Manuel Sánchez: Mexico in an unfriendly world economy

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the 2016 Mexico Opportunities Conference "Harvesting Growth", organized by J.P. Morgan, Mexico City, 21 June 2016.

*   *   *

It is a pleasure to be here with you this morning. I would like to thank J.P. Morgan for the invitation to participate in this annual conference devoted to opportunities for attaining higher economic growth in Mexico.

In my talk, I would like to focus on the challenges and prospects for the Mexican economy in the current difficult international environment. To this end, I will touch first on Mexico's economic developments and outlook; then, I will briefly analyze the impact of widespread uncertainty on the country's financial markets; and finally, I will make some comments on inflation and monetary policy.

Before I begin, I should note that my remarks are entirely my own and do not necessarily reflect the positions of the Bank of Mexico or its Governing Board.

Economic developments and outlook

A natural starting point for my comments is found in international economic conditions, which during the last couple of years can be characterized as less favorable for emerging markets. In particular, advanced nations continue to witness a slow recovery amid decelerating growth in emerging economies and stagnant global trade. Added to this condition are doubts and concerns over monetary policy stances and expected monetary divergence among developed countries.

Worries over the health of the Chinese economy, in turn, persist amid uncertainty growing on geopolitical issues, with Brexit currently the number-one fear. In addition, commodity prices are expected to remain low for some time. Finally, this environment has fueled heightened risk aversion, which has hit emerging economies especially hard.

In this complicated world, the Mexican economy has maintained relatively stable and moderate growth since 2014, reaching 2.8 percent in the first quarter of 2016 on a year-on-year basis. The main driver has been an expanding services sector, as industrial production had decelerated somewhat, although picking up recently.

Three factors behind softer industrial growth are clear. First and foremost, oil extraction has seen a longstanding decline. Construction activity, for its part, has slowed and is somewhat erratic, apparently still affected by the restructuring process to which this sector has been subject in the last few years. To round out the list, manufacturing production, which holds a tight relationship with industry and manufacturing in the United States, has been less dynamic.

Given significant vertical integration between the two countries, slower U.S. industrial activity, reflecting the downsizing of the oil sector amid low prices, has capped the expansion of Mexican manufacturing. As a result, manufacturing exports have lost steam, with declining rates of annual growth falling into negative territory in recent quarters.

This deceleration has taken place in spite of significant real peso depreciation, which has occurred along with that of other emerging-market currencies. This fact highlights the dominant negative effect stemming from a decline in external demand, notably from the United States, Mexico's main trading partner, but also from other nations as well.[1]

In short, the main engine of recent Mexican economic expansion has been domestic spending, largely by the private sector, including both consumption and investment. Yet it is worth noting that, although representing a smaller weight in total aggregate demand, government consumption was expanding, thereby supporting spending as well. In the 2016 first quarter, however, this trend changed. Additionally, public investment, an even smaller contributor to aggregate demand, continues to contract.

As with the global economy and most world regions, Mexico's economic outlook has been subject to downward revisions, with a modest recovery projected for this and the following year. Even in this lackluster scenario, Mexico distinguishes itself, with expected expansion higher than the average pace foreseen for Latin America.[2]

This does not mean we should be satisfied with only middling growth. As an emerging economy, Mexico should eventually enjoy much higher rates of economic expansion, breaking out of its previous long-term, not excessively encouraging, record.

To be sure, in the short term, real challenges prevail. Specifically, Mexico's scenario of modest improvement faces risks, among which the downside forces seem more numerous. Let me mention three.

In the first place, U.S. imports and industrial output may slow further, potentially not only inhibiting the country's manufacturing production, but also generating spillover effects on the services sector and private investment. Second, producer and consumer sentiment could deteriorate due to less favorable international financial events. Finally, a larger-than-anticipated fall in Mexican oil extraction could occur. On the upside, however, recent structural reforms could start to yield greater-than-expected benefits.[3]

Financial markets

International financial markets have been affected by uncertainty on the implications of the extraordinary lax monetary stances undertaken in advanced nations and the normalization process in the United States. As central banks in these regions are navigating unchartered waters, the consequences are impossible to predict.

Meanwhile, portfolios have been adjusted away from emerging markets, with lower capital inflows and even outflows in some cases. Asset prices, at the same time, including those of emerging market bonds and currencies, have seen downward pressure.[4]

Also, spikes in financial volatility have hit amid geopolitical jitters, including fears over Brexit. These developments reflect tensions and headwinds against emerging markets, testing the strength of their fundamentals.

In Mexico, the unprecedented shrinkage of the oil balance has resulted in a larger current account deficit. This gap still remains, however, only slightly below 3 percent of GDP.

---

1 For an econometric estimation of the effects of U.S. manufacturing production and the bilateral real exchange rate on Mexico's manufacturing exports to that country, see Banco de México (2016). *Quarterly Report October – December 2015*, Box 1.

2 Analysts' estimates for GDP in Latin America and Mexico are, respectively, –0.6 and 2.4 percent in 2016, and 2.0 and 2.8 percent in 2017. See Consensus Economics Inc. (2016). "Latin American Consensus Forecasts," May.

3 For an online progress report of Mexico's structural reforms, see Presidencia de la República, *Reformas en Acción*, http://reformas.gob.mx/.

4 See Koepke, R. and Farnham, S. (2016). "May 2016 EM Portfolio Flows Tracker," *Institute of International Finance*, June.

The enlargement of the current account deficit has caught the attention of many observers, perhaps not so much because of the sheer magnitude of the total balance, but likely because of the underlying trends, which may eventually trigger external financing restrictions. This type of concern should not be neglected, and must be properly assessed.

One fact is precisely the weakening of the oil trade balance, reflecting lower extraction and a significant deterioration of the oil terms of trade. A second is that the other component, the nonoil balance, has been improving, partly aided by real exchange rate depreciation. Nevertheless, this performance has not been sufficient to completely offset trends in the oil balance. In a word, recent less favorable balance-of-payments developments reflect Mexico's oil situation.

To preclude the continuation of these tendencies and support financial stability, an adjustment in public-sector spending, already underway, is obviously called for. The necessity is clearly confirmed by rising Pemex credit risk perception, where higher CDS spreads beginning in mid-2014 and coinciding with lower oil prices should not be surprising, with slightly less pressure since last February.

An important consequence is the contamination that Pemex credit risk perception has exerted on Mexico's sovereign debt. Inaction from the state oil company is definitely not acceptable, if for nothing else, because of the danger of further contagion on country risk perception.

Additionally, the share of nonresident holdings of peso-denominated government securities in the total outstanding has decreased, with a change of composition away from short-term zero coupon instruments (cetes) and in favor of long-term bonds. These portfolio changes could be interpreted as a natural investor reaction to less optimistic views on emerging markets. Hence, so far, those seeking the exit have been mainly holders of short-term securities, while holdings of long-term bonds have risen in absolute terms during the year. In any case, developments of foreign funds in Mexico must continue to be monitored.

As in other emerging-market economies, heightened risk aversion since the taper tantrum has widened interest-rate spreads. It is worth noting that current spreads are not unprecedented, as they are similar to those observed at the beginning of 2012, when fears surrounding the sustainability of the euro area also fed risk aversion.

As in other countries, a flexible exchange rate has performed the crucial role of buffering markets in an adverse financial environment. The Mexican peso has depreciated significantly since mid-2014, hurt more than other emerging-market currencies in the present year.

These difficult developments underscore the importance of ongoing fiscal strengthening, a necessary and welcome development to face external headwinds. Adjustment already includes at least four measures, starting with financial and business restructuring being implemented in Pemex. Additionally, cuts to 2016 budgeted public expenditures are in process, with an initiative sent to Congress for a positive primary balance in 2017. Finally, in the aim of keeping the public finances sustainable, a commitment is in place for the stabilization and decline of the total balance of public-sector borrowing requirements over GDP in the medium term.[5]

Inflation and monetary policy

Annual inflation has continued to be benign at unprecedented low levels. Specifically, for 13 months in a row, inflation has remained below the permanent 3 percent target. This is quite an achievement, as convergence to this objective assumes inflation to fluctuate

---

[5] See SHCP (2016). "Documento Relativo al Cumplimiento de las Disposiciones Contenidas en el Artículo 42, Fracción I, de la Ley Federal de Presupuesto y Responsabilidad Hacendaria," April.

sufficiently close to 3 percent, sometimes above and sometimes below. Before 2015, inflation persistently ran around an average above 4 percent.

Lower inflation has resulted from both relatively contained core price increases and declining noncore inflation. A surge in core merchandise inflation reflects a modest effect from peso depreciation on tradable goods prices.

At the same time, the core services component has remained subdued, benefiting from persistently falling telecom tariffs resulting from competition enhanced by reforms in that sector. It may also suggest the absence of significant overall aggregate demand pressures to date. Falling noncore inflation reflects reduced agricultural price increases, as well as contractions in the index for energy and government-determined prices.

Short- and medium-term inflation expectations, as reflected in analysts' surveys, are gradually moving towards the 3 percent permanent target, while those extracted from market instruments seem to have converged to the target, a significant advance in light of a history of high inflation.[6]

Some threats to the consolidation of inflation convergence to the target prevail. Upward risks are particularly substantial in view of the relatively short time inflation has remained anchored on the target. The biggest menace may come from further peso weakness, which could result in greater pass-through and misalignment of inflation expectations.

Another risk could emerge in aggregate demand pressure, as total absorption has increased. Agricultural price rises may also pick up, reverting to the medium-term average, carrying second-round price effects.

Thus, monetary policy must avoid complacency, remaining on watch to consolidate inflation convergence. Results, although recently positive, include no guarantee for the future. In addition, exchange rate considerations have to be viewed from the perspective of the Bank of Mexico's price stability mandate.

For time-consistency considerations, the relative monetary stance vis-à-vis the United States should continue to be a factor. However, challenges to price stability may surface whatever the U.S. Federal Reserve does. Hence, monetary policy actions can be independent of the Fed. In any case, the Bank of Mexico will continue to act in a timely and decisive way to consolidate price stability.

Conclusions

Let me conclude by saying that Mexico's economic fundamentals are being tested. Structural reforms, an improved rule of law, and better security could produce more rapid growth in the medium to long term. With the financial state of Pemex weak and posing contamination risks to the Mexican sovereign, meanwhile, adjustment of the fiscal stance is a welcome development.

Fortifying economic fundamentals is an ongoing challenge for policy makers. As recent good inflation performance is not guaranteed, complacency cannot be allowed to seep into monetary policy. Pursuit of permanent convergence to the target must continue.

---

[6] See Banco de México (2016). "Encuesta sobre las Expectativas de los Especialistas en Economía del Sector Privado: Mayo de 2016," June.