# The Mexican economy: A call for stronger fundamentals

Remarks by

Manuel Sánchez

Deputy Governor

The Bank of Mexico

at the

OMFIF Meeting

London, U.K.

October 21, 2016

I would like to thank the Official Monetary and Financial Forum for the invitation to talk to you today. I am honored by the privilege of participating in this excellent platform for worldwide public-private-sector interaction in finance and economics.

On this occasion, I will exchange my views with you on Mexico's economy in the face of a challenging international environment. I will first consider economic developments and prospects in the country, where external demand, and particularly its effects on the manufacturing sector, are key. I will then analyze the impact of global risk factors on financial markets and why it is important to fortify macroeconomic fundamentals in a context of worldwide uncertainty. Finally, I will look at monetary policy and inflation.

As usual, my views are entirely my own and do not necessarily reflect those of the Bank of Mexico or its Governing Board.[1]

**Softer economic growth**

During the last few years, the world economy has decelerated, with year-on-year growth declining to rates below long-term averages. Since last year, moderation has

[1] For a graphic presentation accompanying these remarks, see Sánchez, M. (2016). "The Mexican economy: A call for stronger fundamentals," presentation at the OMFIF Meeting, October. http://www.banxico.org.mx/publicaciones-y-discursos/discursos-y-presentaciones/presentaciones/%7BA1D7C9D7-F64D-71FB-AD64-67CE393BD1EA%7D.pdf

come mainly from sluggishness in advanced countries, while emerging economies have improved somewhat.

For Mexico, conditions in the United States, its main trading partner, are the most important external determinant. U.S. GDP annual growth has been falling since 2015, reaching only 1.3 percent in the second quarter of 2016. What is worrisome for Mexico is that this slowdown has coincided with contracting trends in industrial and manufacturing production.

Nowhere is Mexico's economic integration with the United States more evident than in the high correlation between both countries' industrial and manufacturing outputs. Furthermore, causation runs from the larger country to the smaller one. Inevitably, U.S. manufacturing fragility translates into a slower sector in Mexico.

A significant driver of weakness in U.S. manufacturing can be found in foreign trade, in the context of a global tendency in recent years of smaller international flows of goods, extending to the United States. In particular, both U.S. manufacturing imports and exports have been shrinking, and statistical evidence suggests that reduced foreign trade is sapping vigor from the manufacturing sector in that nation.[2]

A warning sign comes from forward-looking indicators for U.S. manufacturing, such as those estimated as diffusion indexes based on surveys. The manufacturing PMI,

[2] See Banco de México (2016). Informe Trimestral Abril-Junio 2016, August, Box 2, pp. 30-33.

calculated by the Institute of Supply Management, recently touched contraction territory and since then has stayed close to it.

Against this backdrop, Mexico's annual GDP growth has been relatively stable during the last three years at around its long-term average of 2.3 percent, with a dip in the second quarter of 2016. This development has resulted from two opposing forces: expansion in services and a weaker industrial sector.

Weakness in industrial production reflects both domestic and external restrictions. On the one hand, mining has been dropping significantly, mainly due to a longstanding decline in oil extraction. This, in turn, reflects near depletion of the most profitable oil fields, as well as insufficient investment by the state-run oil company, Pemex, and poor results from exploration projects.

On the other hand, slower manufacturing is linked to softening U.S. production, as suggested earlier. Mirroring developments in the United States, Mexican manufacturing exports, especially those directed to that country, are subdued at negative growth rates, largely explaining trends in manufacturing output.

This has occurred in spite of substantial real peso depreciation vis-à-vis the U.S. dollar. Although peso competitiveness has allowed Mexican exports to gain some market share in the United States, this price effect has been more than offset by a negative effect associated with lower external demand for Mexico's goods.

In contrast, services are still relatively robust, constituting the most significant engine of recent economic growth. However, expansion in the services sector has stalled lately, partly reflecting spillover from contracting foreign trade. For example, slower trends are present in both commerce and trucking, which are tightly linked to external trade.

On the demand side, private consumption has continued to increase at relatively high rates, while total investment has been falling, particularly that related to public works. Investment expenditure cuts have been the main avenue for fiscal adjustment in the face of lower international oil prices.

Confidence indicators imply that economic activity may continue to wane. In particular, declining producer confidence may signal further potential weakening in investment in the short term.

Analysts' consensus forecasts are for moderate economic improvement in 2017 for the world and U.S. economies, and to a lesser extent for Mexico, where growth is foreseen rising from an estimated 2.1 percent this year to 2.2 percent in the next. It is worth noting that the outlook for Mexico's growth next year is for a return of growth to approximately the aforementioned long-term average, obviously insufficient to meet the requirement of significantly improving general living standards.[3]

This necessity and the recognition that the main long-term growth problem in Mexico is stagnant productivity led the country to undertake an ample set of structural reforms, now being put into place. Their benefits depend crucially on the quality of implementation, and will fully be felt only in the medium term.

In addition, Mexico's growth scenario faces downside risks. In the short term, there is the potential for a greater slowdown in the global and U.S. economies, particularly manufacturing, as well as a larger-than-expected fall in crude oil output, and further deterioration in consumer and producer confidence.

In the medium term, global-wide protectionist tendencies are on the rise. Finally, again on the domestic front, obstacles to adequate implementation of structural reforms could arise.

**Heightened risk aversion**

Since 2014, rising risk aversion has hit emerging markets especially hard in terms of lower capital flows and asset prices. Sources of concern have included economic

[3] Analysts' estimates for global and U.S. GDP are, respectively, 2.5 and 1.5 percent in 2016, and 2.8 and 2.2 percent in 2017. See Consensus Forecasts and Latin American Consensus Forecasts, October 2016.

and political issues, such as Chinese economic health and policy actions there, and Brexit.

However, a persistent factor during the last few years has been uncertainty over the degree of monetary accommodation in advanced countries, particularly the United States. Central banks have become more proactive, and their communication and actions have sometimes generated undue volatility.

More importantly, increasingly loose, sustained, and far-reaching monetary stances in developed countries confront at least two challenges. One is maintaining credibility in light of perceived low and decreasing policy effectiveness. Not only has expansionary monetary policy faced difficulties attaining the intended objectives, including support for growth, but lately, such as in Japan and the euro zone, even their financial effects, in terms of exchange rates and other asset price movements, seem to be the opposite of those expected.

The other challenge is to deal with the consequences of asset price distortions as a result of monetary accommodation and consequent financial stability risks. For this and other reasons, future amplification of uncertainty and volatility cannot be ruled out.

To date, heightened risk aversion has not greatly affected Mexico's key financial quantities, such as non-resident holdings of peso-denominated government securities. These foreign portfolio investments are among the highest in emerging markets, a fact which could be interpreted as a sign both of strength and possible vulnerability, for instance, if a sudden change occurs in market sentiment towards emerging markets or Mexico.

These holdings have been relatively stable in absolute terms during the last few years, largely reflecting lower short-term asset positions, namely zero coupon Cetes, while those of long-term M bonds have increased persistently. This behavior may suggest that investors' positive long view on Mexico remains firm. Caution is appropriate, however, as international conditions can always change.

The adverse international environment has exerted a clear effect on Mexico's asset prices. In particular, market interest rates, especially those of medium duration, have been rising, along with risk perception. Consistently, spreads against the United States have been widening, as interest rates in that country have either fallen or stayed flat.

More notably, the value of the dollar in peso terms has been trending upward sharply, along with its value in terms of a basket of emerging-market currencies. However, so far in 2016, the Mexican peso has decoupled from other currencies, with a further substantial weakening, while the others, on average, have appreciated. The obvious question is why the Mexican peso has been hurt more severely.[4]

Several factors could be behind peso underperformance, in particular, three possibly interrelated causes. One is rather mechanical and refers to the fact that the Mexican peso is a highly liquid currency in international markets. This characteristic leads investors to see the peso as an attractive vehicle for hedging against an ample set of risks.

A second, deeper reason may stem from concerns over the results of the imminent U.S. presidential election and its possible impact on its southern neighbor. A third probable factor may be perception of Mexico's fiscal fragility, including weak financial conditions at state-owned oil company Pemex.

Two notable statistics on public finances put analysts and market participants on alert. One is the rising trend observed since 2009 in the historic balance of public-sector borrowing requirements relative to GDP. Although this ratio continues to be inferior to frequent values encountered in the developed world, it does not compare favorably with those of many emerging economies. A second statistic has to do with

[4] See the JP Morgan Index of emerging-market currencies, which includes Brazil, Chile, Mexico, Hungary, South Africa, Turkey, Russia, China, India and Singapore.

Mexico’s sovereign risk premium, which has risen above those of other countries with equivalent credit ratings.[5]

In this scenario, Mexico needs to buttress its fiscal stance without delay. Deep adjustments to public finances are necessary given at least three significant restrictions: reduced oil prices and production, limits to ongoing investment expenditure cuts, and inertia in long-standing growth in current public expenditures.

Markets should be convinced that authorities will do what it takes to stabilize the ratio of public debt to GDP. These actions cannot be postponed for public finances to become sustainable.

**Monetary policy challenges**

Since last year, inflation has remained benign, for several months below the 3 percent target established by the Bank of Mexico since 2003. Obtaining inflation this low and close to the target is an unprecedented achievement which took a long time and must be preserved.

[5] The debt-to-GDP ratio rose from 36.2 percent in 2009 to an estimated 50.5 percent in 2016. See SHCP (2016). *Criterios Generales de Política Económica 2017*. For sovereign risk premium developments, see, for instance, the 5-year Credit Default Swaps for countries with a BBB+ rating from Standard & Poor’s, which are Mexico, Poland, Spain, Peru, and Thailand.

One important consideration is that recent contained inflation has been supported by unusually low noncore price increases. This phenomenon may prove to be transitory.

Core inflation, on the other hand, has been rising in 2016, basically pulled by the impact of peso depreciation on tradable goods prices, as illustrated by the behavior of merchandise inflation, which lately reached almost 4 percent. It is worth noting, however, that this pass-through from peso depreciation has been relatively mild.

Recently, break-even inflation breached the 3 percent target, which may indicate possible future price pressures. Additionally, inflation expectations based on analysts' surveys have stopped falling, thus possibly suggesting that further reductions of inflation are not in sight.[6]

Upside risks to inflation would appear to have the upper hand. The main negative possibility seems to come from widespread contagion of exchange-rate depreciation to inflation and expectations. A second risk stems from the reversion of noncore inflation to historical averages. Third, an upsurge of aggregate demand pressures could occur, in particular considering uncertainty over the degree of slackness in the economy.

[6] See Banco de México, *Encuesta sobre las Expectativas de los Especialistas en Economía del Sector Privado.*

These dangers could cause the price formation process to unravel, with lasting consequences. Prudence is all the more important given the time and effort it took for inflation to reach the target.

Since December 2015, the policy interest rate has been raised four times for a total of 175 basis points, to 4.75 percent, a level just above that in the second half of 2009, in the wake of the global financial crisis.

These moves should be interpreted as preemptive, in full view of the fact that monetary policy exerts its full effects with lags. One central objective has been to avert deviation of inflation expectations from the target due to pass-through. The Bank of Mexico does not target any exchange-rate level. However, exchange-rate developments are taken into account to the extent that they may influence inflation and expectations.

In a more general sense, the hikes have sought to contribute to stronger macroeconomic fundamentals in the face of an adverse international environment. Other factors considered include the relative monetary stance vis-à-vis that of the United States, as well as the phase of the economic cycle. Going forward, monetary policy will remain vigilant.

## Conclusions

A disadvantageous international environment has hobbled Mexican economic performance, and bouts of amplified risk aversion could easily recur. This makes the urgency with which Mexico needs to buttress its macroeconomic fundamentals, including its fiscal stance, overwhelmingly clear.

On the monetary front, pre-emptive policy action has been required. Especially given the time it has taken to reach the 3 percent permanent inflation target, policy will be on the alert to avert any problems that would prevent consolidation of convergence of inflation to this target.