Manuel Sánchez: Mexico – economic integration, challenges and outlook

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the United States-Mexico Chamber of Commerce, California Regional Chapter, Los Angeles, 5 August 2016.

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It is certainly a pleasure to be back in Los Angeles to share my views with you on Mexico's economic prospects. I would like to thank the California Regional Chapter of the United States-Mexico Chamber of Commerce for the kind invitation.

I will organize my presentation in three parts. First, I will briefly discuss Mexico's growing and very dynamic partnership with the United States. I will follow with a focus on growth and financial developments for the Mexican economy, in conjunction with these close ties. And finally, I will make some comments on inflation and monetary policy in Mexico.

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

Economic integration with the U.S.

A natural starting point for this discussion is the tight relationship between our two countries. Mexico is increasingly linked to the United States, through high levels of bilateral exports and imports, significant FDI and technology transfers, and substantial remittances, among other channels. These bonds have yielded dividends on both sides of the border, including business and job creation, wider and more advantageous consumer choices, and higher living standards.[1]

California, home of a long border and migration history with Mexico, is one of the country's most important trade and cultural partners. Merchandise trade has expanded continuously through recent years. Mexico and California, the world's sixth largest economy, both gain greatly from these mutually beneficial exchanges.

One of the most profound and longstanding links between Mexico and the United States comes through tightly integrated industrial operations. This is more than clear in the high correlation between U.S. industrial and Mexican manufacturing data over time.

Recently, structural reforms undertaken by Mexico have opened up even more opportunities for the two countries. The overall reform agenda is extremely ambitious, encompassing broader and greater access to telecom services via more competition, an unprecedented opening of the energy sector to private investment, and changes to rules governing the labor market. However, its ultimate effectiveness obviously depends on the quality and depth of implementation over the coming years.[2]

In any case, some of the reforms are indeed in their first phase of implementation, and they have likely only begun to produce results. Furthermore, the advantages they bring could very well be enhanced down the road through a more effective rule of law, better public security, and improvement to Mexico's physical infrastructure.

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1 For a discussion of the U.S.-Mexico economic relationship, see Villarreal, M.A. (2015). *U.S.-Mexico Economic Relations: Trends, Issues, and Implications*. Washington, DC: Congressional Research Service, pp. 1–9.

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

Growth and financial developments

Let me move on to the second part of this talk, which covers shorter-term developments. On a year–on-year basis, since 2014 Mexico's GDP has grown at an average rate of 2.3 percent, not far from the historical performance, with a dip occurring in the second quarter this year.

Behind this relatively stable backdrop in the past two and a half years, two opposing forces have been at play. Momentum in services has been offset by a slowdown in industrial production.

Softening industrial output in Mexico seems to result from two shocks. One is falling oil extraction due to the near depletion of Pemex's most profitable oil fields. The other is slowing U.S. industrial production. Consistent with this panorama, manufacturing exports to the United States have been on the downswing, aggravating the drag exerted by low demand for Mexican products from other countries.

U.S. manufacturing appears to have a larger impact on Mexican exports to the U.S. than does the bilateral exchange rate. Econometric estimates for the long-term behavior of Mexican manufacturing exports to its northern neighbor point toward an elasticity to U.S. manufacturing production almost four times as high as that for the bilateral real exchange rate.[3]

However, a weaker peso may be partly responsible for the fact that Mexican exports have captured greater U.S. market share. For example, in the last four and a half years, the share of Mexico's automotive exports in total U.S. automotive imports has increased by almost five percentage points.

Private consumption has been a driver of economic expansion, partly compensating for the loss of steam from external demand. Consumption growth seems to have been supported by several factors, including improvement in labor market indicators.

Since 2012, the unemployment rate has fallen from five percent to less than four percent, close to the long-term average. Note that this improvement has occurred in conjunction with relatively stable labor force participation. Additional favorable factors are foreign remittances and consumer lending, exhibiting an almost coincident rebound with consumption.

Investment, on the other hand, is contracting, sending up a warning sign on possibilities for future improvement. Also, forward-looking indicators such as purchasing managers' indexes for both manufacturing and nonmanufacturing are declining, with the latter breaching the contractionary zone. As is the case in the United States, Mexico is expected to face a slowdown this year, while growth next year should pick up moderately.[4]

Mexico's growth scenario faces risks. The world economy may decelerate further, affecting U.S. prospects. A greater-than-expected slowdown in U.S. imports and industrial production could hurt the outlook for Mexico. Also on the radar are weaker consumer and producer confidence, a worse-than-expected drop in crude oil output, and potentially more volatile financial markets, which could bring constraints for financing in both the public and private spheres. To the upside, structural reforms might yield more benefits.

In financial markets, since the middle of 2014, an international trend toward greater risk aversion has hurt emerging markets in particular. In emerging economies, the financial

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3 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.

4 See IMEF, (2016). "Indicador IMEF del Entorno Empresarial Mexicano (IIEEM)," July. Analysts' estimates for GDP in the United States and Mexico are, respectively, 1.9 and 2.3 percent in 2016, and 2.2 and 2.6 percent in 2017. See *Consensus Forecasts and Latin American Consensus Forecasts*, July 2016.

variable most affected has been the exchange rate, with a tendency toward generalized depreciation against the U.S. dollar. To date this year, the Mexican peso has been hit harder than other currencies in this group. The obvious question is why this has been so.

Exacerbated peso depreciation may stem from several factors. One is the role of the Mexican peso, the most traded currency among emerging economies, as an international hedge mechanism. Increased risk aversion has been a constant for currencies, bonds and other investments in the last couple of years, and investors appear to have latched onto the tactic of shorting the Mexican peso as an easy way to hedge their risks when other emerging-market assets face headwinds.[5]

Another factor, however, is Mexico's weakened fiscal position. The nation has seen a longstanding rising trend in overall public-sector debt over GDP. Additionally, Pemex net oil export revenues have dropped drastically.

A stronger fiscal stance is necessary given a historic balance of public-sector borrowing requirements that has grown 14 percentage points relative to GDP in a matter of just a little more than seven years. This situation is more critical given the worsening of Pemex finances and the persistence of low oil prices, with widening negative net income in the state-owned company. The difference between revenues and expenditures maps very closely the rising oil deficit in Mexico's current account.[6]

Finally, holdings of peso government securities by nonresidents have fallen lately, driven by drops in those of short maturities. This bears watching, given that further bouts of international financial volatility could easily occur.

On the world stage, in the wake of Brexit, deeper monetary accommodation is foreseen in most developed countries. Partly as a result, leverage is rising worldwide. Furthermore, the perception of the low effectiveness of monetary policy in terms of intended goals may hurt its credibility.[7]

A highly unusual characteristic of the overall scenario is that advanced nations are saddled with increasing proportions of public and private debt with negative yields. Geopolitical jitters will likely continue. Also, European banks suffer not only from squeezed margins in light of the low and negative interest-rate environment, but also from weak balance sheets. Finally, doubts over the sustainability of the Chinese economic recovery and policy interventions there persist.

Monetary policy and inflation

Let us now focus on monetary policy and inflation in Mexico. Since last year, annual inflation has remained moderate. For 15 consecutive months, it has been below the 3 percent target. This is unprecedented and calls for consolidation of the trend.

This benign result has been supported by unusually low noncore price increases, including soft international agricultural and domestic government-determined prices. On the other hand, core inflation has been rising gradually, reflecting the effect of peso depreciation on tradable goods prices. This is very clearly shown by the behavior of merchandise inflation. Additionally, an accelerating rise in the producer price index also reveals an impact from peso weakening.

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5 See BIS (2014). "Triennial Central Bank Survey of foreign exchange and derivatives market activity in 2013," detailed tables.

6 See SHCP (2016). *Informes sobre la Situación Económica, las Finanzas Públicas y la Deuda Pública, Segundo trimestre de 2016*.

7 See BIS (2016). *BIS Statistical Bulletin*, June, Table F2.3.

Medium-term inflation expectations, as measured by analysts' surveys, have remained relatively stable, albeit above the target. Market-derived expectations appear to show a recent spike.[8]

In this context, monetary policy has been preemptive, with interest rate hikes seeking to avert deviations of inflation expectations and to anchor them on the target, particularly in the face of significant peso depreciation. The resulting flattening of the yield curve seems to reflect confidence that inflation will continue to be contained.

It is worth emphasizing that the Bank of Mexico does not target any level of the exchange rate. Its primary objective is maintaining low inflation, and Mexico adheres to a freely floating exchange-rate regime. This does not mean that movements in the exchange rate have no impact on inflation. In fact, as mentioned, moderate pass-through has occurred from the exchange rate to consumer prices, concentrated in durable goods. But this may change, and monetary policy should remain vigilant.

Some risks to the consolidation of convergence of inflation to the 3 percent permanent target prevail. The most notable danger is more weakening of the peso with a generalized impact on prices, knocking inflation expectations off track. Also, rises in noncore prices could accelerate, returning to historic rates, possibly producing second-round price effects. Finally, given uncertainty on the level of potential GDP, aggregate demand pressures could surface.

Conclusions

Over the course of many years, Mexico and the United States have benefited from increased integration, both cultural and economic. Mexican economic activity, however, has recently decelerated and confronts downside risks, among them, the possibility that the U.S. industrial sector's performance will turn out to be softer than anticipated.

Other dangers are weaker consumer and producer confidence, a steeper-than-expected fall in oil output, and possibly more volatile financial markets. The latter might squelch financing for the government and private firms.

Greater risk aversion could become exacerbated by geopolitical events. In this context, Mexico's fiscal stance should be fortified, and its monetary policy must continue to employ complete flexibility in order to consolidate the convergence of inflation to the permanent target, thereby shielding the economy with stronger macroeconomic fundamentals.

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8 See Banco de México (2016). "Encuesta sobre las Expectativas de los Especialistas en Economía del Sector Privado: Julio de 2016," August.