Mexico: Overcoming Key Domestic Political and Economic Challenges

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Swiss Re Advisory Panel Meeting: “Mexico and Latin America: Emergence of a global economic power?”, Mexico City, 16 May 2014
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.
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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**

<table>
<thead>
<tr>
<th>Year</th>
<th>China</th>
<th>World</th>
<th>U.S.</th>
<th>Eurozone</th>
<th>Japan</th>
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<td>2015</td>
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**US: Real Gross Domestic Product and Industrial Production**

Quarterly change at annual rate, s.a.

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<td>2015</td>
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**Source:** World Economic Outlook, April 2014, IMF.
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.

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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/ Change of 5-year CDS.
Source: Bloomberg, ministries of finance, central banks and other national authorities.

**Current Account and Inflation at the End of 2013**

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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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.

**Industrial Activity**
Index 2008 = 100, s.a.

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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

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Expenditure</th>
<th>Programable Expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013-I</td>
<td>-3.8</td>
<td>-3.8</td>
</tr>
<tr>
<td>2013-II</td>
<td>-1.5</td>
<td>-0.3</td>
</tr>
<tr>
<td>2013-III</td>
<td>-0.3</td>
<td>-0.3</td>
</tr>
<tr>
<td>2013-IV</td>
<td>0.9</td>
<td>6.4</td>
</tr>
<tr>
<td>2014-I</td>
<td>1.1</td>
<td>9.4</td>
</tr>
</tbody>
</table>

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

Observed Public Expenditure\(^1/\)
Annual real growth in Q1, percentage

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Expenditure</th>
<th>Programable Expenditure</th>
<th>Financial Cost</th>
<th>Revenue Sharing</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014 vs 2013</td>
<td>15.2</td>
<td>13.2</td>
<td>8.9</td>
<td>1.4</td>
</tr>
</tbody>
</table>

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

Headline inflation
Variability interval
Core inflation

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

**Annual Headline Inflation Expectations**

**Median, %**

Source: Banco de Mexico’s Survey.

**Break-even Inflation and Inflationary Risk**

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 Mexico 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 well 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 %

Rolling Window Regression between 4-year Inflation Expectations and Supply Shocks: 2005-2014
Coefficient Estimates and Confidence Intervals

Source: Banco de México.

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**

![Sovereign Rating Graph]


**Traded Volume in the Global Foreign Exchange Market**

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

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

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP Growth</th>
<th>Capital (K)</th>
<th>Labor (L)</th>
<th>TFP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991-1995</td>
<td>1.64</td>
<td>1.25</td>
<td>1.19</td>
<td>-0.80</td>
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<tr>
<td>1996-2000</td>
<td>4.92</td>
<td>1.37</td>
<td>2.17</td>
<td>1.39</td>
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<tr>
<td>2001-2006</td>
<td>2.20</td>
<td>1.48</td>
<td>1.22</td>
<td>-0.50</td>
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<tr>
<td>2007-2011</td>
<td>1.71</td>
<td>1.44</td>
<td>1.03</td>
<td>-0.75</td>
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<tr>
<td>2012-2013</td>
<td>2.46</td>
<td>1.25</td>
<td>1.35</td>
<td>-0.14</td>
</tr>
</tbody>
</table>

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.

- **Monetary policy**
  - Oriented at reaching the 3% inflation target

- **External accounts**
  - At reduced and fully financeable levels

- **FCL with IMF**
  - $73 billion dollars

- **Low levels of public debt**

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

- **Flexible exchange rate regime**

- **International reserves** at all-time maximum
Therefore, a major effort has been launched to foster productivity.

<table>
<thead>
<tr>
<th>Structural Reforms</th>
<th>Constitutional Amendment</th>
<th>Secondary Legislation</th>
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</thead>
<tbody>
<tr>
<td>Labor</td>
<td>No</td>
<td>Approved Nov-12*</td>
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<tr>
<td>Education</td>
<td>Yes</td>
<td>Approved Sep-13</td>
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<tr>
<td>Energy</td>
<td>Yes</td>
<td>Pending</td>
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<tr>
<td>Competition</td>
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<td>Yes</td>
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<tr>
<td>Financial</td>
<td>No</td>
<td>Approved Nov-13*</td>
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*/ 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

Middle Class Households, 2000-2010

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

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

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