The Mexican economy: the need for differentiation

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Contents

1  The key leverage of external demand

2  The need for differentiation

3  The flexibility of monetary policy actions
Mexico’s economic activity since 2013 has expanded at rates lower than the long-term average.

Mexico: GDP
YoY % change, s.a.

Average annual growth
1994-2014
GDP 2.6%

s.a. / Seasonally adjusted
Source: INEGI
The main driver of Mexico’s GDP growth has been external demand, which has recently softened.

Mexico: Exports of goods and services
YoY % change, s.a.

Average annual growth
1994-2014
Exports 6.8%

s.a. / Seasonally adjusted
Source: INEGI
A slowdown in nonoil exports is tightly linked to decelerating U.S. industrial production

Mexico and the U.S.: Nonoil exports and U.S. industrial production
YoY % change, s.a.

Average annual growth 1994-2014
Nonoil exports 9.9%
U.S. industrial production 2.3%

s.a. / Seasonally adjusted
*/ July-August average for U.S. industrial production
Source: INEGI, the Federal Reserve and Banco de México
With a lag, private investment has responded to external demand, and improved housing developers’ balance sheets.

Mexico: Private investment
YoY % change, s.a.

Average annual growth 1994-2014
Total 6.5%
Construction 6.1%

s.a. / Seasonally adjusted
Source: INEGI and Banco de México
Private consumption has followed suit, growing moderately

Mexico: Private consumption
YoY % change, s.a.

Average annual growth
1994-2014
2.9%

s.a. / Seasonally adjusted
Source: INEGI
Government expenditures continue to expand at a slow rate

Mexico: Government expenditures
YoY % change, s.a.

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</thead>
<tbody>
<tr>
<td>YoY %</td>
<td>-12.0</td>
<td>-8.0</td>
<td>-4.0</td>
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<td>1.8</td>
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Average annual growth 1994-2014
- Total 1.0%
- Public investment 0.3%

s.a. / Seasonally adjusted
Source: INEGI
Available data suggest that the economy has posted measured growth in Q3 2015

**Global Economic Activity Index**

*YoY % change, s.a.*

- Total: 2.1
- Industrial: 0.7

**Manufacturing production**

*YoY % change, s.a.*

- 1.3

**The dollar value of exports**

*YoY % change, s.a.*

- Nonoil: 1.9
- Oil: -43.9

**Retail sales**

*YoY % change, s.a.*

- ANTAD store sales: 8.2
- Retail business revenues: 4.9

s. a. / Seasonally adjusted; */ Only July
Source: Banco de México and INEGI

s. a. / Seasonally adjusted; */ Only July
Source: INEGI

s. a. / Seasonally adjusted; */ Average July-August
Source: Banco de México

s. a. / Seasonally adjusted; */ Average July-August for ANTAD and only July for retail business revenues. Source: INEGI, ANTAD and Banco de México
Along with the United States, Mexico is forecast to see a gradual recovery this year and in 2016

The United States and Mexico: GDP growth forecasts

<table>
<thead>
<tr>
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<th>2014</th>
<th>2015&lt;sup&gt;F&lt;/sup&gt;</th>
<th>2016&lt;sup&gt;F&lt;/sup&gt;</th>
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<td>U.S. Blue Chip</td>
<td>2.4</td>
<td>2.5</td>
<td>2.7</td>
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<tr>
<td>Mexico Banxico survey</td>
<td>2.1</td>
<td>2.3</td>
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<td>Mexico Banxico</td>
<td>2.1</td>
<td>1.7 – 2.5</td>
<td>2.5 – 3.5</td>
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F/ Forecast
Source: Blue Chip and Banco de México
Downside risks to Mexican GDP growth could predominate

- U.S. industrial production weaker than expected
- Further falls in oil extraction and prices
- More fragility in consumer and producer sentiment
Contents

1. The key leverage of external demand
2. The need for differentiation
3. The flexibility of monetary policy actions

The Mexican economy: the need for differentiation
Two major factors appear to be behind recent international financial volatility

- During the last few months, global financial volatility has risen significantly.

- Sources of pressure include renewed uncertainty on the start of U. S. monetary normalization, as well as fears of worsening Chinese conditions and outlook.

- Doubts about liftoff in the United States appear to have increased in the wake of the most recent FOMC decision.
The Mexican peso has depreciated against the U.S. dollar at the average rate of other emerging economies.

1/ Emerging economies excluding Mexico means the unweighted average of currencies encompassing the Chinese yuan, Russian ruble, Turkish lira, Korean won, South African rand, Brazilian real, Indian rupee, Polish zloty, Hungarian florin, Malaysian ringgit, Thailand baht, Chilean peso, Indonesian rupiah, Philippine peso, Colombian peso, and Peruvian nuevo sol.

Source: Bloomberg
Mexican long-term interest rates rose in 2013, anticipating U.S. monetary policy normalization.
The share of nonresident holdings of peso-denominated government securities has moderated marginally

Mexico: Nonresident holdings of peso-denominated government securities

% of total outstanding

1/ Includes Cetes and Udibonos
Source: Banco de México
To confront more financial uncertainty, Mexico should seek to stand out from other emerging economies

- Growth
  - High quality and deep implementation of structural reforms
  - Improved rule of law and public security

- Macroeconomic policy
  - Sustainable public-debt-to-GDP ratio
  - Timely adjustment of monetary policy

- Monetary policy will continue to take into account the relative stance vis-à-vis the U.S., among other factors
1 The key leverage of external demand
2 The need for differentiation
3 The flexibility of monetary policy actions
Monetary policy has been accommodative in the face of relatively soft economic activity

Mexico: Objective for policy interest rate
% overnight funding rate

Source: Banco de México

September

The Mexican economy: the need for differentiation
Inflation has remained on target throughout 2015, aided by positive shocks.

Mexico: Annual inflation

**%**

- **Headline**
- **Core**

Average annual inflation **2003-2014**

- **Headline 4.2%**
- **Core 3.7%**

*First half

*Source: INEGI*
Steep peso depreciation has had limited pass-through into prices so far, mainly in durable goods

Mexico: The INPC and the nominal exchange rate

Annual % change

Correlation coefficient
2003-2015
0.37

INPC
MXN/USD

1/ The INPC is the National Consumer Price Index; monthly average for the exchange rate
Source: Banco de México
Consolidation of medium-term inflation expectations anchored on the target remains a challenge

Mexico: Inflation expectations for one to four years ahead

Average forecast %

Source: Banco de México, *Survey of private-sector economic analysts’ expectations*
Upside risks to the inflation outlook must be monitored, especially given the possibility of second-round effects

- The positive shocks seen in 2015 could revert, producing direct and indirect price pressures

- Given that potential growth output is an unknown variable, eventual pressures coming from aggregate demand cannot be ruled out

- The persistence of exchange rate depreciation could fuel greater pass-through to prices, affecting inflation expectations and unleashing other second-round effects
Final remarks

- The key risk to continued GDP growth in the short term stems from softer external demand, but in the medium term, comes from stagnant productivity.

- In the face of increasing global financial volatility, Mexico needs to stand out from other emerging economies by improving its growth prospects and macroeconomic policy framework.

- Monetary policy must remain vigilant to any possible obstacle to consolidated convergence to the inflation target.

- With all the flexibility required, monetary policy should be adjusted at the right moment, before problems arise.
Mejoran las perspectivas económicas mundiales