Mexico: Overcoming Key Domestic Political and Economic Challenges

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Outline

1	**Introduction**

| 2	**Short-term Challenges for Economic Growth and Inflation**
	    a. **The External Environment**
	    b. **Domestic Activity and Prices**

3	**The Long Term**

Introduction

- The main objective of monetary policy in Mexico is to attain stability of the purchasing power of the currency.

- The sound development of the financial system and an appropriate functioning of payment systems are also priority objectives of the central bank.

- Main pillars of monetary policy:

  - ✓ *Central bank independence*

  - ✓ *Inflation targeting regime: permanent inflation target of 3 percent, with a variability interval of +/-1 percentage point.*

The central bank has been able to implement a countercyclical monetary policy without affecting long term inflation expectations in recent years.

Overnight Interbank Interest Rate and Inflation Expectations
%
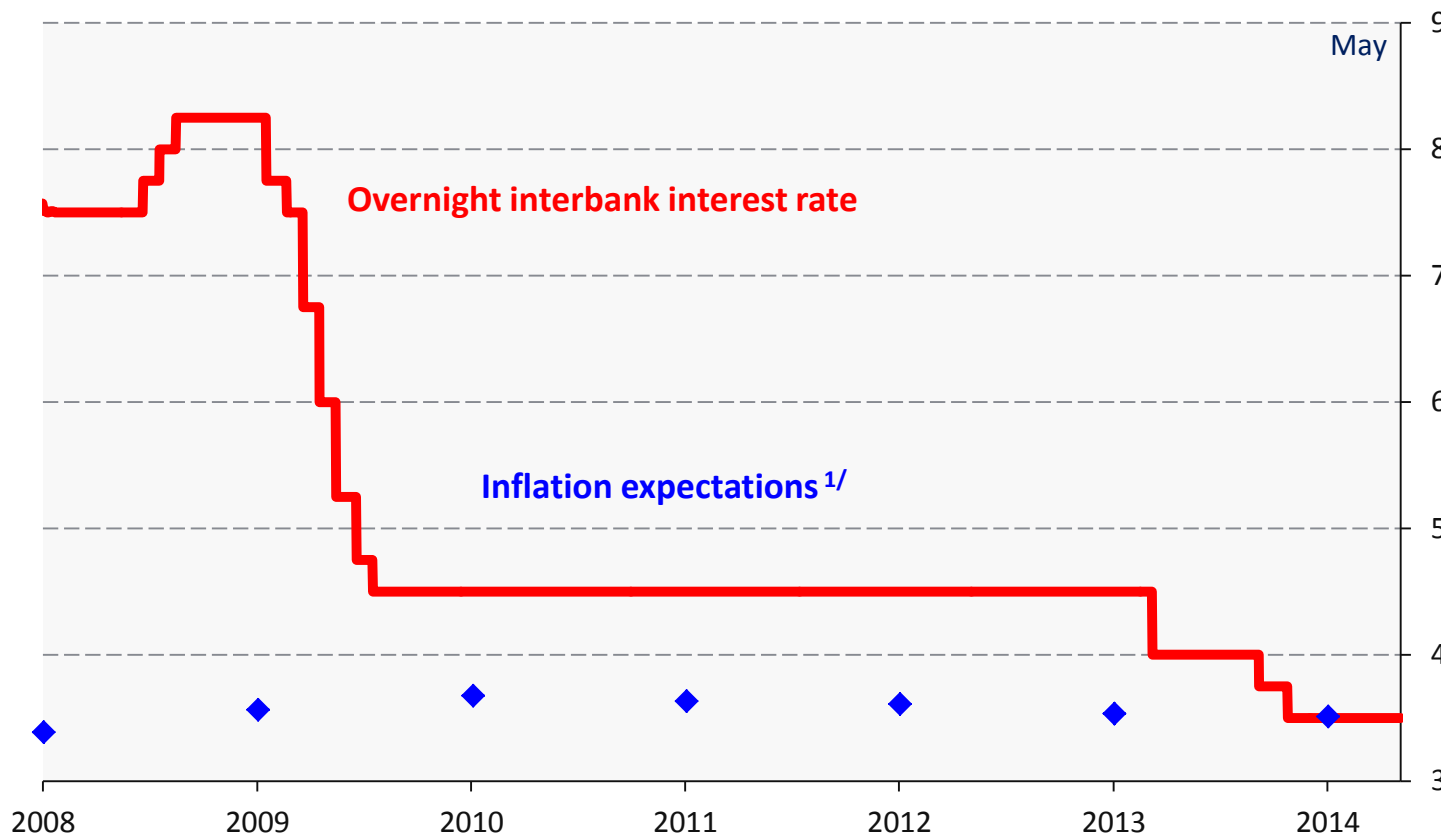
1/ Inflation expectations in January 2014 for the next 4 years.
Source: Banco de México.

In the aftermath of the global financial crisis, the Banco de México, in coordination with other authorities, has paid increasing attention to financial stability.

■ In addition to a number of measures implemented in previous years, in November 2013 Congress approved a financial sector reform which includes among its objectives to strengthen this sector by incorporating into law, among others:

   ✓ *Capital and liquidity rules in accordance with Basel III.*

   ✓ *Compulsory stress tests for banks on the basis of rules set by the National Banking Commission.*

   ✓ *More strict limits for bank operations with related counterparties.*

   ✓ *Measures to mitigate risks arising from non-bank banks.*

   ✓ *Improved procedures for bank resolution based on international standards.*

   ✓ *The Financial System Stability Council (originally created by Presidential Decree in 2009) as an entity of coordination among financial authorities in the area of financial stability.*

■ In addition:

   ✓ *Efforts are under way to enhance regulation for derivatives markets based on FSB guidelines.*

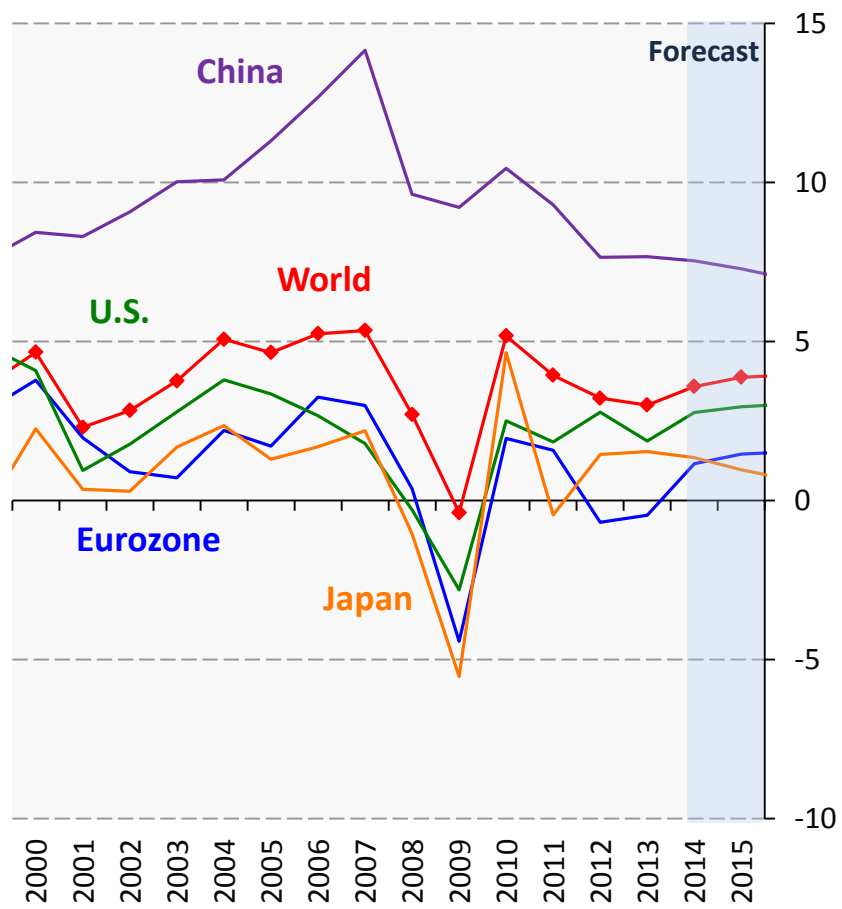   ✓ *The financial stability activities of the central bank have been substantially strengthened.*

Outline

World economic activity in coming years is expected to be led by the US. Although the recovery of the US economy has lagged previous cyclical expansions, GDP is projected to grow above potential in 2014 and 2015.
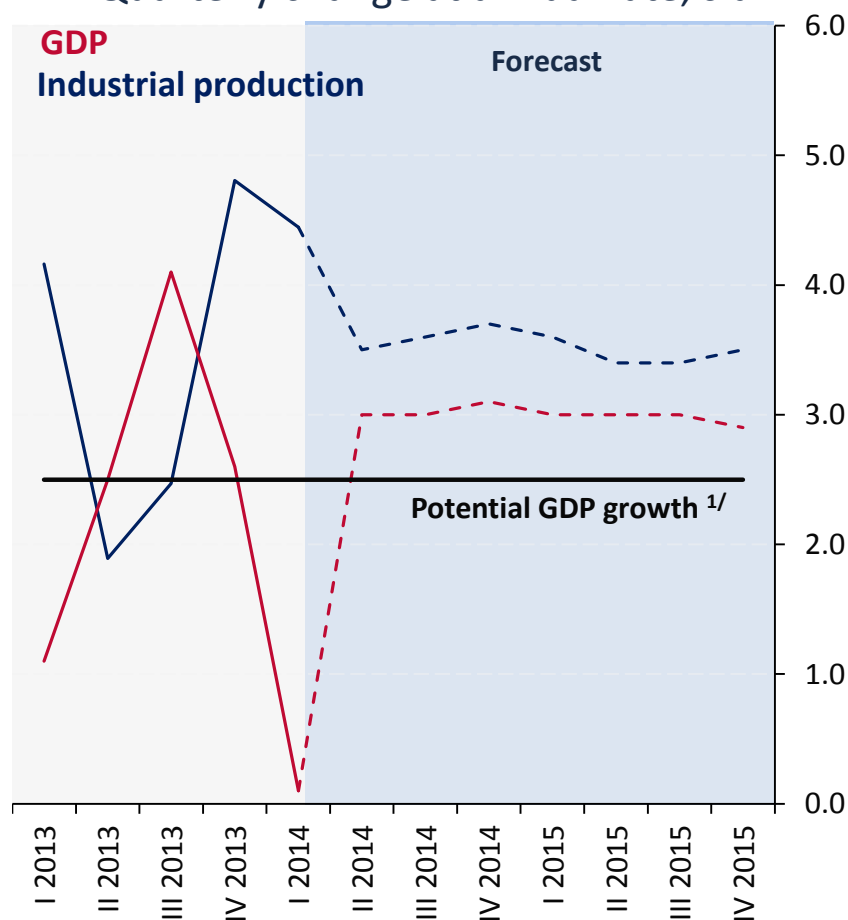
Selected Economies: GDP Growth
%

Source: World Economic Outllok, April 2014, IMF.

US: Real Gross Domestic Product and Industrial Production
### Quarterly change at annual rate, s.a.

1/ Consensus Forecasts Long Term GDP growth. s.a./ Seasonally adjusted.
Source: BEA, Consensus Forecasts, Federal Reserve and Blue Chip.

Expected and actual reduction of monetary stimulus in the US have affected emerging market economies in general. However, markets have differentiated, as evidenced by the evolution of exchange rates and CDS.
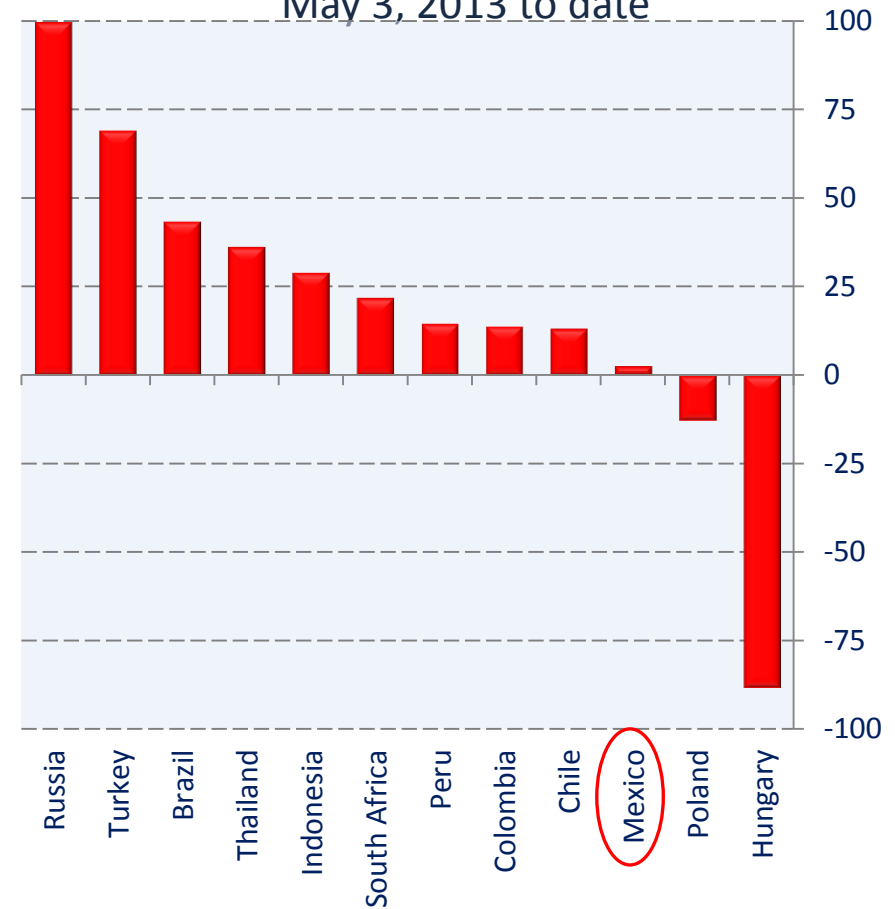
Nominal Exchange Rate
Percent change from May 3, 2013 to date
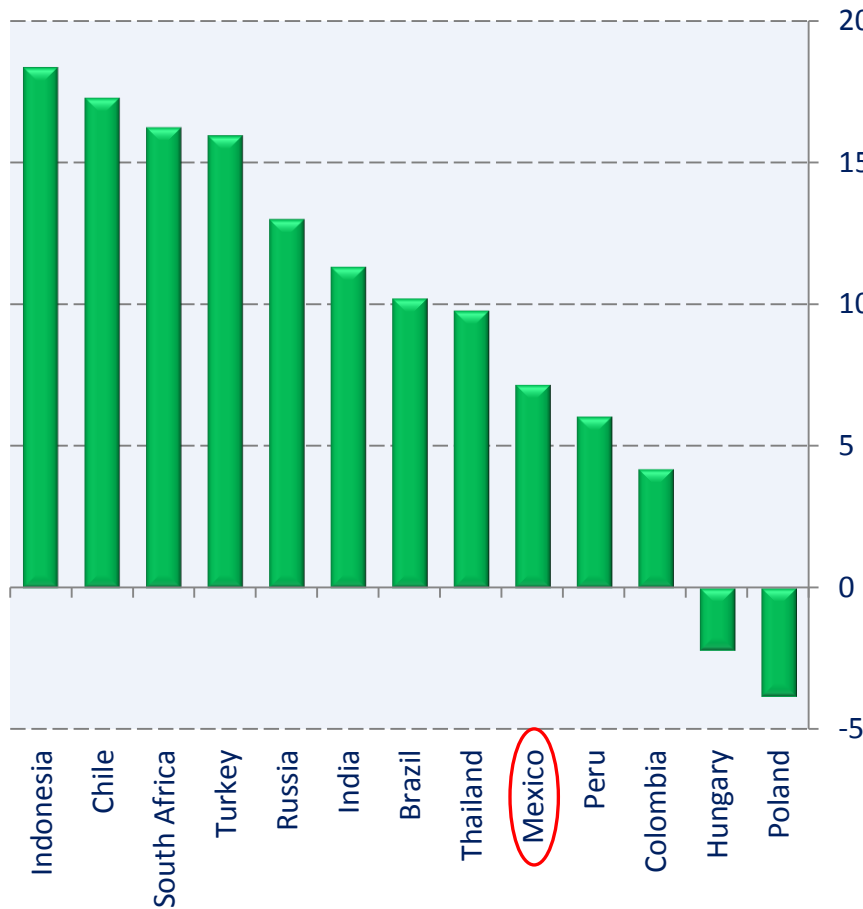
Credit Default Swaps [1]
Change in basis points from May 3, 2013 to date
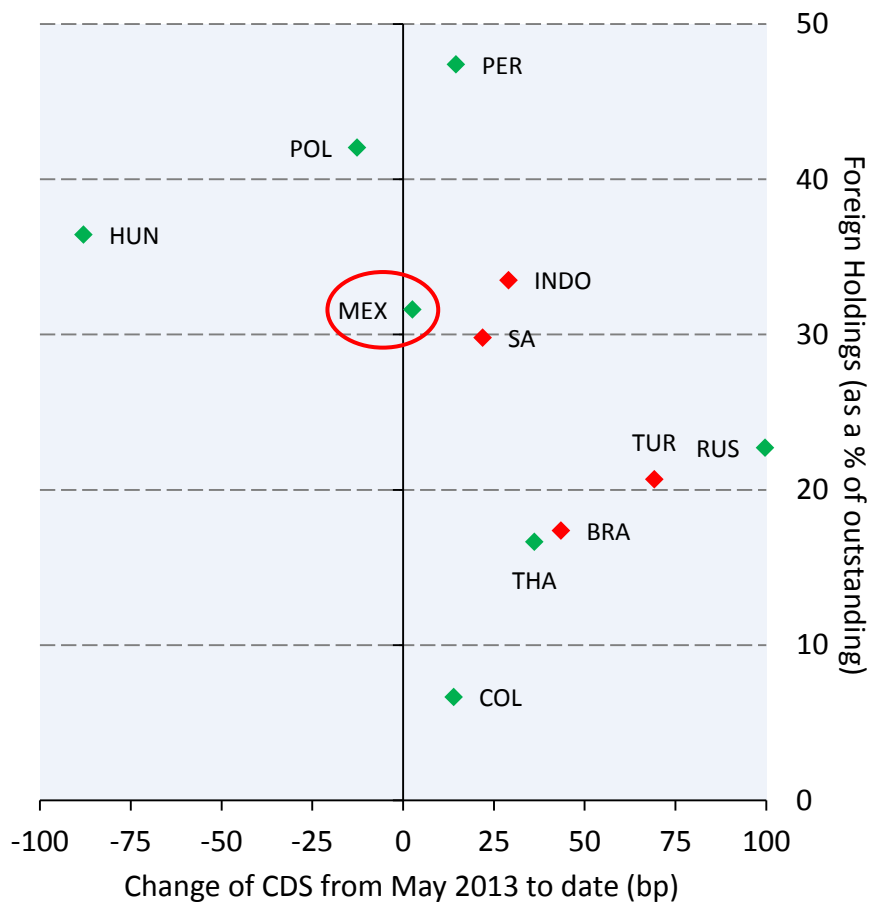

Source: Bloomberg.

1/ 5-year CDS.
Source: Bloomberg.

Economic fundamentals, rather than considerations such as the degree of foreign holdings of domestic bonds, have been the main determinants of differentiation.

Credit Default Swaps and Foreign Sector Holdings of Local Government Debt [1]

Foreign Holdings (as a % of outstanding)

Change of CDS from May 2013 to date (bp)

Current Account and Inflation at the End of 2013 [2]

Inflation Rate in December 2013 (%)

Current Account for 2013 (% of GDP)

1/ Change of 5-year CDS.
Source: Bloomberg, ministries of finance, central banks and other national authorities.
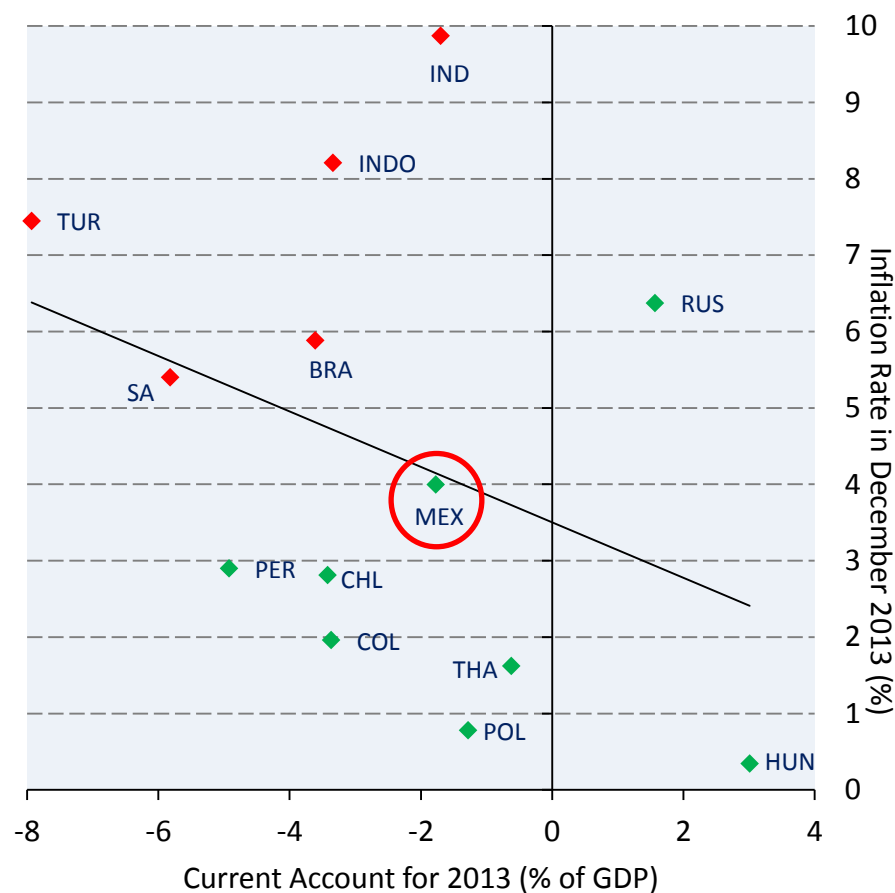
2/ Current account refer to data for 2013, except for Thailand and Turkey, which refer to the average from 4Q 2012 to 3Q-2013.
Source: Haver Analytics.

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2 | **Short-term Challenges for Economic Growth and Inflation**
   a. **The External Environment**
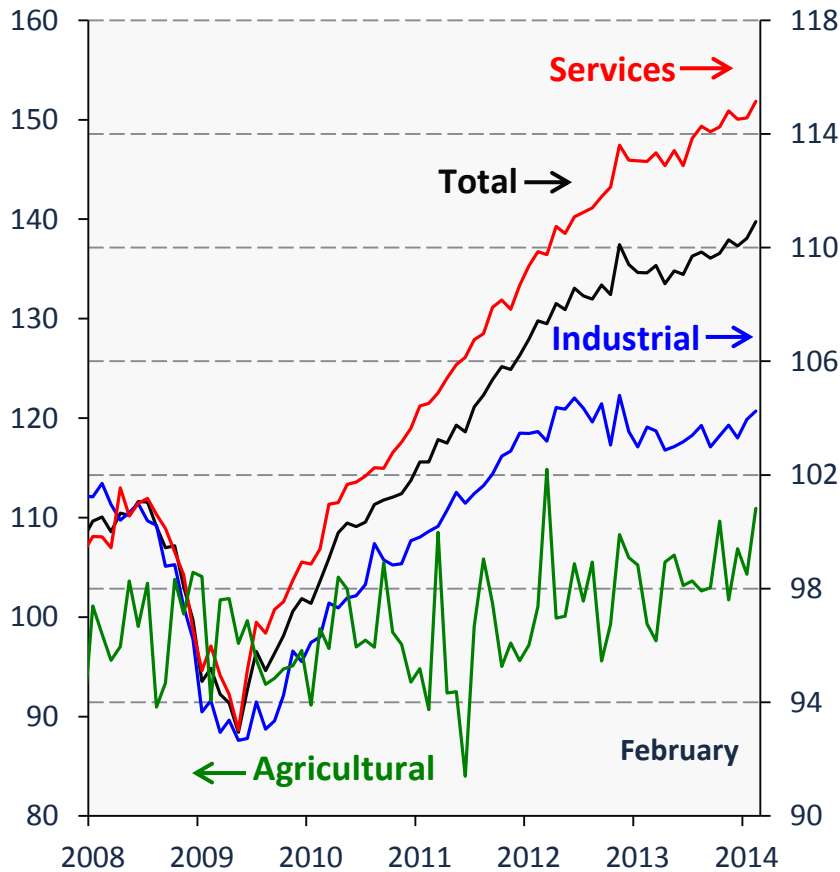   b. **Domestic Activity and Prices**

3 | The Long Term

Economic activity decelerated in 2013 and has remained weak in the first months of this year.

Global Economic Activity Indicator (IGAE)
Index 2008 = 100, s.a.

Services →
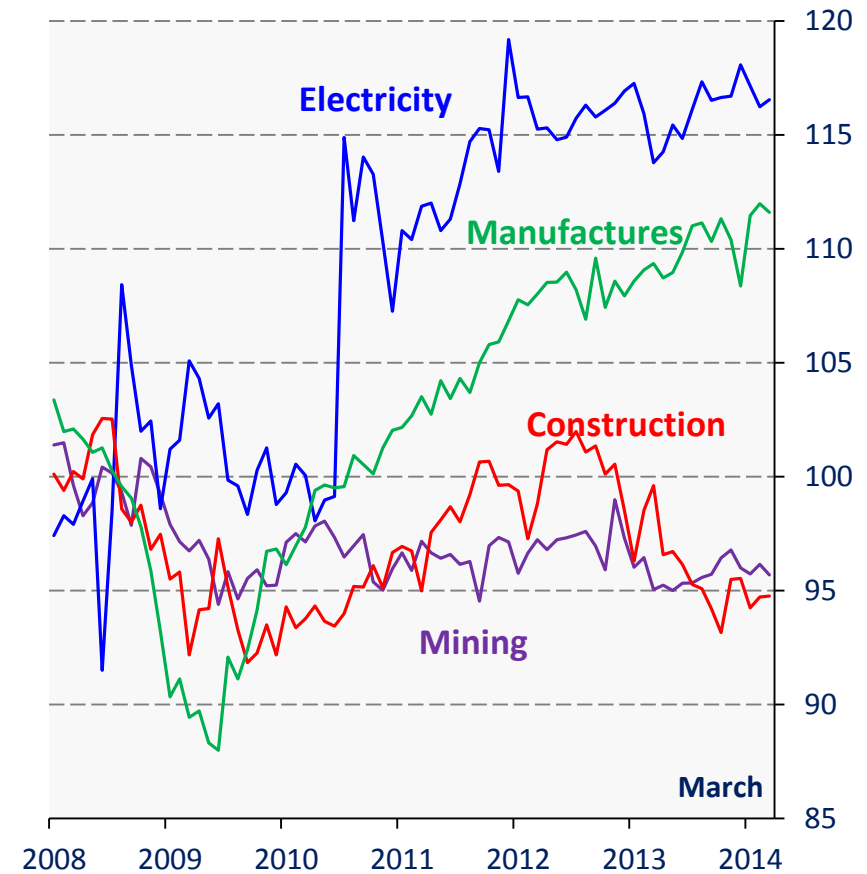
Total →

Industrial →

← Agricultural

February

s.a./ Seasonally adjusted data.
Source: Mexico's System of National Accounts (*Sistema de Cuentas Nacionales*), INEGI.

Industrial Activity
Index 2008 = 100, s.a.

Electricity

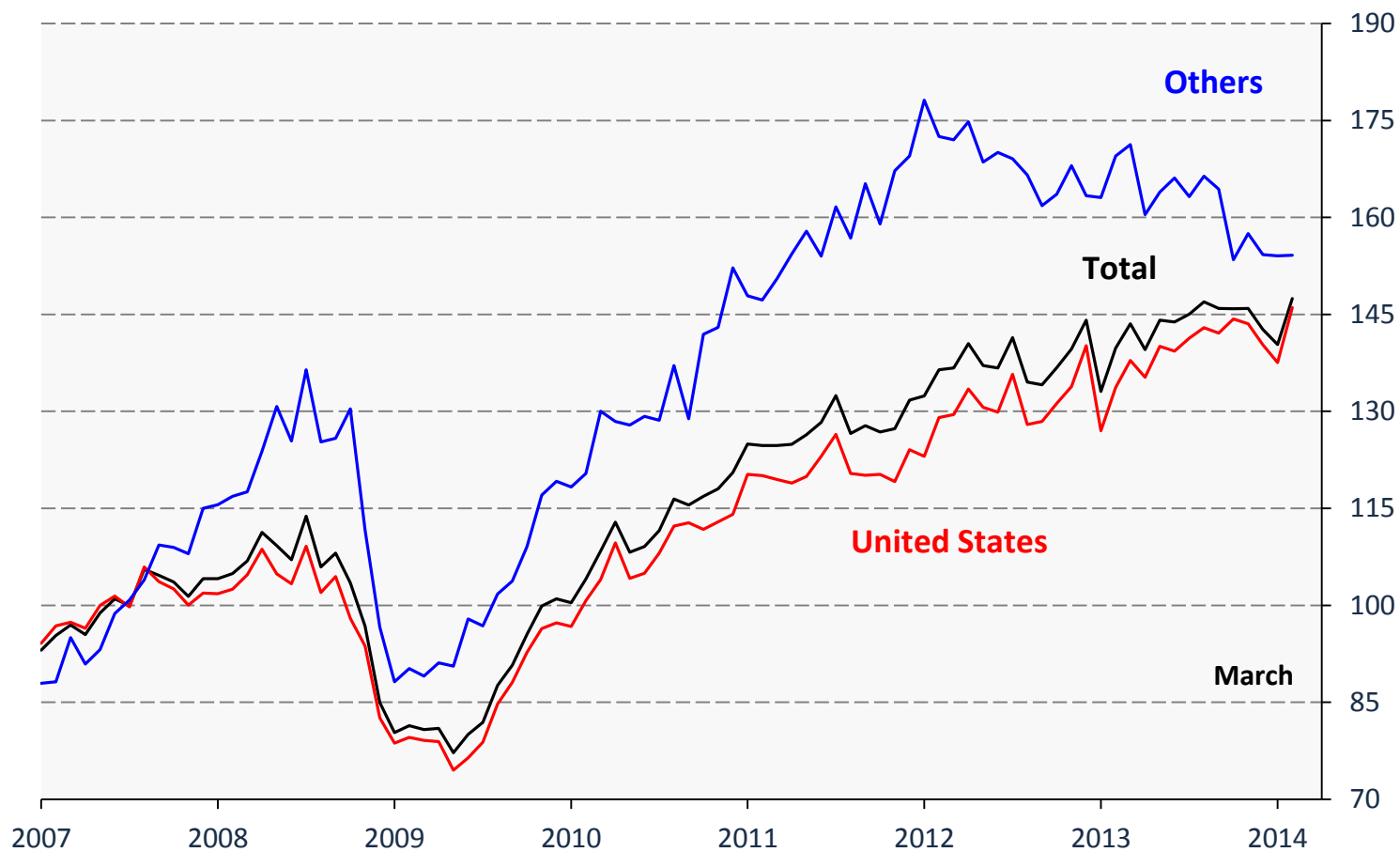Manufactures

Construction

Mining

March

s.a./ Seasonally adjusted data.
Source: Mexico's System of National Accounts (*Sistema de Cuentas Nacionales*), INEGI.

However, exports have begun to recover…

Manufacturing Exports by Region of Destination
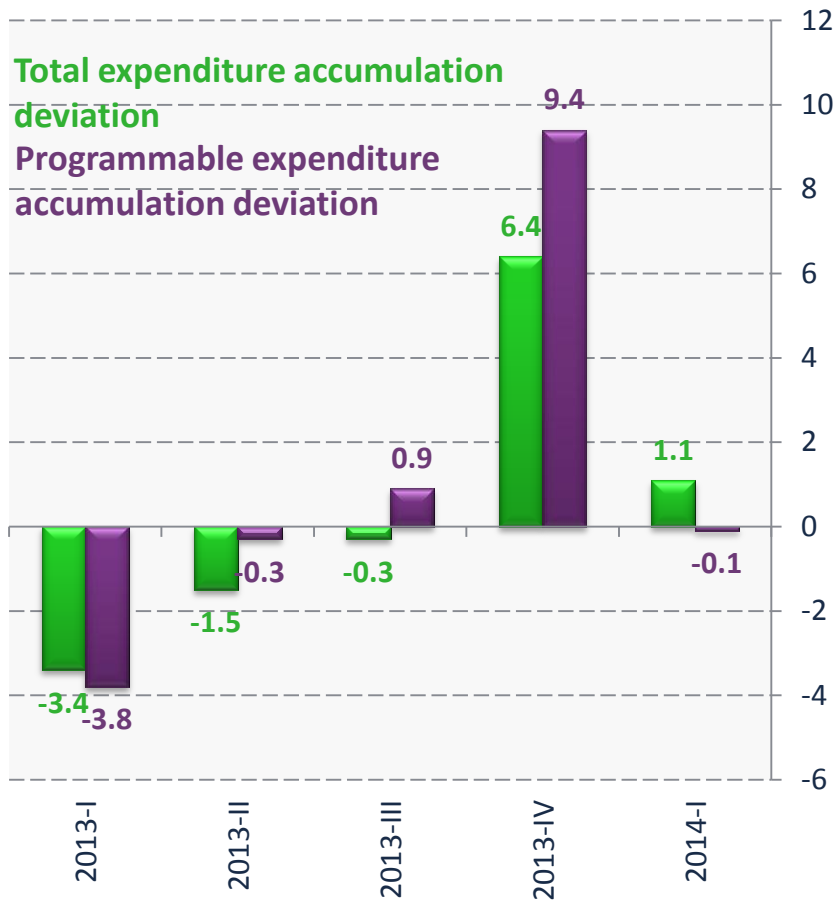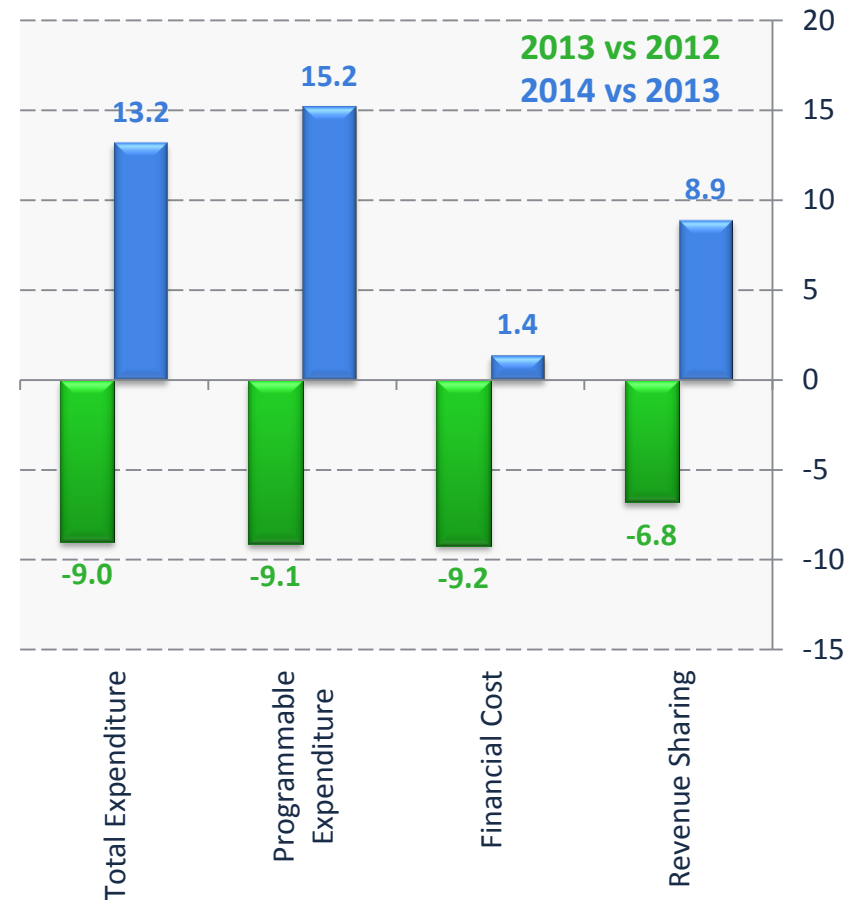### Index 2007=100, s.a.

s.a./ Seasonally adjusted data.
Source: Banco de México.

...and public expenditures have increased sharply.

Observed and Approved Public Expenditure [1]
Quarterly accumulated deviation, percentage

Total expenditure accumulation deviation

Programmable expenditure accumulation deviation

Values: -3.4, -3.8 (2013-I); -1.5, -0.3 (2013-II); -0.3, 0.9 (2013-III); 6.4, 9.4 (2013-IV); 1.1, -0.1 (2014-I)

Observed Public Expenditure [1]
Annual real growth in Q1, percentage

2013 vs 2012
2014 vs 2013

Total Expenditure: -9.0, 13.2
Programmable Expenditure: -9.1, 15.2
Financial Cost: -9.2, 1.4
Revenue Sharing: -6.8, 8.9

1/ The figures include revisions made by the Ministry of Finance for 2013 expenditure in the Public Finance Report of the first quarter of 2014.
Source: Ministry of Finance

Although the recovery of private consumption and investment has lagged, some early signs of a revival of these variables have emerged and the conditions are set for an upturn of economic activity.

- Expansionary fiscal policy.

- Substantial monetary stimulus.

- Significant strengthening of the U.S. economy expected for the rest of the year.

- Positive effect of the above factors on consumption and investment would be reinforced by confidence boost from approval of adequate secondary legislation for pending structural reforms.

Still, a negative output gap is expected to prevail during the rest of this year and the next.

Output Gap
% of potential output, s.a.
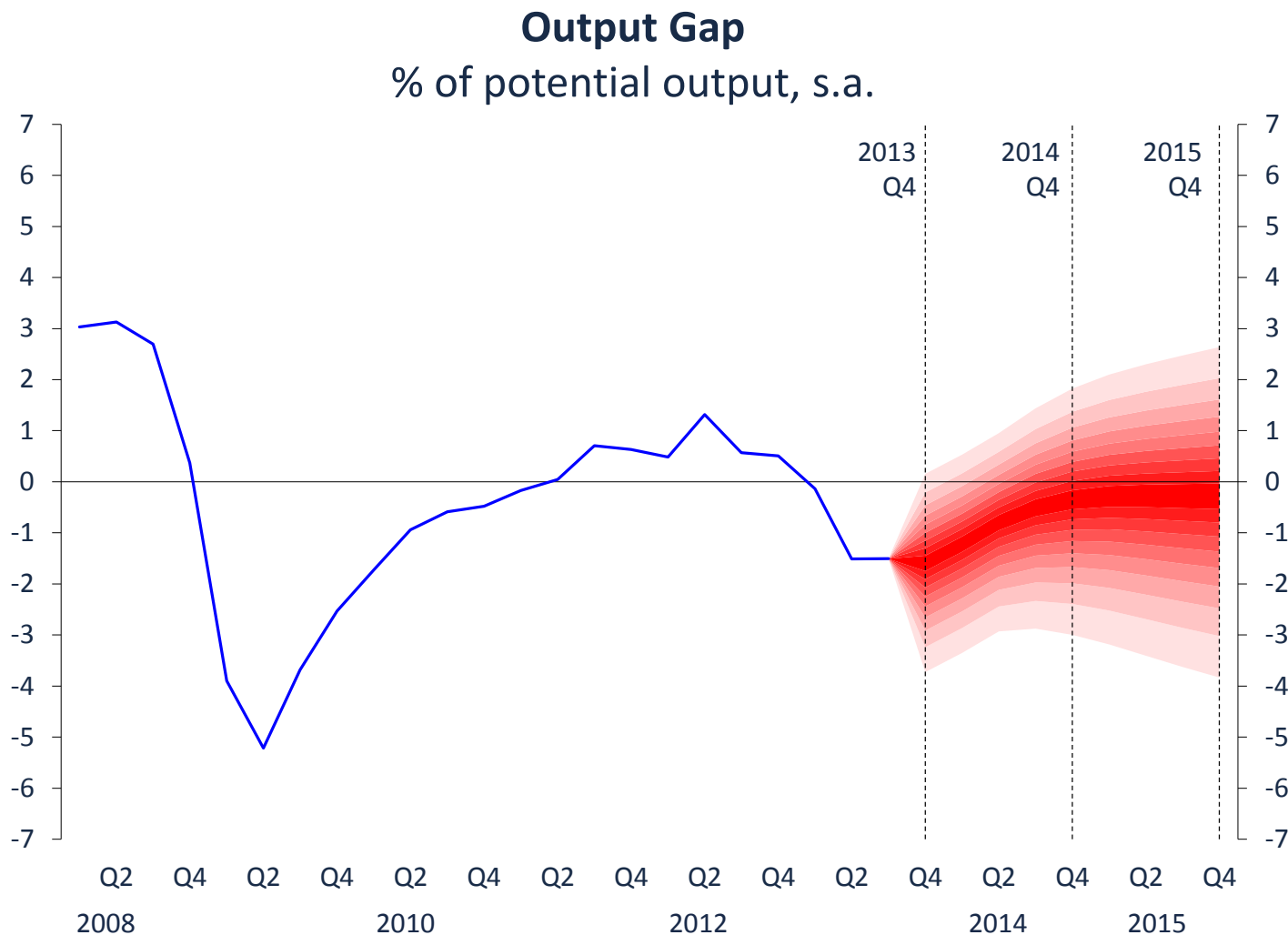
s.a./ Seasonally adjusted data.
Source: Banco de México.

As expected, the impact of recent supply shocks and fiscal reform on prices has been temporary...

Fortnight Inflation
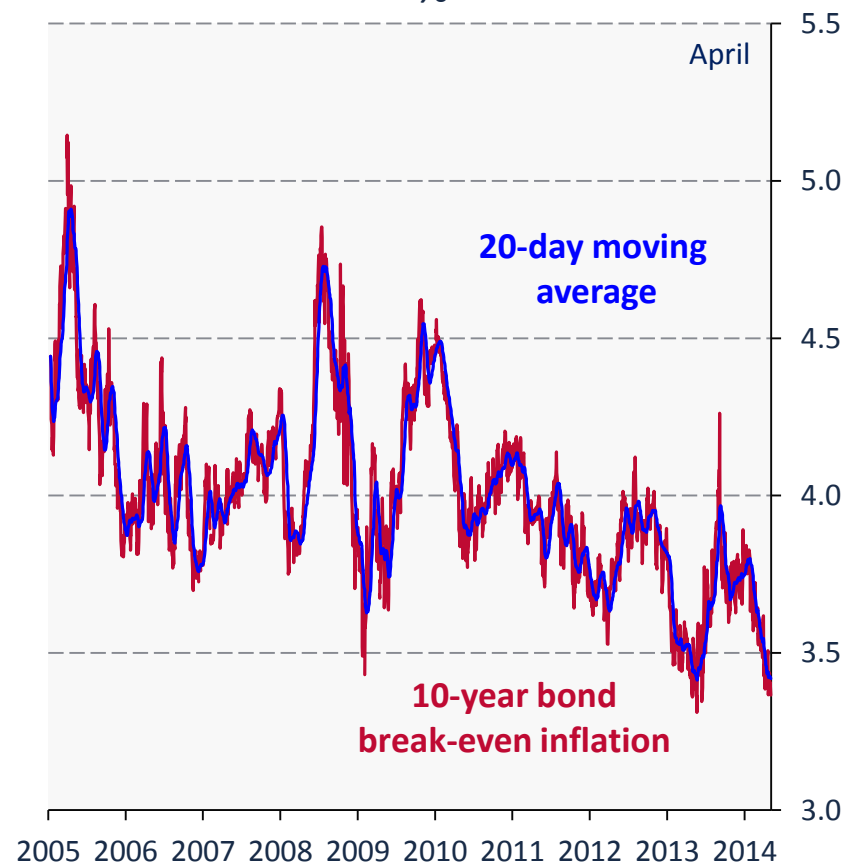Annual % change
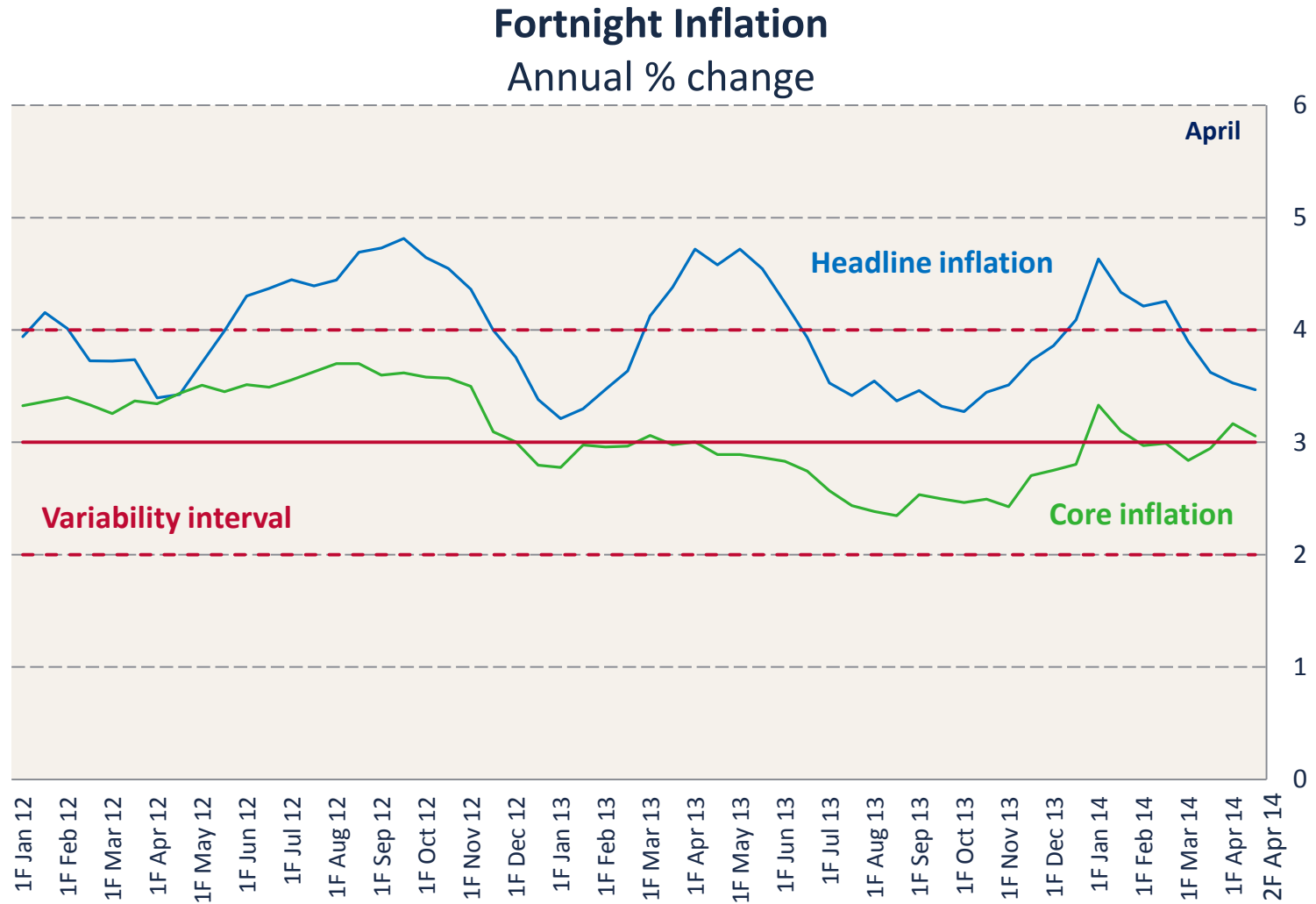
Source: INEGI.

…and no second round effects are observed, although inflation expectations remain above the target.

Annual Headline Inflation Expectations
Median, %

April

End of 2014

Next 4 years

Next 5-8 years

End of 2015

Variability interval

2010 2011 2012 2013 2014

Source: Banco de Mexico's Survey.

Break-even Inflation and Inflationary Risk [1/]
%

April

20-day moving average

10-year bond break-even inflation

2005 2006 2007 2008 2009 2010 2011 2012 2013 2014

1/ The break-even inflation and inflationary risk implicit in 10-year bonds is calculated based on nominal and real interest rates in the secondary market. Source: Banco de México estimate with data from Valmer.

- Banco de México´s Board is of the view that the current stance of monetary policy is consistent with the efficient (i.e. at the lowest possible cost in terms of economic activity) convergence of inflation to the 3 percent target.

- In particular, in the context of an announced adjustment of gasoline prices on the basis of expected inflation in 2015, inflation is projected to converge to levels close to the target during the year.

- However, the Board will continue to monitor closely all the variables that could affect inflation, as wells as medium- and long-term inflation expectations, and adjust the monetary policy stance as needed.

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Since 1980, a sharp reduction of inflation has been observed, accompanied by major structural progress in the fight against inflation.

Headline Inflation and Nominal Exchange Rate Depreciation: 1980-2013
Annual %

FX depreciation

Headline inflation
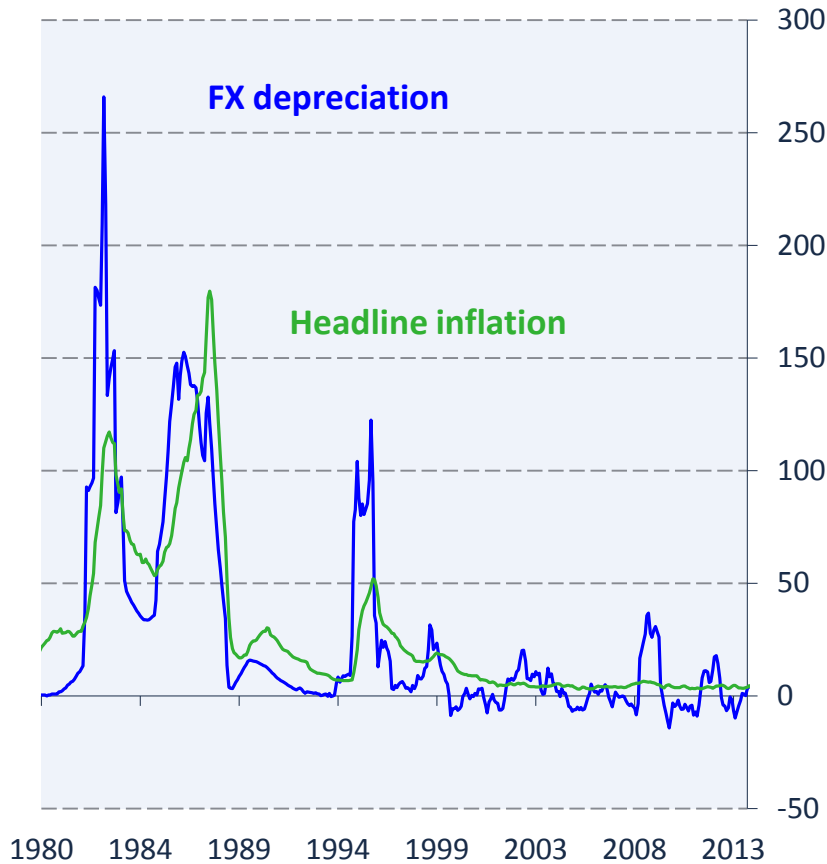
Source: Banco de México .

Rolling Window Regression between 4-year Inflation Expectations and Supply Shocks: 2005-2014
Coefficient Estimates and Confidence Intervals
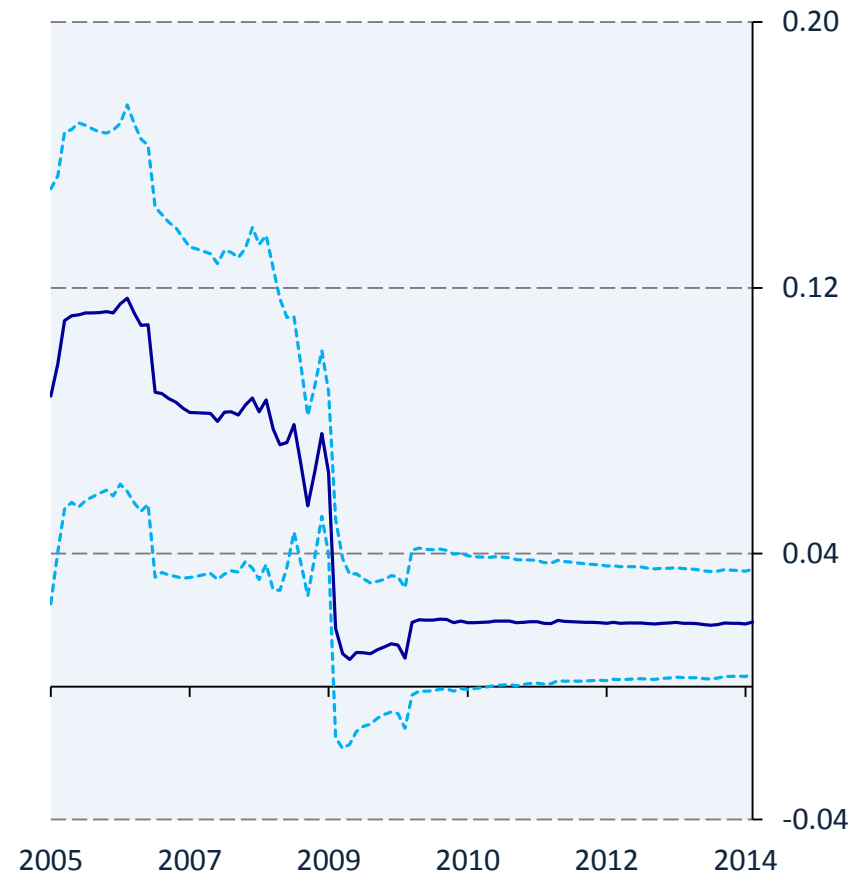
Source: Own estimations based on Box 3 "Anchorage of Medium- and Long-Term Inflation Expectations to Adverse Supply Shocks" in Banco de México's Quarterly Report on Inflation of January-March 2013 .

In addition, the rating of sovereign debt has improved, and the peso has become the most actively traded currency among emerging market economies.

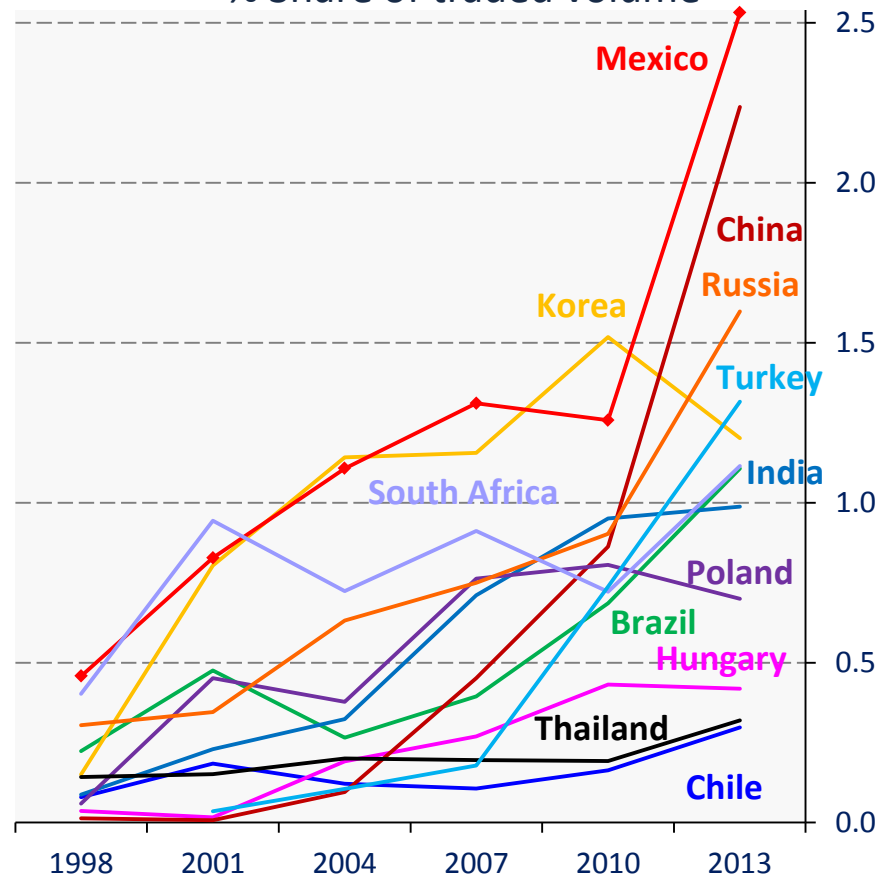## Mexico's Sovereign Rating Evolution
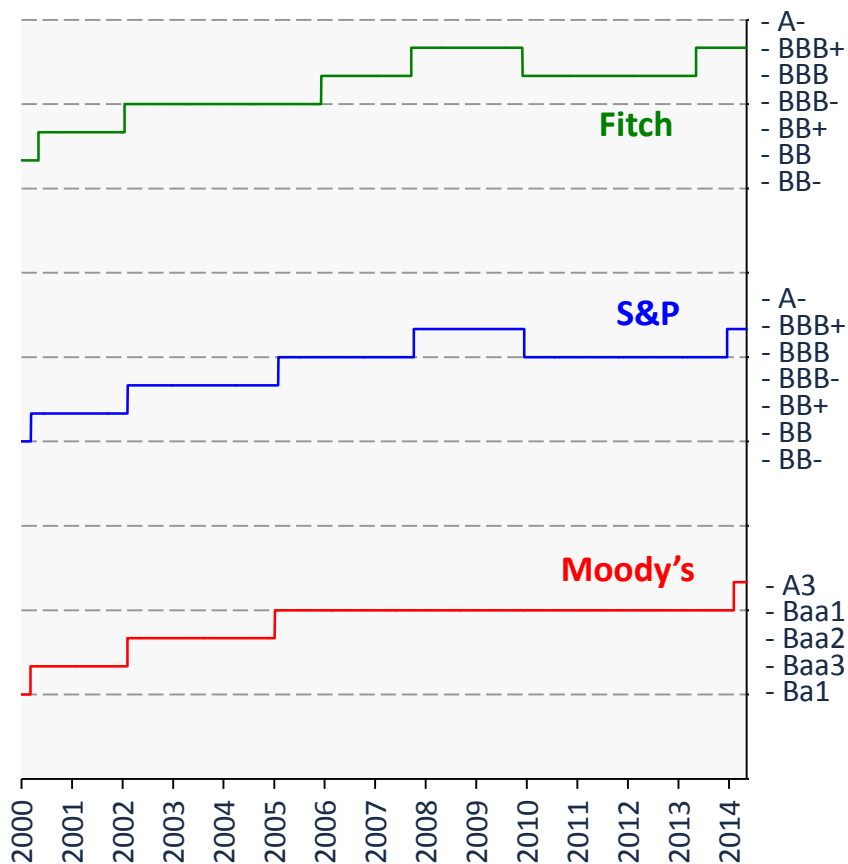
Source: S&P, Fitch Ratings and Moody's.

Traded Volume in the Global Foreign Exchange Market [2/]

% Share of traded volume[3/]

2/ Because two currencies are involved in each transaction, the sum of the percentage shares of individual currencies totals 200% instead of 100%.
3/ Data correspond to April of each year.
Source: Triennial Central Bank Survey , BIS.

However, the rates of growth of GDP and GDP per capita have been too low…

Growth of GDP and GDP per Capita
Index 1980=100

GDP

**1981-2013 GDP
average annual growth: 2.5%**

GDP per capita

**1981-2013 GDP per capita
average annual growth: 0.7%**
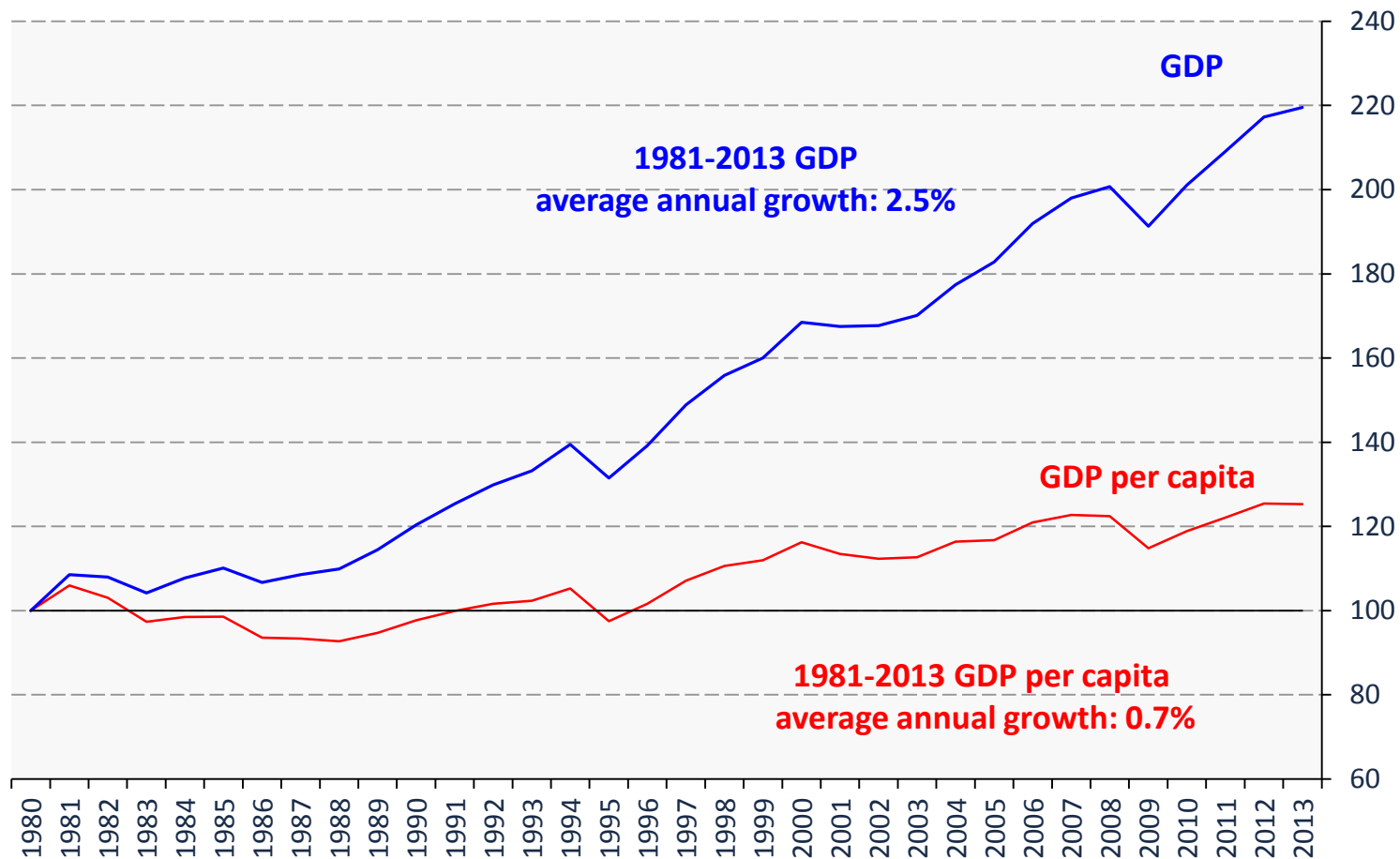
Source: World Economic Outlook, IMF.

...mostly as a result of a negative trend of total factor productivity.

Total Factor Productivity (TFP) and Factor Contribution to GDP Growth
Annual % change and percentage points

GDP growth
Capital contribution
Labor contribution
TFP
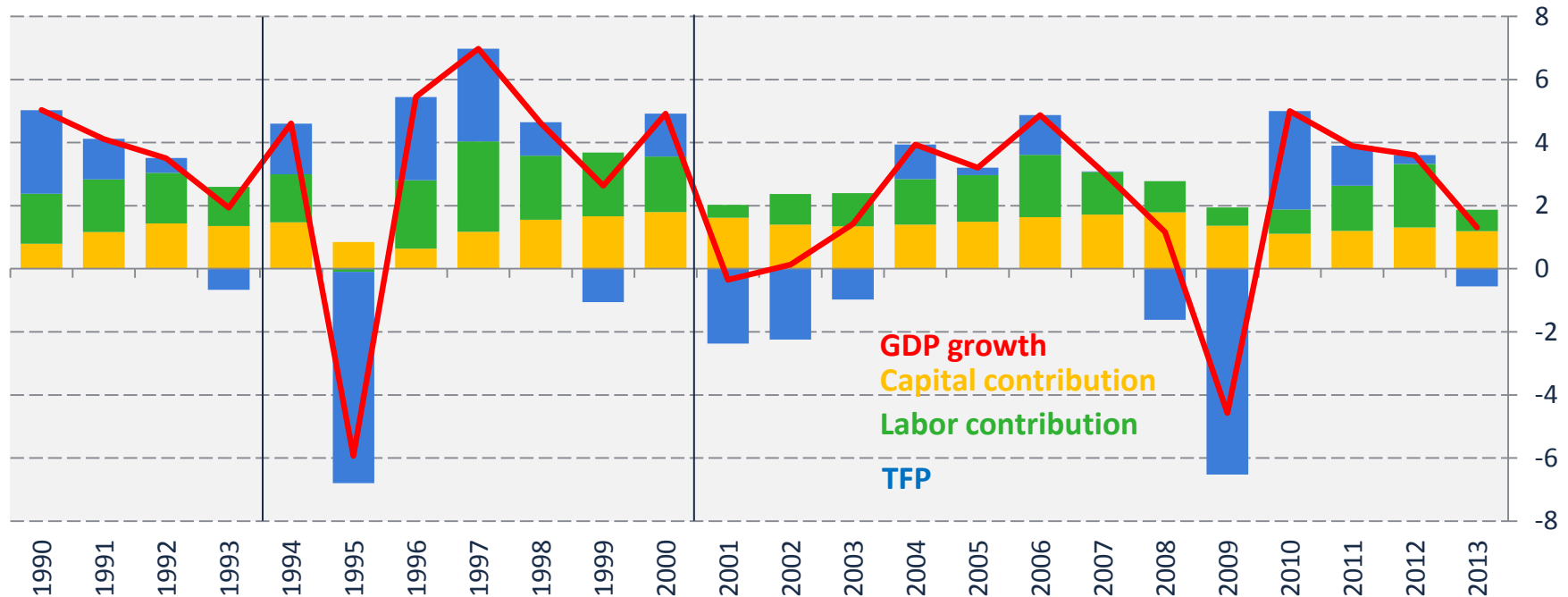
	GDP Growth	Capital (K)	Labor (L)	TFP
1991-1995	1.64	1.25	1.19	-0.80
1996-2000	4.92	1.37	2.17	1.39
2001-2006	2.20	1.48	1.22	-0.50
2007-2011	1.71	1.44	1.03	-0.75
2012-2013	2.46	1.25	1.35	-0.14

Source: Estimated by Banco de México with data from INEGI.

The Mexican economy has solid basis for macroeconomic and financial stability. However, this is a necessary but not a sufficient condition to increase the potential rate of growth.

Growth with Stability

Monetary policy Oriented at reaching the 3% inflation target

Low levels of public debt

Well capitalized **financial system**, with adequate regulation and supervision

Flexible exchange rate regime

External accounts at reduced and fully financeable levels

International reserves at all-time maximum

FCL with IMF $73 billion dollars

Therefore, a major effort has been launched to foster productivity.
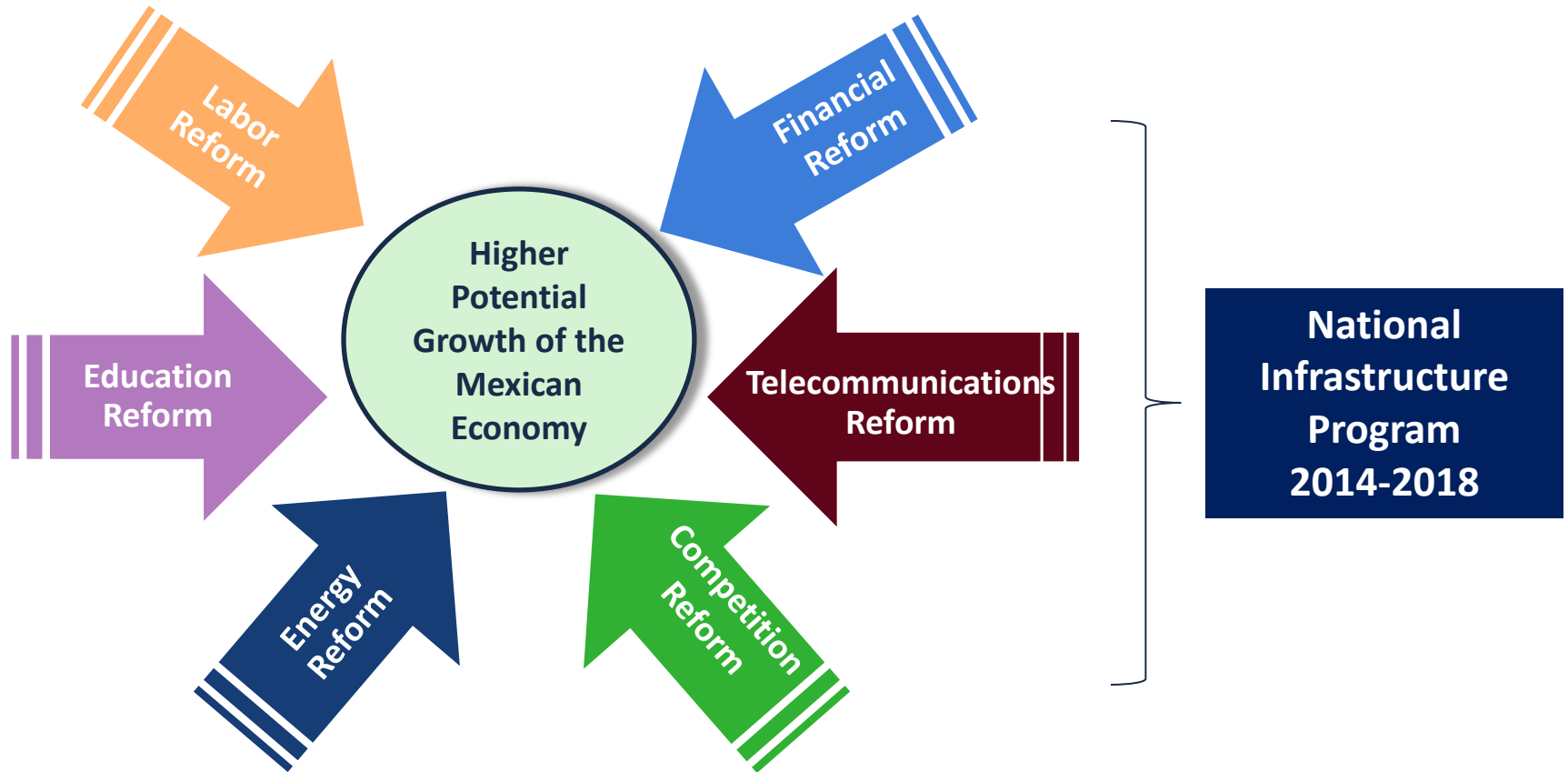
Structural Reforms	Constitutional Amendment	Secondary Legislation
Labor	No	Approved Nov-12*
Education	Yes	Approved Sep-13
Energy	Yes	Pending
Competition	Yes	Approved Apr-14
Telecommunications	Yes	Pending
Financial	No	Approved Nov-13*

*/ No secondary legislation required. The date refers to the one in which the reform was approved by the Congress.

Economic growth in the medium term should also be supported by multiple free trade agreements…

- Free trade agreements.
  - ✓ *Mexico has 12 free trade agreements that cover 45 countries, and has recently signed one with Panama (approval by Congress pending).*
  - ✓ *Tariff-free access to a potential market of more than a billion consumers and 60 percent of world GDP.*
- Furthermore, Mexico is in the process of negotiating deeper integration agreements with other Latin American countries (Pacific Alliance), and is participating in discussions under the Trans-Pacific Partnership Agreement, aimed at establishing a free trade area in the Asia-Pacific region.
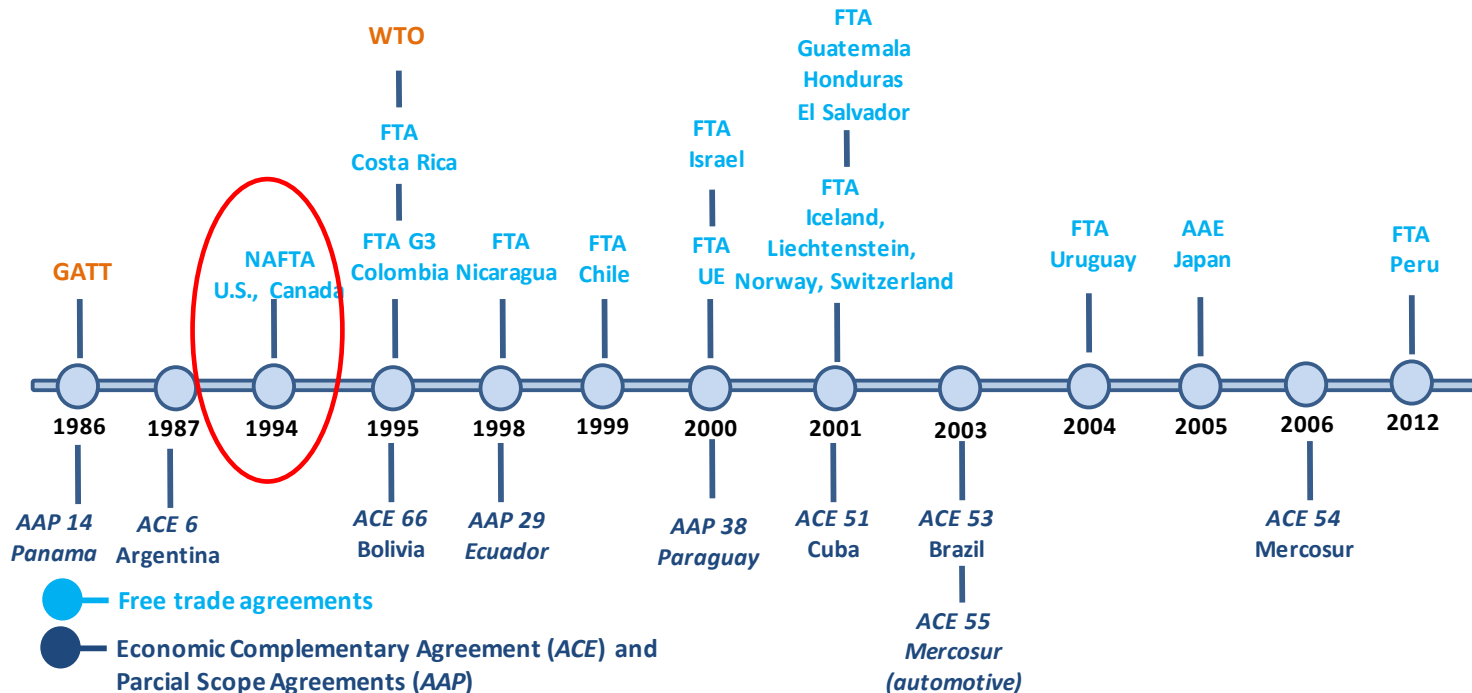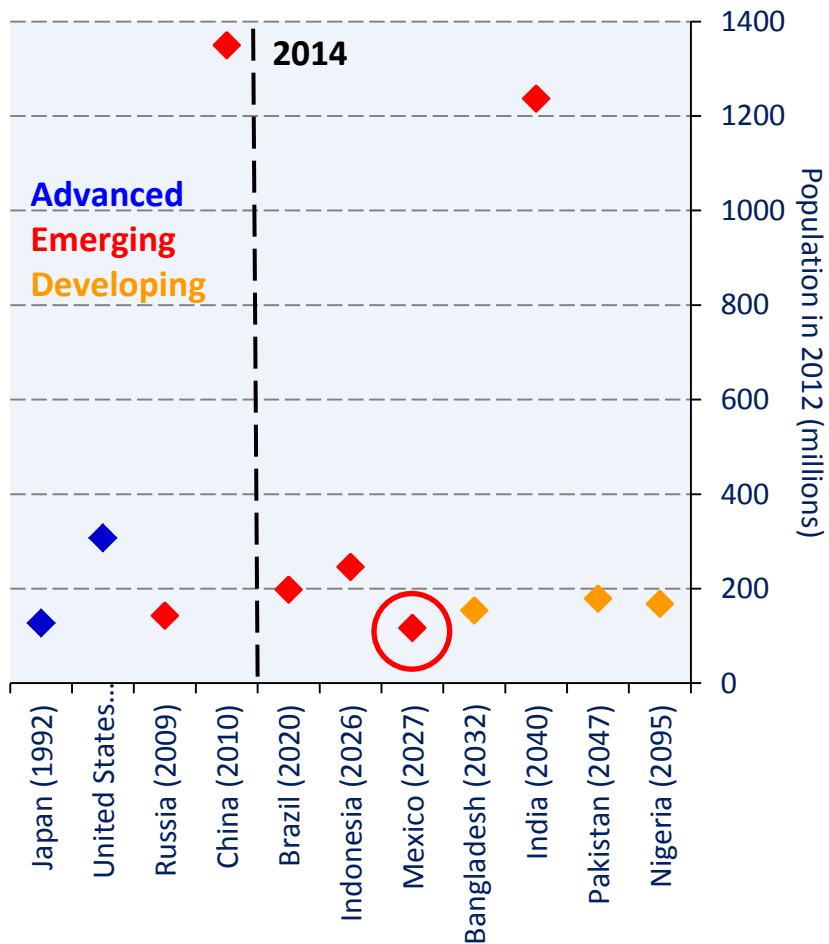

Source: ProMéxico.

…favorable demographics, and a relatively small middle class, which in the face of an increase in potential growth, could show a significant expansion in coming years.
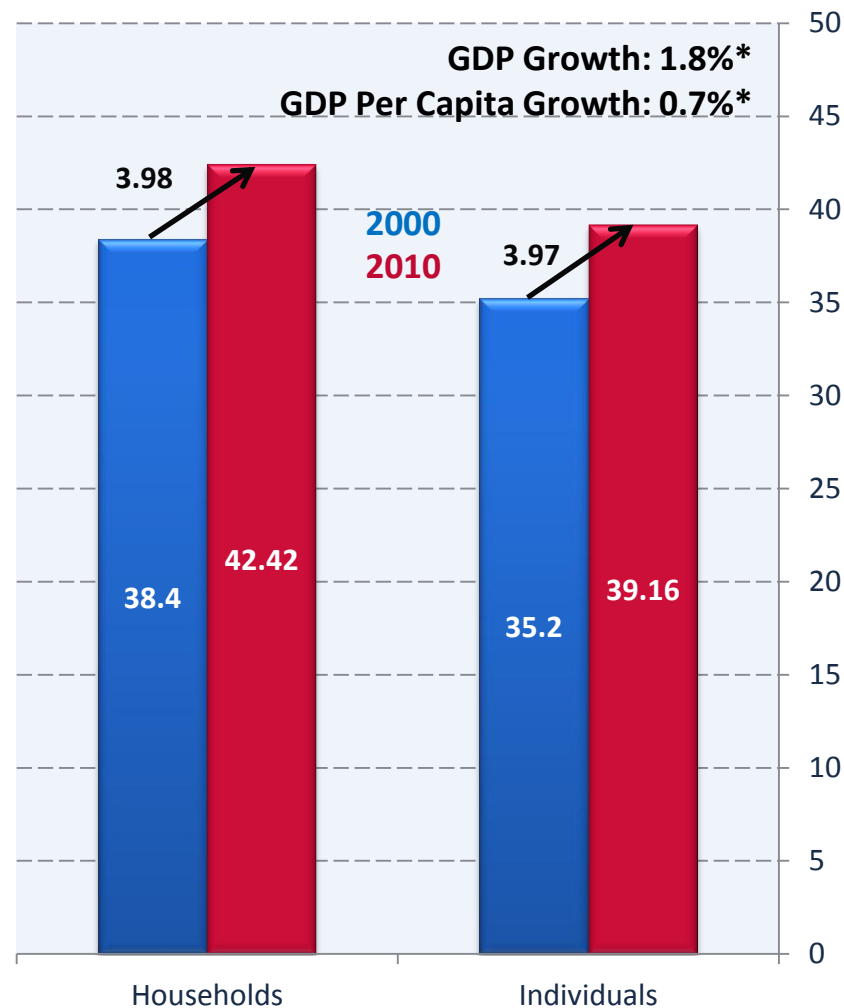
Demographic Dividend for the 11 Countries with the Highest Population

Year of Lowest Dependency Rates, Population

2014

Advanced
Emerging
Developing

Population in 2012 (millions)

Japan (1992)
United States...
Russia (2009)
China (2010)
Brazil (2020)
Indonesia (2026)
Mexico (2027)
Bangladesh (2032)
India (2040)
Pakistan (2047)
Nigeria (2095)

Source: Own Calculations with data from UN, WB and CONAPO.

Middle Class Households, 2000-2010

GDP Growth: 1.8%*
GDP Per Capita Growth: 0.7%*

3.98

2000
2010

3.97

42.42

38.4

35.2

39.16

Households

Individuals

Source: INEGI.
*/ For the period 2000-2010.

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- Notwithstanding the important progress made thus far, we must not lose sight of risks. In particular:

  - ✓ *The normalization of monetary policy in advanced economies is going to take several years, and the possibility of additional episodes of turbulence in international financial markets is high.*

  - ✓ *The rate of world economic growth may be affected by these or other shocks.*

  - ✓ *It is also essential to ensure that pending secondary legislation provides an adequate support to the constitutional amendments approved, and that structural reforms are efficiently implemented.*

- *The strengthening of economic fundamentals takes on added relevance given the higher sensitivity of international capital flows to adverse news in the current context and the degree of openness of the Mexican economy. Thus, it will be important to:*

  - ✓ *Timely adjust macroeconomic and financial stability policies as required in the face of changing circumstances.*

  - ✓ *Tackle other structural obstacles that may have a significant impact on potential growth.*

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