Mexico's Economic Integration and Outlook

Remarks by

Manuel Sánchez

Member of the Governing Board of the Bank of Mexico

at the

United States-Mexico Chamber of Commerce

California Regional Chapter

Los Angeles, CA

December 9, 2011

It is an honor to be in Los Angeles to address the United States-Mexico Chamber of Commerce. I would like to thank the organizers of the 14th Annual Mexico Economic Review and Political Outlook 2011 for the invitation to speak to you today.

Because California is one of the U.S. states most interconnected to Mexico, it is natural to begin my review of the Mexican economy by examining its ever-increasing integration with that of the United States. After that, I would like to describe the effects of current international conditions on Mexico and discuss its economic outlook.

My main message is that, while the strength of the current economic upturn in Mexico may be limited by that of the United States, the benefits of its long-term association with its northern neighbor continue to be substantial. Also, Mexico will realize its upside potential for sustained economic growth if it strengthens its fundamentals and promotes pending structural reforms. As usual, my remarks are entirely my own responsibility and do not necessarily reflect those of the Bank of Mexico.

Expanding economic integration

During the last three decades, Mexico has been undergoing a process of expanding economic integration with the United States. Deeper relations between the two

countries have been built on their geographic proximity, especially as a result of the opening up of the Mexican economy, which began in 1983 with a phase of unilateral reduction of tariffs and other barriers to trade. Ever greater openness has been achieved through the North American Free Trade Agreement (NAFTA) since 1994, which included Canada, the United States and Mexico. Despite the important role that Canada plays in intraregional transactions, in what follows I will focus on the growing economic links between the United States and Mexico.

Enhanced economic integration between these two countries is multifold. The most dramatic reflection of this relation is the consistently high growth of their bilateral trade in goods and services, which surpasses that of their respective GDPs. Specifically, highly dynamic Mexican exports to the United States have implied markedly more Mexican imports from north of the border. Additionally, bidirectional tourism has been increasing, and workers' remittances from the United States are an important source of inflows in Mexico's balance of payments. At the same time, foreign direct investment between the two countries and from other nations has being growing in view of advantages from business opportunities arising from their greater commercial interaction.[1]

[1] From 1980 to 2010, Mexican exports to the United States rose from 5.0 percent of GDP to 23.1 percent, while Mexican imports from the United States increased from 5.7 percent of GDP to 14.0 percent. During the same period, FDI from the United States to Mexico grew by more than 1.8 times in constant dollars, while workers' remittances, most of which come from the United States, increased 32 times.

The benefits of this association have accrued to both nations, but being the less developed economy, Mexico has profited in particular. One direct effect of Mexico's opening to trade has been a trend towards product specialization and efficiency, a result of fiercer competition from abroad as well as multiplied opportunities to send goods to the world's largest market. Of course, this transformation has not been a zero-sum game, as suggested by the complementary roles that the two countries have played in certain expanding sectors, such as Mexico's in-bound maquiladora and auto industries. More importantly, and as predicted by theory, both economies have benefited from a wider availability of goods and services at lower prices.[2]

Mexico's economic integration with the United States has not prevented it from expanding transactions with other nations and regions. In fact, the rapid growth of flows to and from the United States has coincided with a decline in the relative importance of the United States as a trade and investment partner. This observation is consistent with a previous finding that any possible trade diversion stemming from NAFTA has been more than surpassed by total trade creation.[3]

---

[2] Kehoe and Ruhl (2010) demonstrate that welfare from foreign trade in Mexico has increased more than the real GDP data indicate. See Kehoe, T. J. and K. J. Ruhl, (2010), "Why Have Economic Reforms in Mexico Not Generated Growth," *Journal of Economic Literature* 48(4): 1005-1027.

[3] As a proportion of Mexico's total exports, exports to the United States rose from 56.4 percent in 1982 to almost 90 percent in 2000, but fell to about 80 percent in 2010. Magee (2008) shows that in the case of NAFTA and other regional trade agreements, trade creation considerably surpasses any trade diversion. See Magee, C.S.P, (2008), "New Measures of Trade Creation and Trade Diversion," *Journal of International Economics* 75: 349-362.

An implication of the tight links between the two nations is that the Mexican economy is very cyclically synchronized with the United States, especially in manufacturing production, for which the correlation is more than 0.9. This effect has been enhanced during the last fifteen years, a time period in which Mexico has undertaken sounder fiscal and monetary policies, thus avoiding previously recurrent currency crises.

The global financial turmoil in 2008 and 2009, the epicenter of which was the United States, affected Mexico more profoundly than many other emerging markets, given its close ties with the larger country. The persistence of some structural problems and the unusually weak ongoing recovery in the United States have led some to advocate the diversification of Mexico's international economic relations away from its northern neighbor. While this notion may be sensible if it is the result of a natural market evolution, it becomes risky if it implies the application of policy measures that introduce distortions and inefficiency.

Some diversification of Mexico's trade and investment relations may continue to occur as a natural outcome of more global trade opening and better transport and communications possibilities. However, being next to the largest and most diversified economy of the world is a strong advantage that should not be artificially limited.

Financial volatility and economic rebound

Since the end of August 2011, international financial markets have been buffeted by heightened risk aversion and a generalized flight to quality resulting from the perceived worsening of the financial and fiscal problems in the euro area and, to a lesser extent, the fear of another recession in the United States. The general result has been a tendency toward volatility and lower asset prices in many stock, bond and currency markets.

In the case of Mexico, the most notable financial impact has been increased instability and substantial depreciation of the Mexican peso against the U.S. dollar. From the end of August to the end of November 2011, Mexican peso depreciation reached more than 10 percent, a rate that is similar to that experienced by other currencies, such as the New Zealand dollar and the Brazilian real. Against the backdrop of widespread risk aversion, very few currencies other than the U.S. dollar have played the role of safe havens.

The international financial turbulence has also negatively affected the peso bond market, although to a much lesser degree than the foreign exchange market. During September-November 2011, the domestic yield curve tended to move up and to steepen slightly, but this movement was not continuous, as it was interrupted by downward shifts. In any case, interest rates for tenors of one year and longer remain below the maximum levels observed in the first half of the year.

The relatively minor impact of the financial instability on Mexico's yield curve seems to reflect the high proportion of long-term bonds within foreign holdings of peso-denominated government securities. Furthermore, during the last few months, the amount of long-term bonds held by foreigners increased slightly more than a reduction observed in holdings of short-term securities. The important role played by long-term investors in the government securities market seems to reflect their confidence in the sound management of public debt as well as the flexible exchange rate regime. Two additional possible factors explaining the prevalence of contained long-term interest rates are a decline in projected economic growth, and stable and moderate inflation expectations in recent months.[4]

During 2011, the Mexican economy has continued a recovery process after surpassing, by the beginning of the year, the maximum levels of economic activity observed prior to the global financial crisis. Indeed, GDP quarterly growth has been successively rising and, in the third quarter, the change in output was positive for each of the economy's three sectors. On a year-over-year basis, GDP grew 4.4 percent in the third quarter.

[4] Government securities in the hands of foreigners increased 0.9 percent in peso terms during September-November 2011; as of the end of this last month, more than 80 percent of government securities held by foreigners corresponded to tenors longer than one year, and total government securities held by foreigners accounted for 25 percent of total government securities outstanding. According to the Bank of Mexico's survey of private-sector analysts, the growth forecast for Mexico's GDP for 2012 fell from 4.1 percent in July 2011 to 3.3 percent in November, while expected inflation for 2012 stayed at 3.7 percent in the same period.

The services sector, which accounts for about two-thirds of Mexican GDP, was highly dynamic in the first nine months of the year, and particularly in the third quarter. This growth, along with extraordinarily high agricultural production, more than compensated for a slight deceleration in industrial activity in the third quarter.

Lower industrial growth reflected, notably, a slowdown in manufacturing production, which in turn responded to lower growth from Mexican non-oil exports, particularly non-auto products, to the United States. Apparently, a slowing of manufacturing production in the United States had an almost instantaneous impact on Mexico's manufacturing production. October data on foreign trade suggests that this deceleration has probably continued in the fourth quarter of 2011.

Domestic demand, as reflected by retail sales and investment, continued showing high rates of growth, although investment levels remain below those observed before 2008, mainly because of a virtual stagnation in the construction industry. Retail sales growth seems to have been fueled by a recovery in employment, real wages, and consumer credit.

Monetary Policy and Outlook

During 2011, monetary policy continued to be consistent with the 3 percent inflation target established by the Bank of Mexico at the end of 2003. The policy interest rate has been kept at 4.5 percent since July 2009. As a result, in 2011 annual inflation has remained relatively stable and close to, though slightly above, the target.[5]

The Governing Board of the Bank of Mexico has repeatedly stated that it will continue to implement a monetary policy stance that fosters the convergence of inflation to the permanent target. Risks must be closely monitored. At the moment, the main threat seems to come from the possibility that a weaker Mexican peso, for example affected by continued uncertainty in the euro zone, may translate into generalized inflation pressures. Although the pass-through from exchange rate movements to inflation has fallen in recent years, the potential impact of a considerable depreciation of the Mexican peso is unknown.

Other risks include the possible worsening of inflation expectations stemming from the disappearance of favorable nonrecurring factors, such as low increases in agricultural product prices, which this year have supported benign inflation. Another important challenge for monetary policy continues to be the need to anchor inflation expectations around the 3 percent permanent target. To date,

[5] Up to November, average annual inflation in 2011 was 3.4 percent.

measures of expected inflation for all time periods, as reflected in analyst surveys and the bond market, remain above the target.

Finally, the Bank of Mexico estimates that GDP growth will settle between 3.5 percent and 4 percent in 2011 and between 3 percent and 4 percent in 2012. This forecast assumes fairly stable, moderate growth in the United States. Revised economic prospects in the U.S. economy would likely trigger an adjustment in the same direction for Mexico's GDP growth.

Despite the significance of its close links to the United States, which are especially important to cyclical economic activity, Mexico's potential long-term economic growth has substantial upside if the nation continues to fortify its fundamentals, which include healthy fiscal finances, low inflation, and a liquid and well-capitalized banking system. Its upside potential will also be greater if it promotes pending structural reforms fostering productivity growth and investment.

Concluding remarks

The increasing economic integration of Mexico with the United States during the last three decades has benefited both countries significantly. Advantages to Mexico include greater product specialization and efficiency, and for both nations, a wider variety of goods and services at lower prices. Being next to the largest and most

diversified economy in the world is a strong advantage for Mexico which should not be underestimated.

Recently, international financial instability has affected Mexico mainly through substantial currency depreciation, similar to that experienced by other emerging market currencies, and, to a lesser extent, through slightly higher interest rates. Meanwhile, the Mexican economy has continued a recovery process which has included more moderate growth in the industrial sector, mainly reflecting slower exports to the United States.

Mexico's economic outlook remains dependent on the strength of the U.S. economy, but long-term upside potential can be realized if Mexico's fundamentals are strengthened, and pending structural reforms approved. Finally, monetary policy will continue to be consistent with preserving the convergence of inflation to the permanent 3 percent target.