

The Mexican Economy: Tackling the problems

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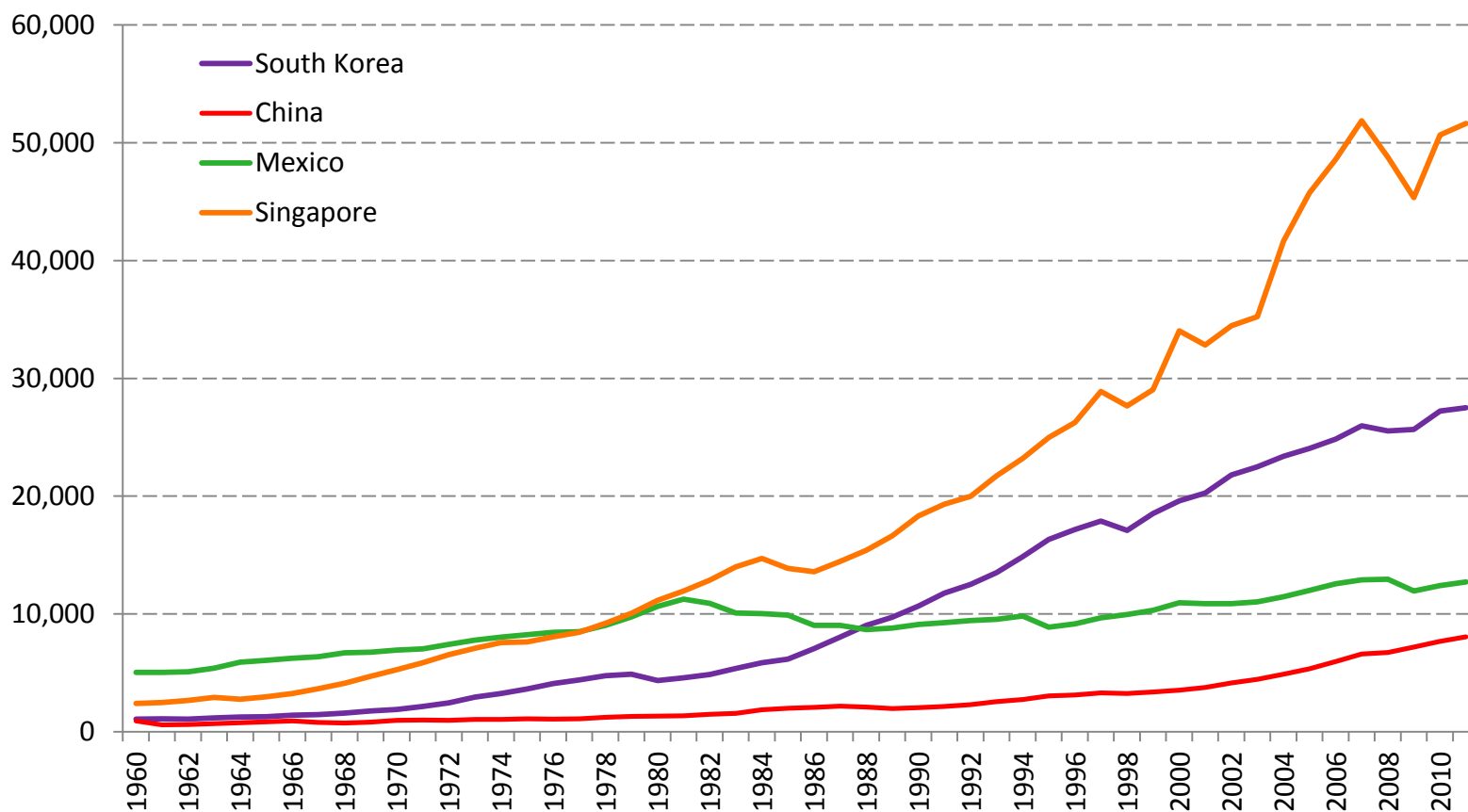
1 The problem of long-term growth

2 Two short-term challenges

3 The economic outlook

Despite the modernization of the last few decades, Mexico's long-term economic performance has been less than stellar

GDP per capita at chained PPPs¹
2005 U.S. dollars



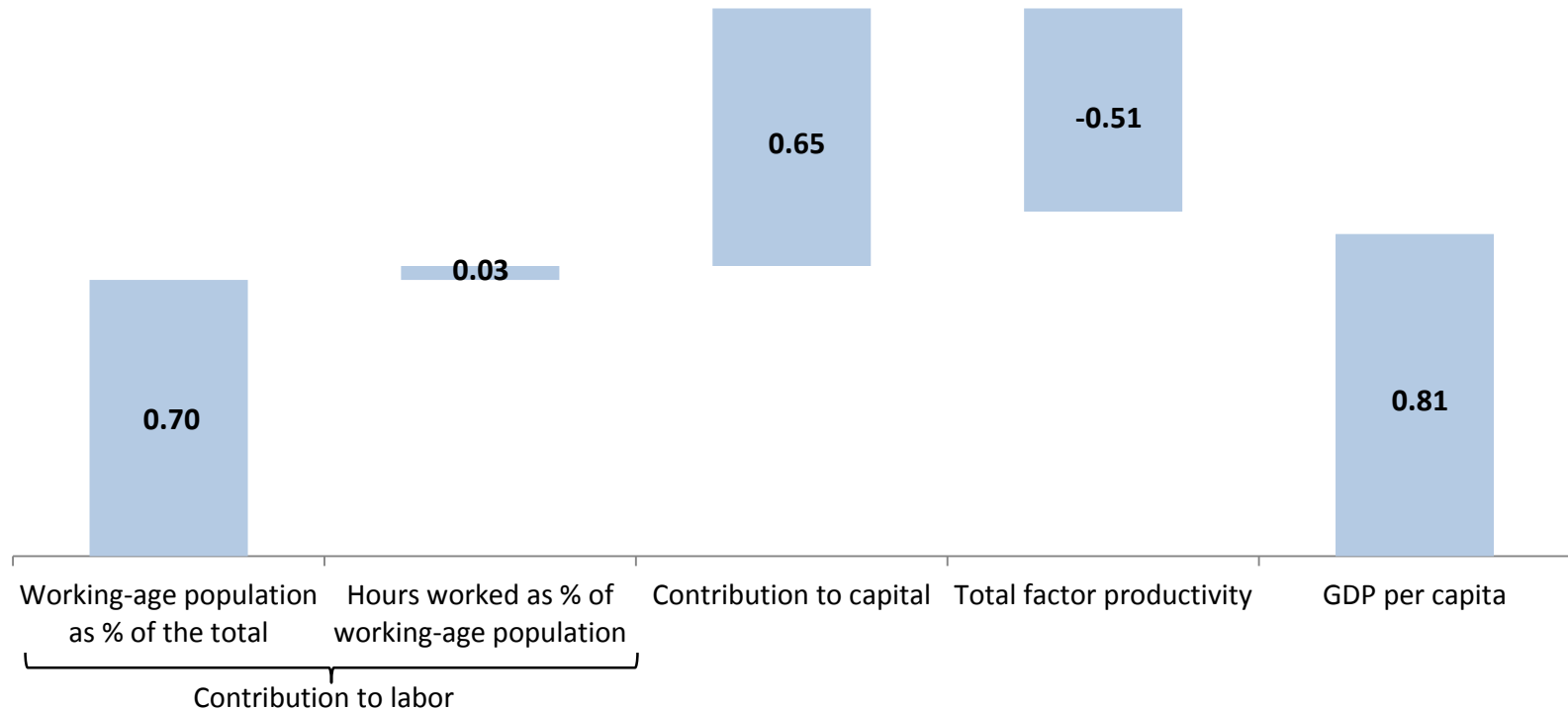
1/ GDP per capita at current dollars in 2014 was US\$10,837

Source: Penn World Table 8.0

The key problem is stagnant total factor productivity

Mexico: Growth accounting from 1981 to 2013^{1,2}

Annual average % change



1/ Own calculations with data from the World Development Indicators, International Financial Statistics, Conference Board Total Economy Database and data and theory from Kehoe, T.J. and F. Meza, (2011), "Catch-up Growth Followed by Stagnation: Mexico, 1950-2010," *Latin American Journal of Economics*, 48(2)

2/ Sums might not be equivalent to totals due to rounding

Mexico has undertaken an ample reform agenda in the aim of tackling this problem

- Reforms encompass many sectors, including
 - ✓ Labor
 - ✓ Education
 - ✓ Financial system
 - ✓ Telecommunications
 - ✓ Energy
- The general objective is to promote greater market flexibility, investment in both human and physical capital, and competition

The telecoms reform seeks to widen access to services at lower prices

- FDI caps have been lowered, operators can now offer a broad basket of services, and two new national digital TV networks are in the works
- Customer mobility is facilitated across telecoms operators
- A price restriction is imposed on all telephony operators in the elimination of national long distance fees
- An asymmetric regime applies to dominant telecoms and broadcasting players in order to level the playing field
- The reform has yielded benefits, with an already declining trend in relative telecoms prices deeper, and greater variety in packages offered

The energy reform allows private participation in virtually all aspects of the sector

- Contracts to govern upstream oil and gas activities, and permits to be granted for middle and downstream undertakings
- Permits conceded to generate, sell and import electricity
- Recent progress:
 - ✓ Two auctions announced for oil exploration and extraction
 - ✓ Two contracts awarded to deliver gas in private pipelines
 - ✓ The first permit granted to import electricity connected to the National Electric System
- Investment, production efficiency and lower domestic energy prices are expected

Deep-seated results from the reforms require fundamental conditions

- Good-quality implementation in the sense of actually producing greater market flexibility, investment and effective competition
- Complementary policies
 - ✓ A strengthened rule of law
 - ✓ Further investments made in physical infrastructure
 - ✓ Enhanced public security

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1 The problem of long-term growth

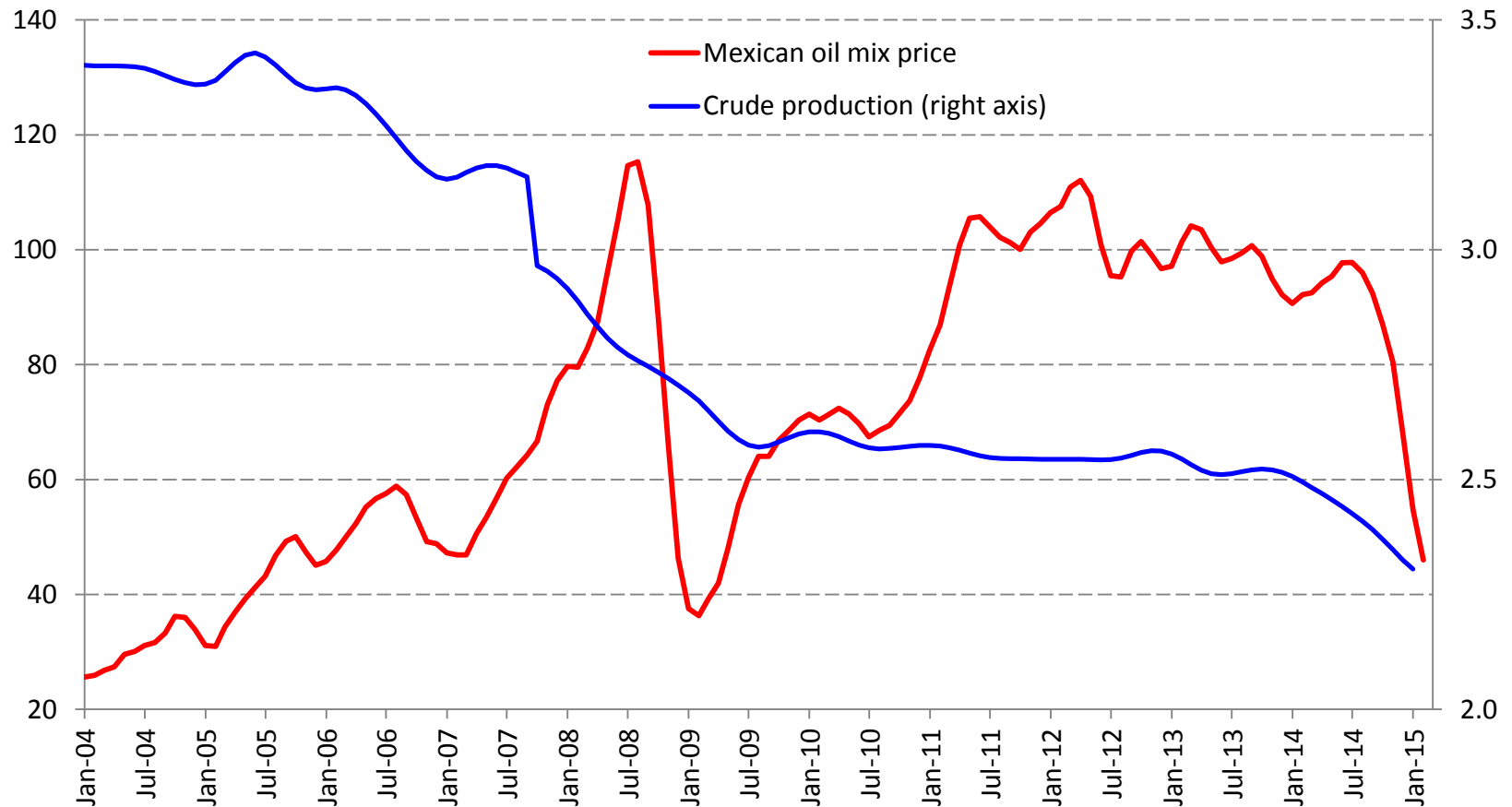
2 Two short-term challenges

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The first challenge comes from lower oil prices and declining production

Mexico: Price for the Mexican oil mix and crude production

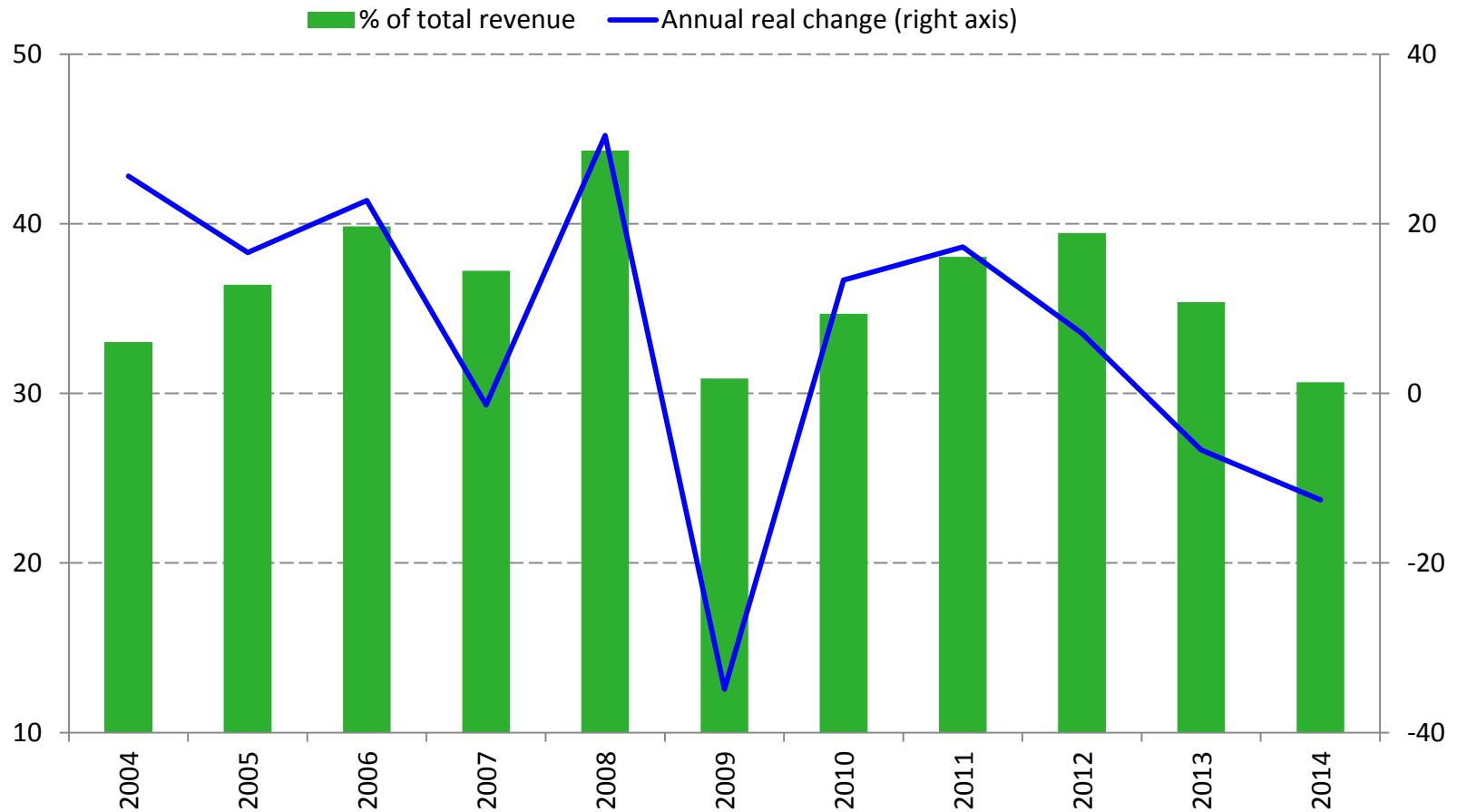
Dollars per barrel, 3-month moving average; millions of barrels on a daily basis, trend



Source: Bloomberg and INEGI

... which have weakened the public-sector financial position

Mexico: Oil-related public revenues



Source: Haver Analytics

The government has sent investors a sign of fiscal responsibility

- Proactive spending cuts announced amounting to 0.7 percent of GDP
- Austerity measures taken across government ministries and the state oil and electricity companies
- Some investment projects cancelled or postponed
- The above despite the fact 2015 budgeted oil revenue is almost fully hedged

Although still important for the government, oil accounts for a declining share of Mexico's total exports and output

Mexican oil indicators

	2004	2014	2015*
Mexican oil mix price <i>Dollars per barrel, daily average</i>	31.1	87.7	43.0
Oil production <i>Million of barrels per day, average</i>	3.4	2.4	2.3
Oil and gas extraction <i>% of GDP</i>	9.1	5.9	n.a.
Oil exports <i>% of total exports</i>	12.6	10.8	7.3
Oil trade balance <i>Millions of dollars</i>	12,434	1,489	-1,423

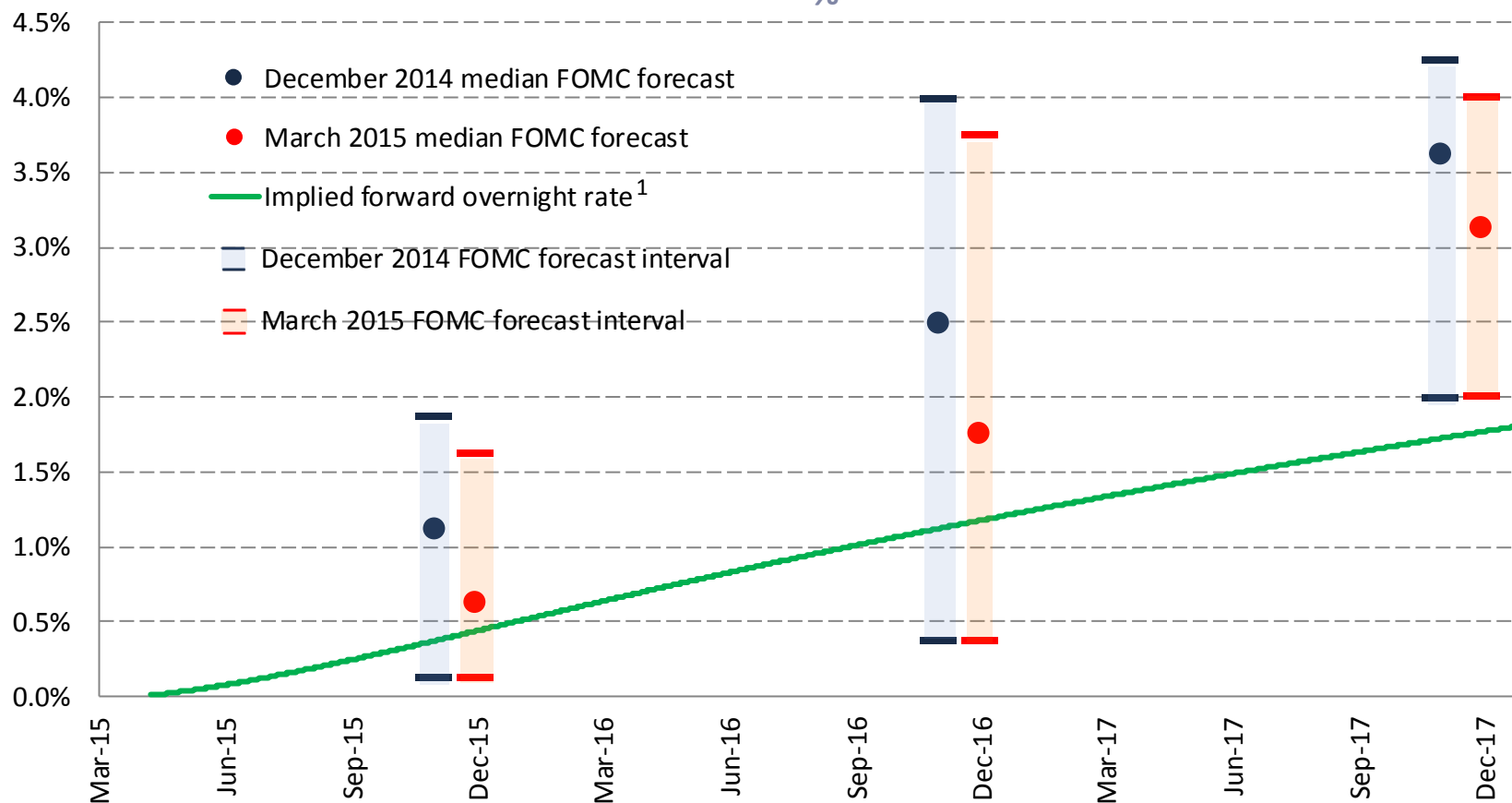
*/ January-February, except oil production, which is to January

Source: Banco de México, Haver Analytics and INEGI

The second challenge stems from future U.S. monetary normalization, the pace of which remains highly uncertain

Federal Reserve: Implied forward overnight rate and FOMC fed funds rate forecasts

%

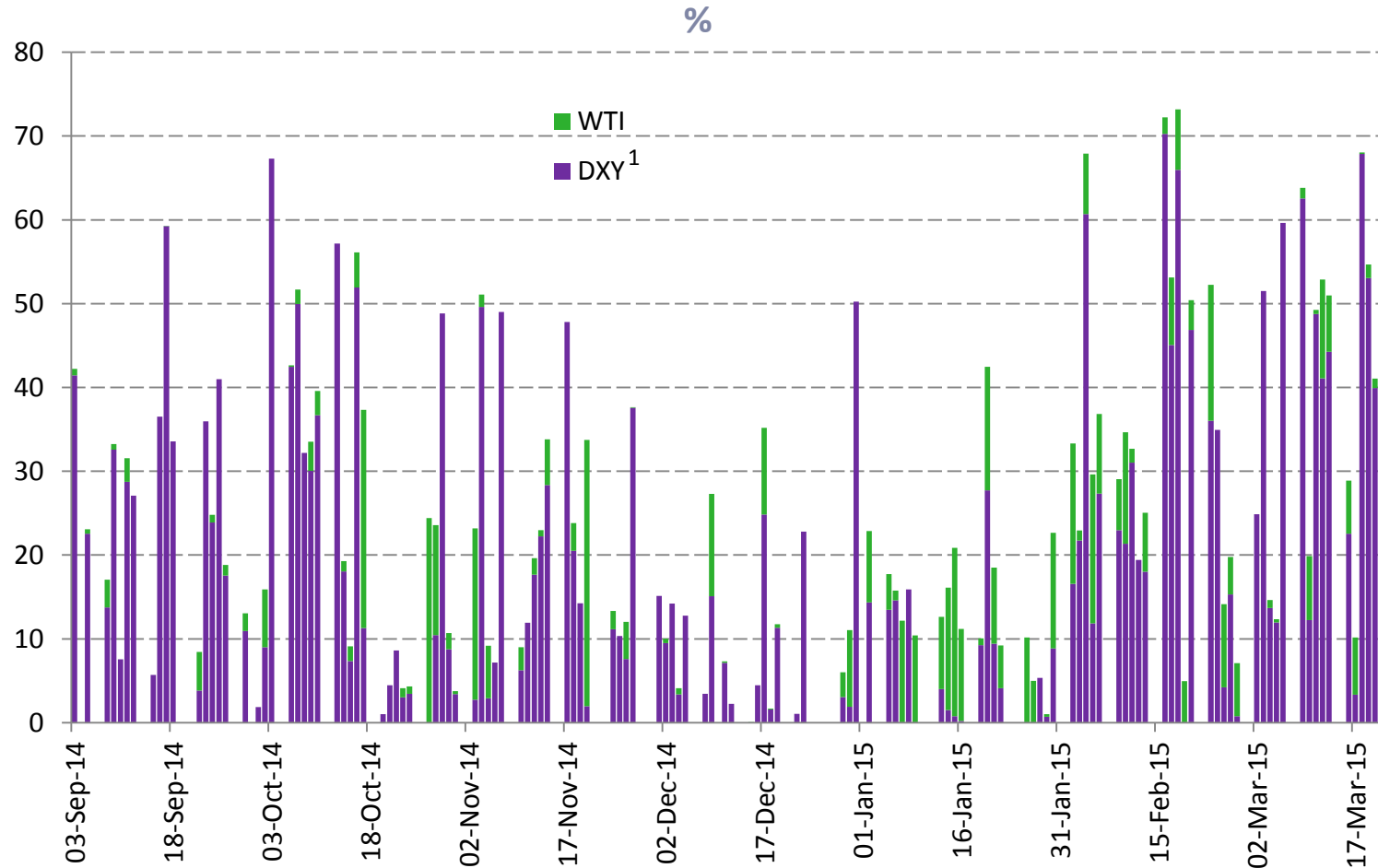


1/ As of March 20, 2015

Source: Bloomberg with calculations by Banco de México

The Mexican peso has been hit by international volatility mainly reflecting broad dollar strength

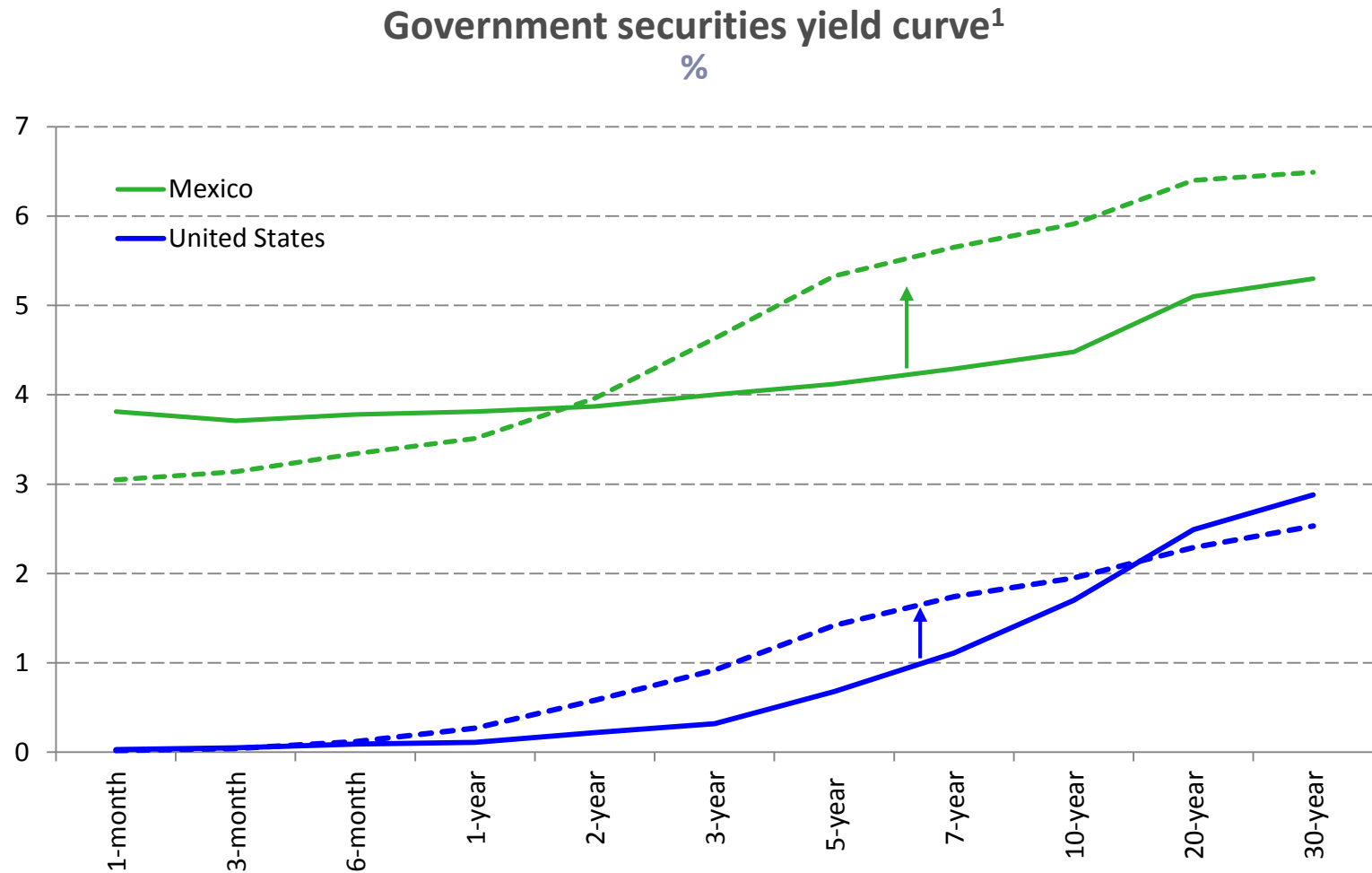
Mexico: Changes in MXN/USD rate explained by oil prices and the U.S. dollar



1/ The DXY is a weighted average of the dollar's value relative to the euro (57.6%), Japanese yen (13.6%), pound sterling (11.9%), Canadian dollar (9.1%), Swedish krona (4.2%), and Swiss franc (3.6%)

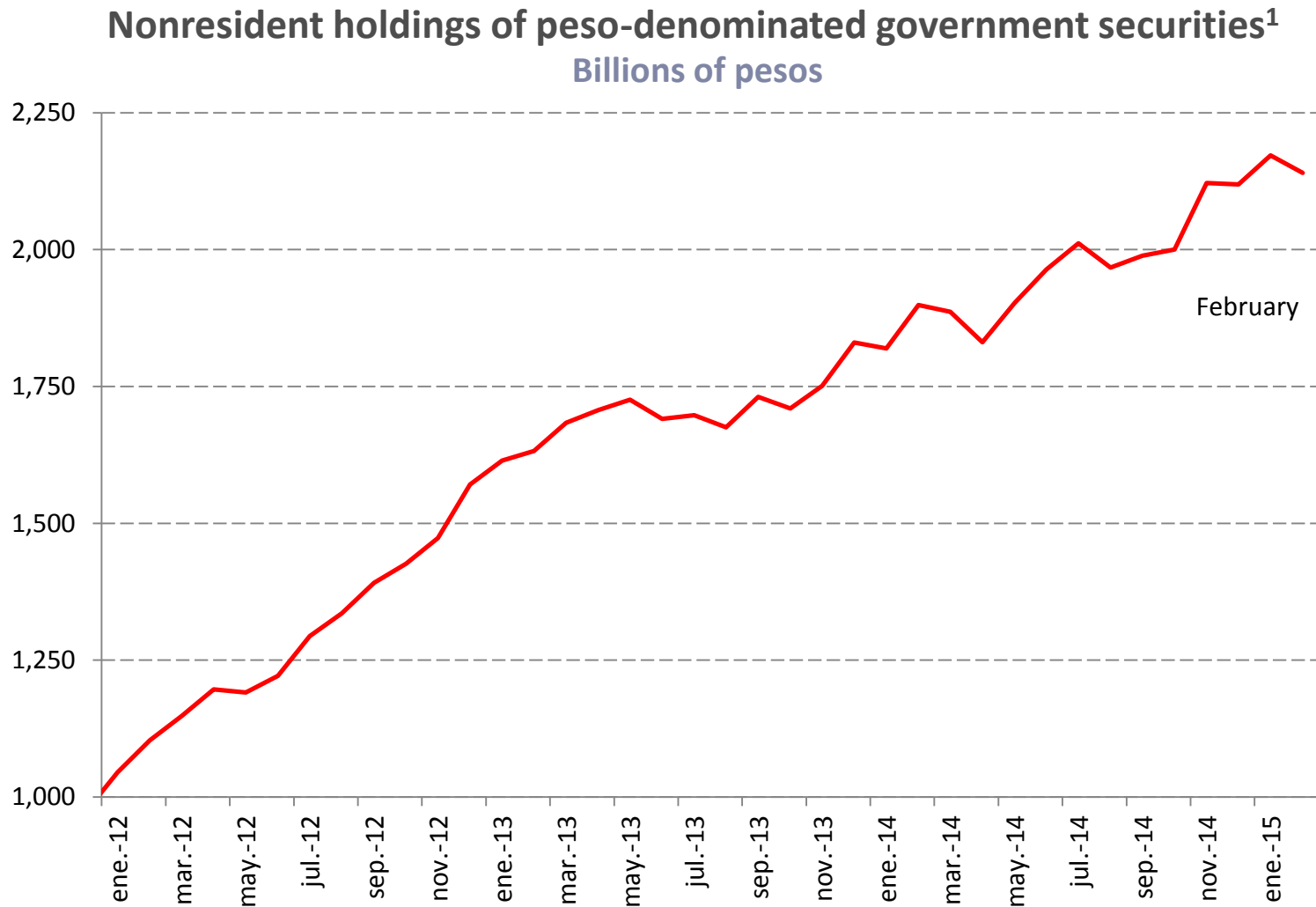
Source: Own calculations based on a first difference of logarithms linear regression with Bloomberg data

The yield curve has shifted upward, largely along with that of the United States



1/ Solid line, April 30, 2013. Dotted line, March 27, 2015
Source: Banco de México and U.S. Treasury

Although nonresident holdings of peso government securities have continued to rise, future portfolio adjustments cannot be ruled out



1/ Cetes, Bondes D, Bonos and Udibonos
Source: Banco de México

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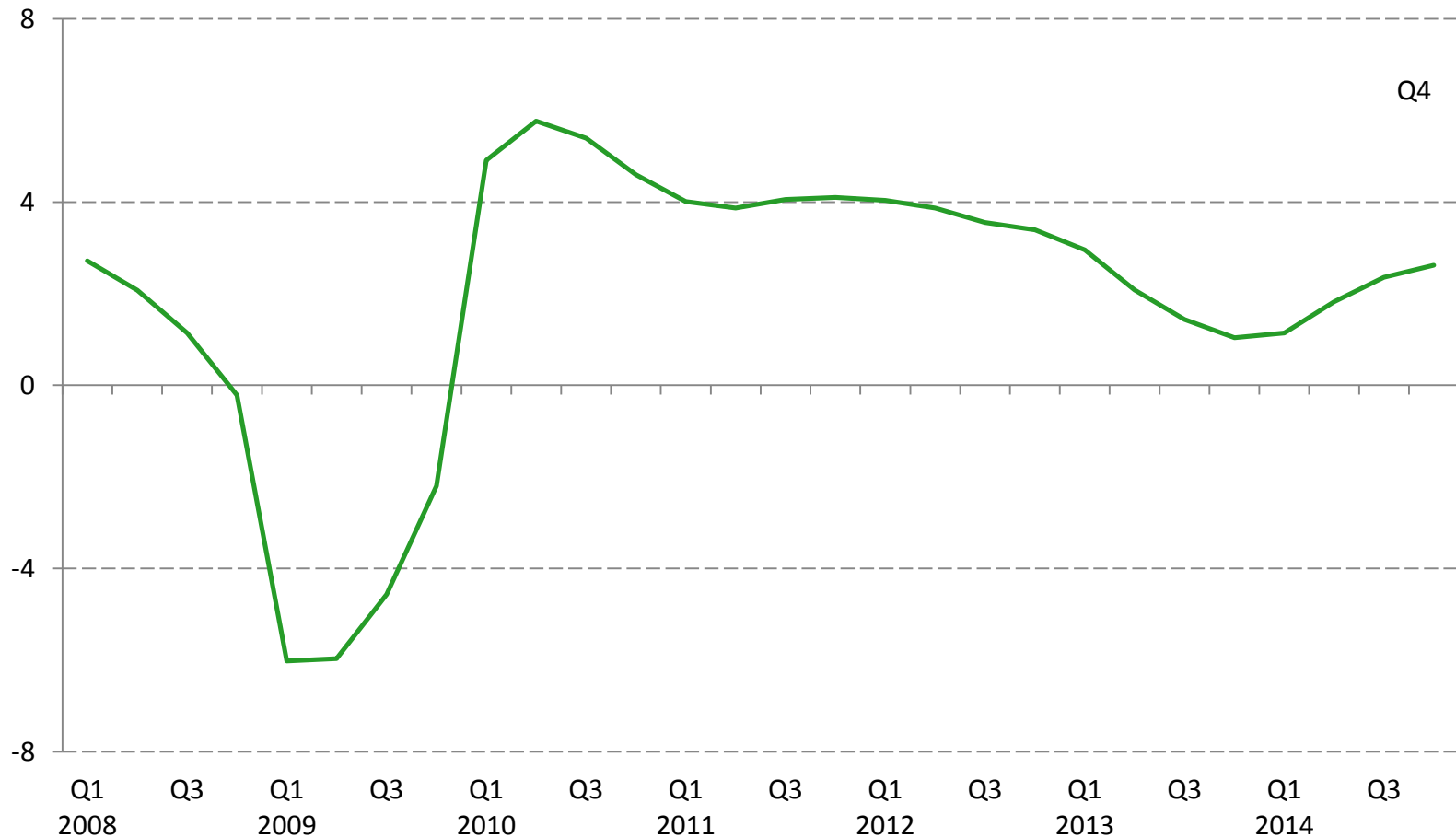
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In Mexico, economic activity has begun to gain some steam

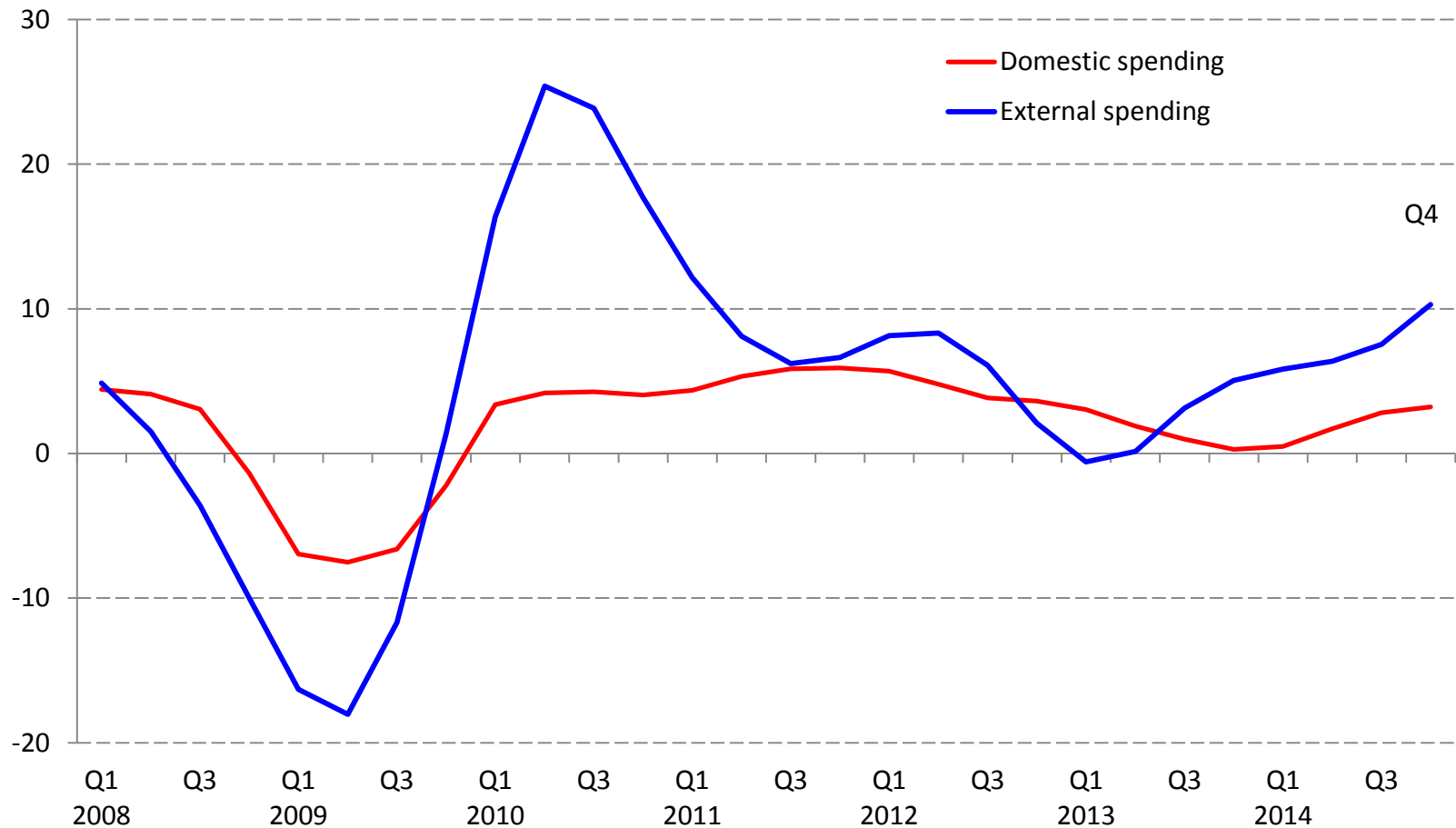
Mexico: GDP growth
Annual % change, trend



Source: INEGI

The current upturn has been driven largely by external demand

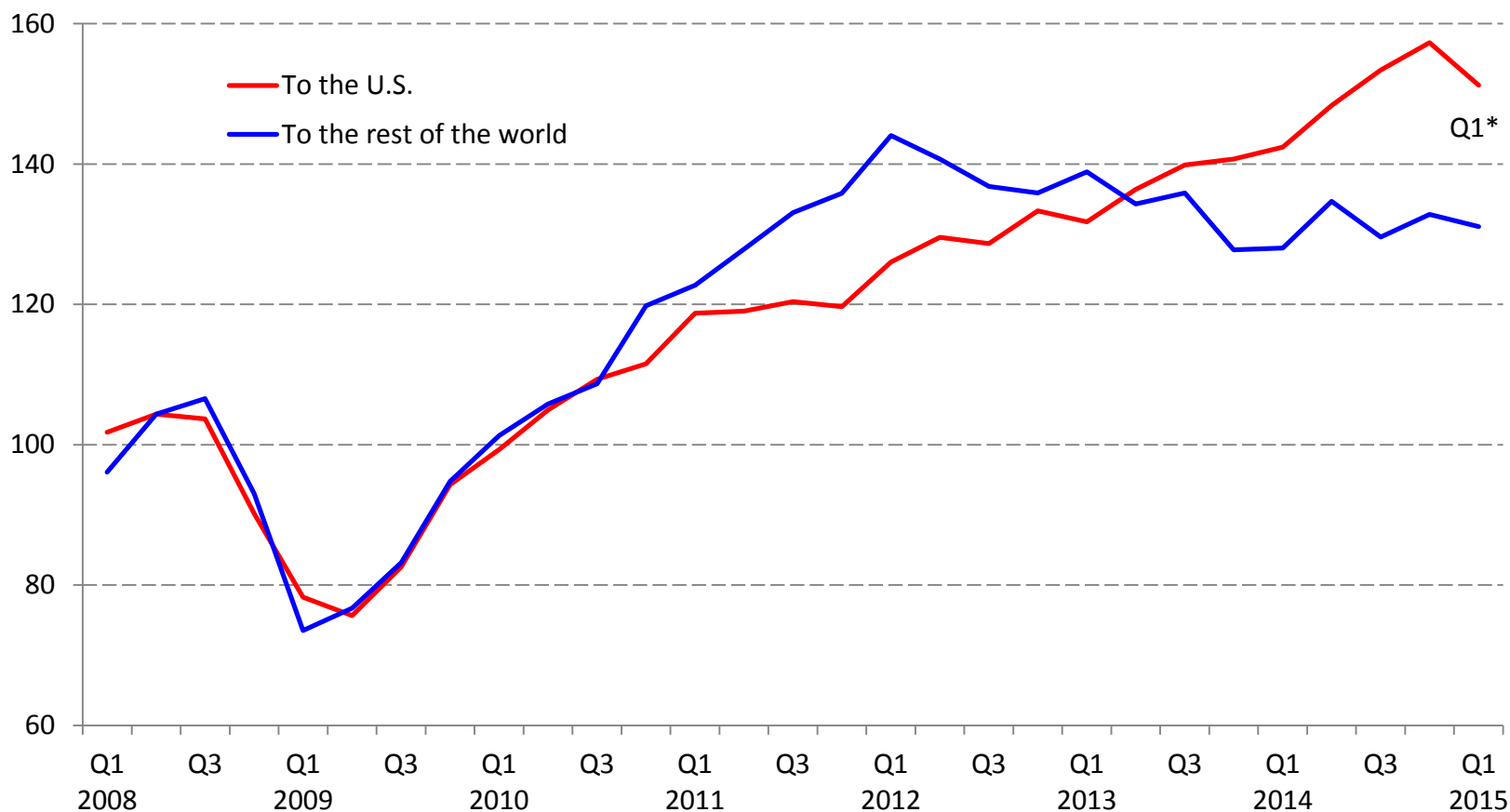
Mexico: Aggregate demand
Annual % change, trend



Source: INEGI

An important source of impetus has come from manufacturing exports to the U.S., which have recently weakened due to temporary factors

Mexico: Manufacturing exports
2008=100; s.a.



*/ Estimated on the basis of January and February data

s.a. / Seasonally adjusted

Source: Banco de México

Going forward, Mexico should benefit from a stronger U.S. economy

U.S. and Mexican GDP forecasts YoY % change

	2014	2015	2016
U.S. Blue Chip	2.3	3.1	2.9
Mexico Blue Chip	2.1	3.1	3.7
Mexico Banxico	2.1	2.5 – 3.5	2.9 – 3.9

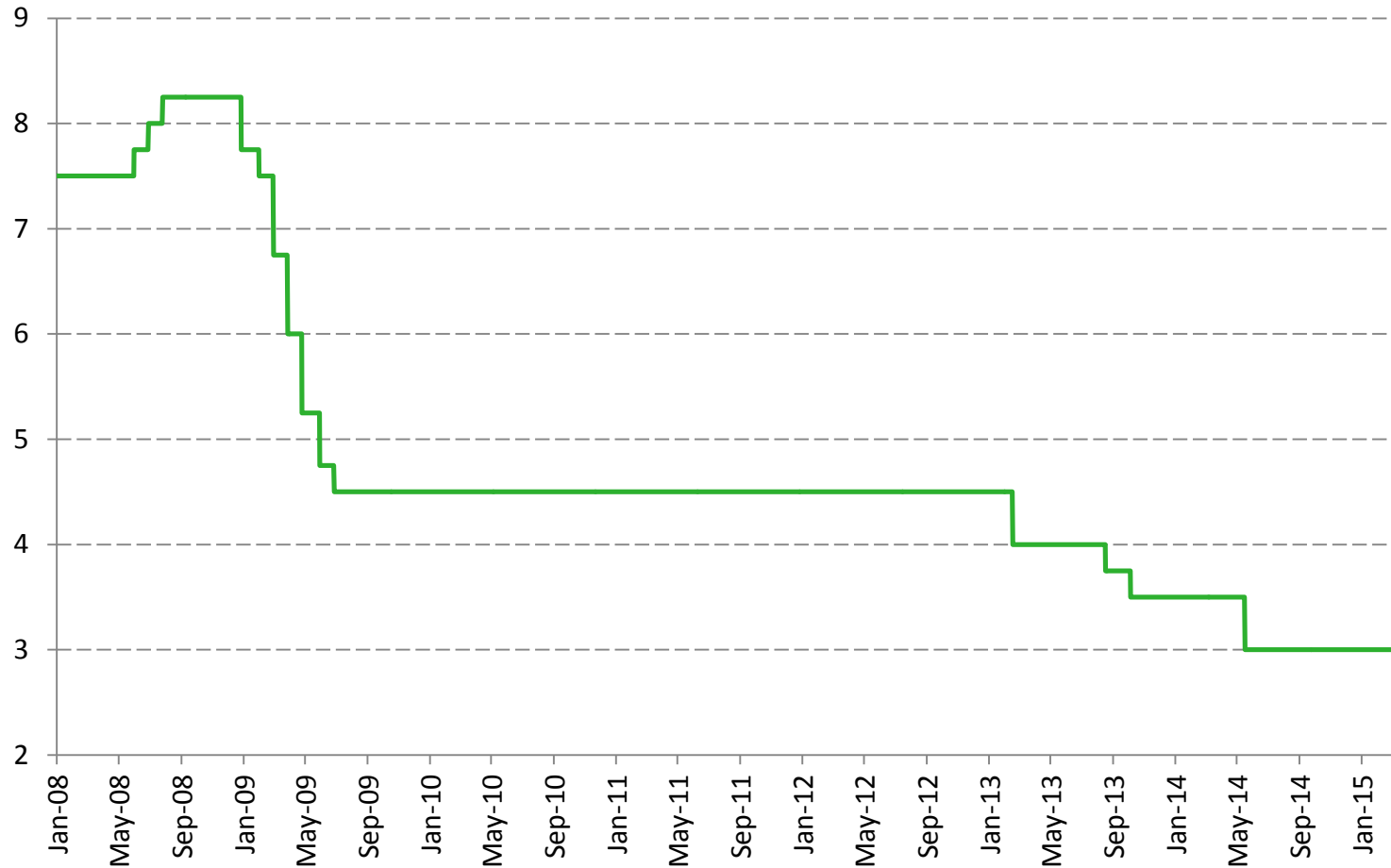
Source: *Blue Chip Economic Indicators*, March 2015 and Banco de México (2015), *Quarterly Report, October-December 2014, Summary*, February

However, the growth scenario faces some risks

- To the downside
 - ✓ Consumer and producer confidence potentially remaining stagnant
 - ✓ The risk of a negative impact on economic activity from social unrest
 - ✓ Possibly continuing declines in oil production and prices
- To the upside
 - ✓ Stronger-than-foreseen U.S. economic recovery
 - ✓ Greater-than-expected push from structural reforms

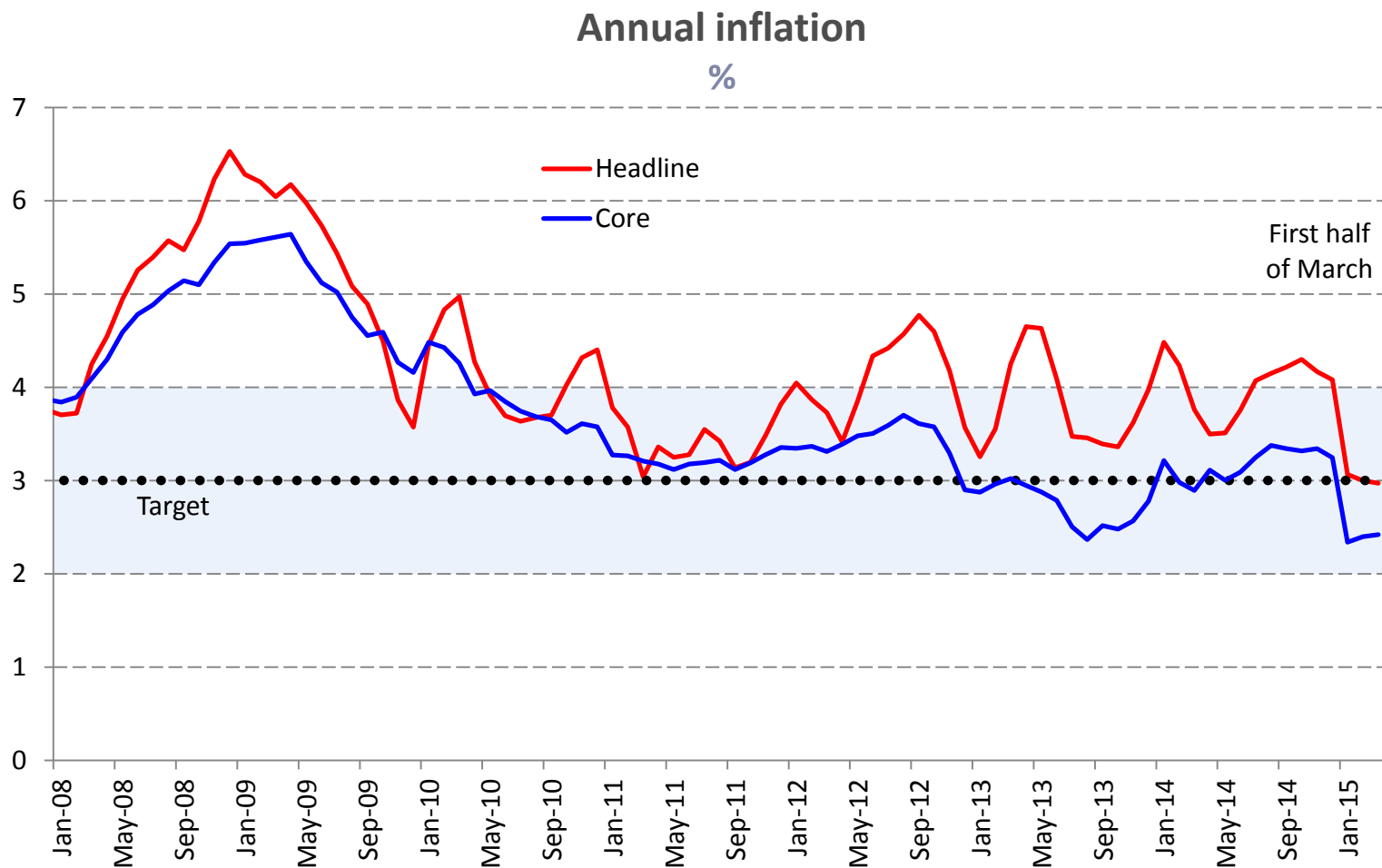
In the wake of soft economic activity, Mexico's monetary policy accommodation increased

Mexico: Monetary policy rate
%



Source: Banco de México

After an off-track period reflecting mainly noncore components, inflation has returned to a path toward the 3 percent permanent target



Source: INEGI

In this context, inflation risks should be carefully monitored to consolidate convergence to the target

- Risks

- ✓ Despite low pass-through in recent years, substantial currency depreciation may have a wide impact on inflation
- ✓ Renewed substantial rises in noncore price components
- ✓ Eventual aggregate demand pressures

- Challenges

- ✓ Relative monetary stance vis-à-vis the United States
- ✓ Analysts' long-term inflation expectations remain above the target

Concluding remarks

- Mexico has undertaken an ample reform agenda to tackle the problem of low productivity growth
- Success depends on the degree the reforms actually bring about market flexibility, investment, and effective competition
- In the short term, financial challenges stem from lower oil prices and upcoming U.S. monetary normalization
- Further bouts of volatility may occur, and thus authorities must remain on alert
- The Mexican economic recovery is picking up steam, although there are risks to the growth scenario
- Inflation risks should be carefully monitored to make convergence to the target a permanent phenomenon



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