and slower increases in energy prices. These phenomena may prove ephemeral.

Peso depreciation has not affected inflation much so far, and the impact has been concentrated in durable goods. This may not be the case going forward, especially if the weakening of the currency becomes amplified.

Additionally, in spite of current unprecedented declines in inflation, survey expectations for the medium term are stable but above the target. This may reflect a perception that work still needs to be done to solidify the good results. Price stability will not be secure until medium-term inflation expectations are firmly anchored on the objective.

The Bank of Mexico expects inflation to remain around the target in 2015 and 2016.[9] Nevertheless, upside risks should be monitored, especially given the possibility of second-round effects. Continued significant peso depreciation, negative supply shocks, and eventual aggregate demand pressures are among these risks.

Concluding remarks

Let me conclude by saying how much I value the contributions of the University of Texas at El Paso to the understanding and collaboration between our societies. We have exploited opportunities in better ways due to the assiduous efforts of academics from this university, and I have no doubt that further progress is yet to come.

Texas and Mexico continue to find new avenues to profit mutually from trade, investment, and human capital resources. Mexico currently faces challenges both on the international and domestic fronts. The best way to deal with them is by cultivating long-term economic growth prospects, notably through well-implemented structural reforms, and buttressing the macroeconomic framework, including monetary policy.

On that note, inflation this year has reached historically low levels. This achievement requires consolidation for Mexico to reap the full benefits of permanent price stability.

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[9] See Banco de México (2015), idem.