Mexico: Economic integration, challenges and outlook
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United States-Mexico Chamber of Commerce, Los Angeles
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1 Economic integration with the U.S.

2 Growth and financial developments

3 Monetary policy and inflation
Mexico is increasingly integrated with the United States¹

- Highly dynamic bilateral exports and imports
- Significant FDI and technology transfers
- Substantial remittances
- Benefits on both sides of the border
  - Business and job creation
  - Wider and better consumer choices
  - Higher living standards

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California and Mexico have long been important trade partners

California and Mexico: Merchandise trade

Billions of dollars

- Exports from Mexico to California (red line)
- Exports from California to Mexico (blue line)

Source: U.S. Department of Commerce
Perhaps there is no better indicator of binational economic ties than industrial integration

The United States and Mexico: Industrial and manufacturing production
YoY % change, s.a.

s.a. / Seasonally adjusted
*/ Data until 2Q16, with Mexican manufacturing in that period based on the April-May average
Source: INEGI and the U.S. Federal Reserve
Structural reforms undertaken by Mexico have opened up broad mutual opportunities¹

- Hiring and firing flexibility should benefit labor productivity
- Wider and cheaper access to telecoms services is already resulting from the entrance of new players
- The unprecedented opening of the energy sector to private investment will yield lower key input prices
- An enhanced rule of law, better public security, and improved physical infrastructure could further leverage the positives

¹/ For an online progress report of Mexico’s structural reforms, see Presidencia de la República, Reformas en Acción, [http://reformas.gob.mx/](http://reformas.gob.mx/)
Since 2014, Mexico has grown at close to historically average rates, with a dip in 2Q16

Mexico: GDP

\[ \text{% s.a.} \]

Quarterly annualized change

Annual change

Source: INEGI

Since 2014, Mexico has grown at close to historically average rates, with a dip in 2Q16.

Source: INEGI
In the past two and a half years, an expanding services sector has been offset by slowing industrial production.

Mexico: GDP
Annual % change, s.a.

- Industry
- Services

s.a. / Seasonally adjusted
*/ Based on April-May IGAE average
Source: INEGI
Softer Mexican industry has been affected by two shocks: a contraction in oil extraction ...

Mexico: Mining and oil production

Annual % change, s.a.

s.a. / Seasonally adjusted
*/ Mining production is based on April-May IGAE
Source: INEGI
and decelerating U.S. industrial production

The United States and Mexico: Industrial and manufacturing production
YoY % change, s.a.

s.a. / Seasonally adjusted
*/ Mexican manufacturing is based on the April-May average
Source: INEGI and the U.S. Federal Reserve
Consistent with this picture, manufacturing exports to the U.S. have fallen

Mexico: U.S. dollar value of manufacturing exports
Annual % change, s.a.

-2.3

-6.5

s.a. / Seasonally adjusted. Source: Banco de México with data from the Ministry of Finance (SAT), Ministry of Economy (SE), Banco de México, INEGI. Merchandise Trade Balance. SNIEG. Information of National Interest
Mexican exports to the U.S. respond more to manufacturing output there than to the bilateral real exchange rate...

The United States and Mexico: U.S. manufacturing output and bilateral RER

Annual % change, s.a.

s.a. / Seasonally adjusted
Source: Banco de México
although peso competitiveness may have contributed to a higher proportion of Mexican exports in the U.S. market

Mexico: Nonoil exports
% of U.S. nonoil imports, s.a.

s.a. / Seasonally adjusted
Source: Own calculations with data from the United States Department of Commerce
Private consumption has been a driver of recent economic expansion

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

s.a. / Seasonally adjusted
*/ Based on April-May data
Source: INEGI
This performance coincides with better labor market indicators

Mexico: Unemployment and labor force participation

% of EAP and % of population, s.a.¹

1/ EAP = Economically active population. Measures based on 15-year-old and older population s.a. / Seasonally adjusted. Source: INEGI
... as well as an upturn in remittances and consumer lending

Mexico: Remittances and consumer lending
Annual % change, s.a.

![Graph showing remittances and consumer lending trends from Q1 2012 to Q4 2016. The graph indicates an upturn in both remittances and consumer lending.]

s.a. / Seasonally adjusted
Source: Banco de México
In contrast, investment has stumbled

Mexico: Investment and capital imports
Annual % change, s.a.

s.a. / Seasonally adjusted. */ Gross fixed investment is based on April-May average
Source: INEGI and Ministry of Finance (SAT), Ministry of Economy (SE), Banco de México, INEGI. Merchandise Trade Balance. SNIEG. Information of National Interest
Forward-looking indicators of economic activity have deteriorated

Mexico: Purchasing Managers’ Indexes\(^1\)

1/ Adjusted by company size
\(^*\)/ Only July
Source: IMEF
Along with the U.S., Mexico is expected to experience a transitory deceleration in 2016

### The United States and Mexico: GDP forecasts

**Annual % change, average**

<table>
<thead>
<tr>
<th></th>
<th>2015&lt;sup&gt;1&lt;/sup&gt;</th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>The United States</td>
<td>2.4</td>
<td>1.9</td>
<td>2.2</td>
</tr>
<tr>
<td>Mexico</td>
<td>2.5</td>
<td>2.3</td>
<td>2.6</td>
</tr>
</tbody>
</table>

<sup>1/ Observed</sup>

Source: Consensus Forecasts and Latin American Consensus Forecasts, July 2016
Mexico’s short-term growth scenario faces risks

- A greater slowdown in U.S. imports and industrial production
- Deterioration in consumer and producer confidence
- A larger-than-expected fall in crude oil output
- Potentially greater financial volatility, yielding restrictions on financing possibilities
- To the upside, recent structural reforms could begin to yield more benefits
In 2016, the Mexican peso has depreciated more than other EME currencies

Dollar in peso terms vs. dollar in terms of a basket of EME currencies\(^1\)

January 1, 2015 = 1, 30-day moving average

1/ Basket based on JP Morgan Index of emerging-market currencies, which includes Brazil, Chile, Mexico, Hungary, South Africa, Turkey, Russia, China, India and Singapore

*/ To August 1. Source: Banco de México with data from Bloomberg
Exacerbated peso depreciation may stem from several factors

- The role of the Mexican peso as an international hedge mechanism\(^1\)
- A weakened fiscal position
  - Longstanding rising trend of the historic balance of public-sector borrowing requirements over GDP
  - Drastic reduction of Pemex net oil export revenues
- Geopolitical jitters

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A stronger fiscal stance is necessary given increasing public debt

**Mexico: Public debt¹**

% of GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>Public debt of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>32.9</td>
</tr>
<tr>
<td>2009</td>
<td>34.3</td>
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<tr>
<td>2010</td>
<td>34.4</td>
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<td>2011</td>
<td>34.9</td>
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<td>2013</td>
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<tr>
<td>2014</td>
<td>41.4</td>
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<tr>
<td>2015</td>
<td>45.7</td>
</tr>
<tr>
<td><em>2016</em></td>
<td>46.9</td>
</tr>
</tbody>
</table>

¹/ Historic balance of public-sector borrowing requirements. */ To June

... and worsening Pemex finances, which have a bearing on the current account

Pemex sales revenue and budgetary expenditure
First half for each year, billions of 2015 pesos

1/ Revenue from net foreign and domestic sales, minus taxes paid by Pemex. Excludes various sources of income, such as federal government transfers
Source: Own calculations with data from SHCP
Holdings of peso government securities by nonresidents have fallen lately, driven by drops in those of short maturities.

Mexico: NR peso-denominated government securities holdings

Billions of pesos

1/ Zero coupon bonds, coupon bonds, and inflation-linked bonds

* / To July 27

Source: Banco de México
Further bouts of international financial volatility could easily occur

- In the wake of Brexit, deeper monetary accommodation is foreseen in most developed countries
  - Rising leverage worldwide\(^1\)
  - Increasing proportions of debt with negative yields in advanced nations
- European banks face fragile financial conditions
- Concerns persist on Chinese economic health and policy interventions

\(^1\) See BIS (2016). *BIS Statistical Bulletin*, June
Since last year, annual inflation has remained moderate, largely supported by unusually low noncore inflation.
The rising path of core inflation reflects the effect of the exchange rate on tradable goods prices

Annual core inflation

%
An accelerating rise in the producer price index also reveals an impact from peso depreciation
Medium-term inflation expectations as measured by analysts’ surveys have remained relatively stable, albeit above the target.
Also, market-derived expectations appear to show a recent spike

Compensation for inflation and inflation risk implicit in bonds

%

* To August 2
Source: Own calculations with data from PiP
Policy interest rate hikes have sought to avert deviations of inflation expectations and to anchor them on the target

**Policy overnight interest rate**

Source: Banco de México
The resulting flattening of the yield curve seems to reflect confidence that inflation will continue to be contained.

**Mexico: Government securities yield curve**

<table>
<thead>
<tr>
<th>Period</th>
<th>November 30, 2015</th>
<th>August 5, 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-day</td>
<td></td>
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<td>1-month</td>
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<tr>
<td>30-year</td>
<td></td>
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</tr>
</tbody>
</table>

Source: Banco de México
Some risks to the consolidation of convergence of inflation to the 3 percent permanent target prevail

- The most notable danger is more weakening of the peso with a generalized impact on prices, knocking inflation expectations off track
- Rises in noncore prices could accelerate, returning to historic rates, possibly producing second-round price effects
- Aggregate demand pressures could surface
Conclusions

- Mexico and the United States have benefited from increased economic integration
- Mexican economic activity has recently decelerated and confronts downside risks
- In a context of greater risk aversion, which could become exacerbated by geopolitical events, the fiscal stance should be fortified
- Monetary policy should continue to employ complete flexibility in order to consolidate the convergence of inflation to the target
Mejorar las perspectivas económicas mundiales