The Mexican Economy: Some Old and New Issues
Manuel Sánchez
Santander Mexico Day 2015, Mexico City, January 12, 2015
The Mexican Economy: Some Old and New Issues

Outline

- The U.S. economic recovery solidifies
- Oil prices take a dive
- The Federal Reserve is close to increasing rates
- Mexico’s economic rebound is weak
- Domestic financial markets show resilience
- Inflation turns upward
The U.S. economic recovery continues to gain momentum

The United States: GDP growth
% change, s.a.

s. a. / Seasonally adjusted
Source: The U.S. Bureau of Economic Analysis
Unemployment has been dropping significantly, surpassing the Fed’s successive projections

The United States: Unemployment and Fed’s unemployment projections

Unemployment

Projections 2011

Projections 2012

Projections 2013

Projections 2014

% 10 9 8 7 6 5 4 1/ Seasonally adjusted unemployment; median of projections contained in the FOMC Minutes of September of each year, except for 2011 which corresponds to November

In contrast, growth in the euro zone has stalled at low rates.

**Euro zone: GDP growth**

% change, s.a.

<table>
<thead>
<tr>
<th>Year Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>2008</th>
<th>2009</th>
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<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
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<td>Q1 2008</td>
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s. a. / Seasonally adjusted
Source: Haver Analytics
Oil prices have fallen to levels not seen in more than five years

WTI oil prices
U.S. dollars per barrel

Source: Bloomberg
The drop in oil prices, driven mainly by an abundant supply, should enhance U.S. economic recovery

- An oil production boom started in the U.S. in 2008
- Increased competition has triggered the price drop since the middle of 2014
- Slower global economic growth precedes the oil price fall
- Lower fuel prices should stimulate consumption in the U.S.
The recent FOMC statement suggests that gradual monetary normalization in the U.S. is close

- Economic activity is expanding at a moderate pace and is expected to continue this path
- Decisions on hikes will be data dependent
- The FOMC can be “patient” in beginning to normalize the stance of monetary policy
- Even after attaining its dual mandate, the federal funds rate may stay, for some time, below long-run normal levels
The majority of FOMC members expect the first Fed funds rate hike in 2015

First Fed funds rate hike expected by FOMC participants
% of FOMC participants

Source: The Federal Reserve
Although with significant volatility, futures markets have tended to anticipate the first hike in 2015.
Superior U.S. economic performance and expected monetary tightening may have contributed to dollar strength.

U.S. dollar versus six key currencies (DXY)

Change %

1/ 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: Bloomberg
In Mexico, economic rebound has not consolidated

Mexico: GDP growth
% change, s.a.

s.a. / Seasonally adjusted
Source: Own calculations with data from INEGI
In 3Q14, most sectors decelerated

Key real GDP components
2008 = 100; s.a.

s.a. / Seasonally adjusted
*/ Estimation based on October-November industrial production
Source: INEGI
Although strong external demand, mainly from the U.S., continued to support manufacturing exports

Manufacturing exports
U.S. dollar value; 2008 = 100; s.a.

s.a. / Seasonally adjusted
*/ Estimation based on October-November
Source: Banco de México
.... growth in domestic spending, especially in private consumption, has softened

Real private consumption and investment
2008 = 100, s.a.

s. a. / Seasonally adjusted
Source: INEGI
Despite some improvement, consumer and producer confidence remain relatively weak

Confidence indicators
Quarterly averages, 2008 = 100, s.a.

s.a. / Seasonally adjusted
Source: INEGI and Banco de México
Labor market yardsticks imply that informality is on a slight decline

Total and formal employment

2008 = 100

1/ Quarterly averages
* / October-November
Source: Banco de México with data from IMSS and INEGI
However, unemployment is falling rather slowly

Unemployment
Quarterly averages, %, s.a.

s.a. / Seasonally adjusted
*/ October-November
Source: INEGI
The weakening of the Mexican peso largely reflects global factors such as the U.S. economy and oil prices.

Exchange rates
January 2 2013=100

Mexican peso vs. U.S. dollar
Emerging-economy currencies excl. MXN vs. U.S. dollar
DXY

Depreciation

1/ Brazil, Chile, Colombia, Poland, Czech Rep., Turkey, Russia, India, South Korea, Indonesia, and Thailand
2/ 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: Bloomberg
The FX adjustment has been orderly with highly liquid markets

Peso-Dollar trade volume and spreads
Millions of dollars and MXN cents

Volume of spot and forward transactions in the local MXN-USD market (left axis)
Interbank bid-ask spread

Source: Reuters and Banco de México
The derivative markets have allowed investors to hedge FX risks

Speculative position in the peso-dollar IMM futures market

Millions of U.S. dollars

Source: Banco de México and Chicago Mercantile Exchange
The share of peso-denominated government bond holdings by nonresidents has recently risen

Emerging economies: Foreign holdings of local government bonds
Share in total local-currency government debt outstanding, %

1/ Federal government debt issued in the domestic market, in local currency. Emerging markets excluding Mexico include Brazil, Colombia, Hungary, Indonesia, Malaysia, Peru, Poland, Russia, Thailand, Turkey, Israel, and South Africa.
Source: Selected countries’ central banks and finance ministries.
Investors’ preference for peso-denominated bonds has contributed to a flattening of the yield curve.

Mexico: Government securities yield curve

Source: Banco de México
However, adverse spillovers from factors unassociated with fundamentals continue to pose risk for Mexico

- Uncertainty on the pace of U.S. monetary normalization still looms
- How markets will react to policy news is unpredictable
- Long positions in fixed-income assets are bound to result in losses for investors as yields in advanced economies normalize
- Authorities must remain alert to domestic financial risks
Eventually, higher U.S. rates will most probably affect Mexican interest rates

10-year government bond interest rate

%  

Mexico
United States

* Average up to January 9
Source: Proveedor Integral de Precios (PiP) and the Federal Reserve
Mexico, along with the U.S., should see a gradual economic recovery this and next year

### GDP growth forecasts

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<th>2014</th>
<th>2015</th>
<th>2016</th>
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<td><strong>U.S. Blue Chip</strong></td>
<td>2.3</td>
<td>3.2</td>
<td>2.9</td>
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<tr>
<td><strong>Mexico Blue Chip</strong></td>
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<td><strong>Mexico Banxico</strong></td>
<td>2.0 – 2.5</td>
<td>3.0 – 4.0</td>
<td>3.2 – 4.2</td>
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Source: *Blue Chip Economic Indicators*, December 2014 and January 2015, and Banco de México (2014), *Quarterly Report, July-September 2014, Summary*, November
There are significant downward risks to this growth scenario

- **Upside**
  - Stronger U.S. economic recovery
  - Higher-than-expected results from structural reforms

- **Downside**
  - Consumer and producer confidence may remain stagnant
  - Social unrest may have a negative impact on economic activity
  - Oil production and prices could continue declining
In the context of weak economic activity, monetary accommodation has increased.

Mexico: Monetary policy rate

%
Inflationary pressures have recently arisen from core and noncore components

Annual inflation

Source: INEGI
Several factors will likely lower annual inflation in the short term

- Favorable base tax effects
- Lower gasoline price adjustment
- Elimination of national long-distance phone charges
The Bank of Mexico expects inflation in 2015 to approach the 3 percent permanent target.

Annual headline inflation\(^1\)

\(^1\) Quarterly average, annual headline inflation

Source: Banco de México (2014), *Quarterly Report, July-September 2014, Summary*, November
Inflation risks should be carefully monitored to attain convergence to the permanent target

- Weaker peso for a prolonged period of time
  - Despite low pass-through in recent years, significant currency depreciation may have an impact on inflation
- Renewed substantial rises in noncore price components
- Eventual aggregate demand pressures
Concluding remarks

- The U.S. economic recovery has continued to gain momentum, which could be enhanced by low oil prices
- International financial volatility may continue
- Mexico should face external uncertainty by strengthening its economic fundamentals
- A gradual recovery is forecast for the Mexican economy
- Inflation risks should be carefully monitored to channel inflation to its permanent target
Mejorar las perspectivas económicas mundiales