Javier Guzmán Calafell: The Mexican economy in an adverse external environment – challenges and policy response

Remarks by Mr Javier Guzmán Calafell, Deputy Governor of the Bank of Mexico, at "Santander Mexico Day", Mexico City, 11 January 2016.

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The views expressed in this document are strictly personal.

I would like to start by thanking Banco Santander for the opportunity to share with such a distinguished audience some views about the Mexican economy, the challenges deriving from a harsh external environment, and the policy approach that has been implemented to cope with these challenges.

More than seven years after the eruption of the worst financial crisis since the Great Depression, the world economy continues to face a difficult situation. Global growth remains below its long-term trend, affected by a low rate of expansion of advanced economies (AEs) and a sharp deceleration in emerging market economies (EMEs). Although difficulties of a cyclical nature are behind these developments, the persistence of this trend points to the presence of structural causes as well. In this context, the volume of world trade has continued to moderate and seems in fact to be declining at the margin,[1] and as a result of a combination of demand and supply forces, commodity prices are showing a generalized retrenchment. The situation is further complicated by persistent nervousness in international financial markets and the consequent volatility of capital flows.

Naturally, these difficult external conditions have affected the Mexican economy. I would stress in particular three developments in this regard:

First, the US economy remains one of the best performers in the advanced world. During 2015, GDP growth in this country is estimated at 2.5 percent, above calculations for potential growth. This compares with a figure of only around 1.5 percent for the rest of AEs. Nonetheless, the expansion of economic activity in the US has been unequal among sectors. In particular, industrial output has remained stagnant since early last year as a result of the appreciation of the dollar, lower output and investment in the oil sector following the decline in oil prices, and weak global growth. Since there is a close association between the industrial sectors in Mexico and the US, this has had an adverse impact on exports and economic activity in Mexico.

Second, the price of the Mexican oil mix has declined by 77 percent since mid-2014. This has had important repercussions on the Mexican economy, particularly in view of the importance of oil revenues in the fiscal accounts. And the impact has been worsened by a pronounced fall in oil output. The latter, of around 33 percent since 2004, has also adversely affected industrial production through direct and indirect channels. In addition, as export capacity has been reduced, Mexico has become a net oil importer. To have an idea of the magnitude of the shock, it is worthwhile to note that the oil trade balance switched from a surplus of 0.7 percent of GDP in 2013 to a deficit of 0.8 percent of GDP in the period January–September 2015.

Third, uncertainty in international financial markets has also influenced economic developments in Mexico. Concerns have related partly to the expected normalization of monetary policy in the US. But financial markets in Mexico have also been affected by other developments, such as nervousness about the situation in several EMEs, especially China, the divergent monetary policy stances in the main advanced economies, and problems of a

[1] Organisation for Economic Co-operation and Development (2015): *OECD Economic Outlook*, Volume 2015 Issue 2, November.

geopolitical nature. In this context, net portfolio capital flows to Mexico fell from US$ 39 billion in January–September 2014 to 20 billion in the same period of 2015.

The exchange rate has worked as the main adjustment mechanism to these shocks. Thus, the nominal peso-dollar rate has shown a significant depreciation, of around 37 percent from early September 2014 to January 8, 2016. It should be noted that depreciation of the Mexican peso vis-à-vis the US dollar is consistent with movements observed in the currencies of some commodity exporting AEs, such as Canada and Norway. Likewise, the evolution of the peso compares favorably with the exchange rates of other EMEs in that period.[2] It is also important to stress that, as I will explain in more detail later on, the pass-through from the depreciation of the peso to domestic prices has been modest.

Furthermore, adjustment of the Mexican peso has been orderly, as shown not only by the volatility of foreign exchange options, well below the average for EMEs, but also by the behavior of capital flows. In particular, notwithstanding the prevailing uncertainty, investments by foreigners in long-term government securities denominated in pesos have shown resilience. These are developments worth noting, particularly since the Mexican economy is one of the most open to international capital movements among the emerging world. Indeed, the orderly depreciation of the peso has been supported by a solid macroeconomic position, the mechanisms that have been implemented to provide liquidity to the foreign exchange market, the high level of international reserves, and the FCL agreement currently standing with the IMF.

What have been the implications of these developments for economic growth and inflation in Mexico?

Naturally, the difficult external environment has adversely affected economic growth. In the face of weakness in industrial production in the US, and an even more complicated situation in the rest of the world, manufacturing exports have remained flat over the course of 2015.

Consequently, the upturn in economic activity observed in 2015 is mostly explained by domestic demand.[3] On the one hand, the increase in employment, the recovery of real wages made possible by low inflation, higher remittances in peso terms and the expansion of bank credit have stimulated private consumption. At the same time, private investment, mainly in machinery and equipment, has shown an upward trend. When seen from the supply side, services has been the leading sector, as industrial production has been affected by the decline in oil output and stagnation of this sector in the US.

It is reasonable to expect the continuation of a gradual strengthening of economic activity in 2016 and 2017. The anticipated revival of industrial output in the US, coupled with depreciation of the peso, should reflect in the evolution of manufacturing exports. In addition, consumption growth would be supported by a favorable behavior of its main determinants. By enhancing confidence, the expansion of exports and consumption should provide additional stimulus to private investment. The latter would also be underpinned by the ongoing efforts of structural reform. On the other hand, it is important to note that downside risks for growth persist, and that a negative output gap is expected to prevail until the end of 2017.

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[2] Since early September 2014, the Canadian dollar and the Norwegian Crown have depreciated, respectively, by 29.8 and 41.7 percent against de US dollar, while a basket of EME currencies excluding the Mexican peso (the sample includes the currencies of Brazil, Chile, Colombia, Hungary, Indonesia, Malaysia, Peru, Poland, Russia, South Africa and Turkey) has depreciated between 44.2 (simple average calculation) and 59.7 percent (GDP-weighted average calculation).

[3] Even though, from a national accounts perspective, the external sector has continued to contribute positively to real GDP growth, this is to a significant extent due to the effect of the peso depreciation on the valuation of trade flows.

Expectations for economic growth in Mexico for 2015 and 2016 have been adjusted downwards, but to a lesser extent than in other EMEs.[4] On the other hand, even though current GDP growth (around 2.5 percent at annual rate through the first three quarters of 2015) remains insufficient, this has to be seen against the context of the adverse shocks that the economy has faced, the anticipated pickup in coming years, and a Latin American region which is estimated to have contracted in 2015 and foreseen to show very modest, if any, GDP growth in 2016.

In the case of inflation, performance has been better than expected. Headline CPI inflation registered eight consecutive months of historical minima in the period May–December 2015, with a figure of 2.1 percent in December. This is explained by a low and stable core component, and a downward trajectory of non-core inflation. In this context, short-term inflation expectations have been adjusted downwards, while those for the medium and long term have remained stable.

These favorable inflation results have been achieved despite the significant depreciation of the peso. In fact, the impact of the exchange rate has concentrated on the prices of tradable goods, without second round effects.

The latter is explained by a combination of factors. The most important among them is the credibility of monetary policy and in general of the macroeconomic policy framework over the course of many years. This has allowed a structural change in the process of price determination in Mexico, which has yielded, among other results, a decline in the pass-through from the exchange rate to inflation. In addition, the measures of structural reform carried out by the government have led to declines in the prices of several key inputs, telecommunications and electricity among them. This has combined with a negative output gap and a favorable evolution of the prices of agricultural goods, which have also contributed to contain inflation.

Of course, upside risks to inflation must not be disregarded. The recent behavior of the exchange rate in the context of strengthened recovery of economic activity might result in a higher pass-through from the exchange rate to prices. In addition, given the natural uncertainty that surrounds estimates of potential growth, the output gap might close faster than anticipated.

The relatively favorable evolution of the Mexican economy in the face of major shocks, has been enabled by an adequate economic policy framework. This includes:

First, as I already noted, a credible monetary policy. In the context of the inflation targeting framework, the implementation of monetary policy in Mexico has focused on achieving an efficient convergence to the 3 percent target, i.e. at the lowest possible cost in terms of economic activity. On the basis of this rationale, Banco de México responded to internal and external developments by reducing its benchmark interest rate by 150 basis points from March 2013 to June 2014. Headline inflation fell from 4.3 percent in March 2013 to 2.1 percent at the end of 2015. In other words, the monetary policy stance allowed to simultaneously reduce the inflation rate and support economic activity.

On December 17, 2015, Banco de México's Board decided to increase the target for the overnight interbank rate by 25 basis points to a level of 3.25 percent. The presence of record low levels of inflation, stable medium- and long-term inflation expectations, and the anticipation of a negative output gap during the period of influence of monetary policy supported an

[4] According to IMF data through October 2015 presented in its *World Economic Outlook*, Mexico's real GDP growth forecast for 2015 has been revised downwards by 1.7 percent points (p.p.) since it was initially projected at 4.0 percent in April 2010. In contrast, the median revisions on growth forecasts for other EMEs (namely Brazil, Chile, China, Colombia, Hungary, India, Indonesia, Malaysia, Peru, Poland, Russia, South Africa, Thailand and Turkey) amount to –2.3 p.p., while growth for the Latin American and Caribbean region (LAC) has been revised downwards by 4.2 p.p. For the 2016 forecasts, the corresponding revisions (with respect to the initial estimate in April 2011) are: –0.4 p.p. for Mexico, –1.8 p.p. for other EMEs, and –3.1 p.p. for LAC.

unchanged monetary policy stance. However, with the increase in interest rates in the US, such a strategy would have implied costs well above the potential benefits.

In particular, it carried the risk of disorderly capital outflows and an additional depreciation of the peso. This would have endangered both the inflation target and financial stability. It is also important to take into consideration that, notwithstanding the interest rate increase, monetary conditions in Mexico remain very lax, due to the significant real exchange rate depreciation. Thus, the impact of an increase in the reference rate on economic activity should be modest.

Looking ahead, monetary policy in Mexico will continue to be implemented in a highly uncertain environment. To start with, while first adjustment of interest rates in the US has removed a major source of concern for the world economy and normalization of monetary policy in that country is expected to proceed gradually, it is also true that the implications of further increases in the federal funds rate for international and domestic financial markets are unclear. Furthermore, as I already mentioned and as underlined by the events of the last days, the world economy is facing a particularly challenging situation.

Naturally, the evolution of inflation in Mexico will be responding to a combination of many factors, both external and domestic, and a careful monitoring of them will be required. The Board of Banco de México has made clear that close attention will continue to be paid to all determinants of inflation and to medium- and long-term inflation expectations, with particular focus on the relative monetary position between Mexico and the US, the pass-through of movements in the exchange rate to prices, and the degree of slack in the economy. The Board has also stressed that any additional measures required will be implemented, with due flexibility and whenever this is needed, to consolidate the efficient convergence of inflation to the target.

Second, a timely adjustment of fiscal policy. Oil revenues account for a high share of total public revenues, thus implying a significant vulnerability to fluctuations in oil prices.[5] In view of this risk, the government has decided to hedge oil prices yearly since 2005. This allowed to ensure an oil price for the Mexican mix for public finance purposes of 76 dollars per barrel (dpb) in 2015 (against the observed average of 47 dpb) and of 49 dpb for 2016 (24 dpb at present). In addition, a number of measures on the revenue and expenditure sides have been implemented to guarantee the sustainability of the fiscal accounts. On these bases, the government remains committed to reduce the PSBR (public sector borrowing requirements) from 4.1 percent of GDP in 2015 to 3.5 percent in 2016, and further to 2.5 percent in 2018. This will also allow a downward path for public debt as a share of GDP.

Third, a sound financial system. Mexico was one of the first EMEs to meet the Basel capitalization requirements, and as of November 2015 the schedule for compliance with Basel liquidity standards was met by the required banks, with nearly all others having met this regulation in advance. In addition, the levels of corporate and household indebtedness are moderate, and as a share of GDP well below the figures observed in other EMEs and in AEs.[6] Furthermore, risks from corporate foreign-currency liabilities are alleviated by long amortization periods, fixed interest rates, natural hedging and the prudent use of derivatives. It is also important to note that a comprehensive framework has been set in place for monitoring financial stability risks. On the other hand, risks must be carefully assessed, particularly in view of the difficult external environment. For these reasons, it will be essential to persevere in the strengthening of the macroeconomic framework and in the implementation of any regulatory measures required to cope with those risks.

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[5] During the period 2010–2014, the corresponding figure was around 36 percent. With the increase in tax revenues, the drop in oil prices and the reduction in oil output, the share fell to 19.3 percent in January–November 2015.

[6] See Institute of International Finance (2015): *Emerging Market Debt Monitor – Update*, December.

Fourth, a major effort of structural reform. The potential rate of GDP growth in Mexico during the last decades has been insufficient to meet the population's needs. The measures of structural reform adopted since late 2012, considered by the OECD as the most ambitious among the organisation's membership,[7] have been focused on overcoming this problem, by increasing both private investment and productivity. It is worth to highlight the broad-ranging scope of such efforts, as they comprise not only several key sectors of the economy, but also measures aimed at improving the institutional framework. Even though the full impact of these structural changes on potential GDP will take time to materialize, some effects are readily visible in a number of areas. These include, among others, a more flexible labor market; increased competition in several sectors of the economy; a fall in the prices of some widely used key inputs; higher private investment in areas such as telecommunications, gas and electricity generation; widespread participation of private firms in oil field auctions; and a more important role of the financial system, through both private and public intermediaries, in supporting economic growth.

Two additional implications of the policies implemented are worth noting. According to the World Bank, the business climate in Mexico has improved significantly in recent years, to levels close to best performers in the emerging world.[8] Also, Mexico's creditworthiness, as measured by credit ratings assigned to government securities, has continued to ameliorate over the last couple of years, to levels above most EMEs, while still maintaining a positive outlook amidst a difficult external environment.

To conclude, I would like to emphasize that, notwithstanding major economic shocks, the Mexican economy has shown a relatively good performance, and it is reasonable to expect a gradual strengthening of economic activity in the next couple of years. In fact, Banco de Mexico's forecasts currently place real output growth at 2.5–3.5% in 2016, and at 3.0–4.0% in 2017. In addition, following an ambitious program of structural reform, Mexico is one of the few EMEs where an increase in potential GDP is expected. Meanwhile, CPI inflation is projected to rise moderately from the current minima to levels around the 3 percent target throughout both 2016 and 2017. It should also be noted that with the recent increase in the federal funds rate signaling confidence of US authorities in the economic outlook, Mexico is likely to benefit in coming years from close links to that economy.

However, external conditions for Mexico will probably remain very difficult. Not only is the world economy moving across a particularly complicated juncture, but major structural challenges need to be overcome.

Therefore, it will be essential to continue to implement a prudent and flexible monetary policy; adhere strictly to the announced strengthening of public finances; pursue the overall stability of the financial system, while promptly addressing emerging risks; and maintain the structural reform momentum, by ensuring that the policies underway are timely and efficiently implemented, as well as by adopting any additional measures required to achieve a rate of potential growth in accordance with the country's needs.

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7 See Organisation for Economic Co-operation and Development (2015): *OECD Economic Surveys: Mexico*, January.

8 See World Bank (2015): *Doing Business 2016: Measuring Regulatory Quality and Efficiency*, October.