The Mexican Economy: Tackling the problems
Manuel Sánchez
Bank of Japan, Tokyo, March 31, 2015
1  The problem of long-term growth

2  Two short-term challenges

3  The economic outlook
Despite the modernization of the last few decades, Mexico’s long-term economic performance has been less than stellar.

GDP per capita at chained PPPs\(^1\)
2005 U.S. dollars

1/ GDP per capita at current dollars in 2014 was US$10,837
Source: Penn World Table 8.0
The key problem is stagnant total factor productivity

Mexico: Growth accounting from 1981 to 2013\textsuperscript{1,2}

Annual average \% change

Working-age population as \% of the total: 0.70
Hours worked as \% of working-age population: 0.03
Contribution to capital: 0.65
Total factor productivity: -0.51
GDP per capita: 0.81

2/ Sums might not be equivalent to totals due to rounding
Mexico has undertaken an ample reform agenda in the aim of tackling this problem

- Reforms encompass many sectors, including
  - Labor
  - Education
  - Financial system
  - Telecommunications
  - Energy

- The general objective is to promote greater market flexibility, investment in both human and physical capital, and competition
The telecoms reform seeks to widen access to services at lower prices

- FDI caps have been lowered, operators can now offer a broad basket of services, and two new national digital TV networks are in the works
- Customer mobility is facilitated across telecoms operators
- A price restriction is imposed on all telephony operators in the elimination of national long distance fees
- An asymmetric regime applies to dominant telecoms and broadcasting players in order to level the playing field
- The reform has yielded benefits, with an already declining trend in relative telecoms prices deeper, and greater variety in packages offered
The energy reform allows private participation in virtually all aspects of the sector

- Contracts to govern upstream oil and gas activities, and permits to be granted for middle and downstream undertakings
- Permits conceded to generate, sell and import electricity
- Recent progress:
  - Two auctions announced for oil exploration and extraction
  - Two contracts awarded to deliver gas in private pipelines
  - The first permit granted to import electricity connected to the National Electric System
- Investment, production efficiency and lower domestic energy prices are expected
Deep-seated results from the reforms require fundamental conditions

- Good-quality implementation in the sense of actually producing greater market flexibility, investment and effective competition

- Complementary policies
  - A strengthened rule of law
  - Further investments made in physical infrastructure
  - Enhanced public security
Contents

1. The problem of long-term growth
2. Two short-term challenges
3. The economic outlook
The first challenge comes from lower oil prices and declining production

**Mexico: Price for the Mexican oil mix and crude production**

Dollars per barrel, 3-month moving average; millions of barrels on a daily basis, trend

Source: Bloomberg and INEGI
... which have weakened the public-sector financial position

Mexico: Oil-related public revenues

Source: Haver Analytics
The government has sent investors a sign of fiscal responsibility

- Proactive spending cuts announced amounting to 0.7 percent of GDP
- Austerity measures taken across government ministries and the state oil and electricity companies
- Some investment projects cancelled or postponed
- The above despite the fact 2015 budgeted oil revenue is almost fully hedged
Although still important for the government, oil accounts for a declining share of Mexico’s total exports and output.

### Mexican oil indicators

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2014</th>
<th>2015*</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Mexican oil mix price</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dollars per barrel, daily average</td>
<td>31.1</td>
<td>87.7</td>
<td>43.0</td>
</tr>
<tr>
<td><strong>Oil production</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Million of barrels per day, average</td>
<td>3.4</td>
<td>2.4</td>
<td>2.3</td>
</tr>
<tr>
<td><strong>Oil and gas extraction</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>% of GDP</td>
<td>9.1</td>
<td>5.9</td>
<td>n.a.</td>
</tr>
<tr>
<td><strong>Oil exports</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>% of total exports</td>
<td>12.6</td>
<td>10.8</td>
<td>7.3</td>
</tr>
<tr>
<td><strong>Oil trade balance</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Millions of dollars</td>
<td>12,434</td>
<td>1,489</td>
<td>-1,423</td>
</tr>
</tbody>
</table>

*/ January-February, except oil production, which is to January
Source: Banco de México, Haver Analytics and INEGI
The second challenge stems from future U.S. monetary normalization, the pace of which remains highly uncertain.

Federal Reserve: Implied forward overnight rate and FOMC fed funds rate forecasts

1/ As of March 20, 2015
Source: Bloomberg with calculations by Banco de México
The Mexican peso has been hit by international volatility mainly reflecting broad dollar strength.

Mexico: Changes in MXN/USD rate explained by oil prices and the U.S. dollar

1/ The 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: Own calculations based on a first difference of logarithms linear regression with Bloomberg data
The yield curve has shifted upward, largely along with that of the United States

Government securities yield curve¹

1/ Solid line, April 30, 2013. Dotted line, March 27, 2015
Source: Banco de México and U.S. Treasury
Although nonresident holdings of peso government securities have continued to rise, future portfolio adjustments cannot be ruled out out.

Nonresident holdings of peso-denominated government securities

<table>
<thead>
<tr>
<th>Months</th>
<th>Billions of Pesos</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ene.-12</td>
<td>1,000</td>
</tr>
<tr>
<td>Mar.-12</td>
<td>1,250</td>
</tr>
<tr>
<td>May.-12</td>
<td>1,500</td>
</tr>
<tr>
<td>Jul.-12</td>
<td>1,750</td>
</tr>
<tr>
<td>Sep.-12</td>
<td>2,000</td>
</tr>
<tr>
<td>Nov.-12</td>
<td>2,250</td>
</tr>
<tr>
<td>Ene.-13</td>
<td>1,000</td>
</tr>
<tr>
<td>Mar.-13</td>
<td>1,250</td>
</tr>
<tr>
<td>May.-13</td>
<td>1,500</td>
</tr>
<tr>
<td>Jul.-13</td>
<td>1,750</td>
</tr>
<tr>
<td>Sep.-13</td>
<td>2,000</td>
</tr>
<tr>
<td>Nov.-13</td>
<td>2,250</td>
</tr>
<tr>
<td>Ene.-14</td>
<td>1,000</td>
</tr>
<tr>
<td>Mar.-14</td>
<td>1,250</td>
</tr>
<tr>
<td>May.-14</td>
<td>1,500</td>
</tr>
<tr>
<td>Jul.-14</td>
<td>1,750</td>
</tr>
<tr>
<td>Sep.-14</td>
<td>2,000</td>
</tr>
<tr>
<td>Nov.-14</td>
<td>2,250</td>
</tr>
<tr>
<td>Ene.-15</td>
<td>1,000</td>
</tr>
</tbody>
</table>

1/ Cetes, Bondes D, Bonos and Udibonos
Source: Banco de México
Contents

1. The problem of long-term growth

2. Two short-term challenges

3. The economic outlook
In Mexico, economic activity has begun to gain some steam

**Mexico: GDP growth**

*Annual % change, trend*

<table>
<thead>
<tr>
<th>Year</th>
<th>Q1</th>
<th>Q3</th>
<th>Q1</th>
<th>Q3</th>
<th>Q1</th>
<th>Q3</th>
<th>Q1</th>
<th>Q3</th>
<th>Q1</th>
<th>Q3</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2010</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2011</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: INEGI
The current upturn has been driven largely by external demand.

**Mexico: Aggregate demand**

Annual % change, trend

Source: INEGI
An important source of impetus has come from manufacturing exports to the U.S., which have recently weakened due to temporary factors.

Mexico: Manufacturing exports
2008=100; s.a.

* Estimated on the basis of January and February data
s.a. / Seasonally adjusted
Source: Banco de México
Going forward, Mexico should benefit from a stronger U.S. economy

**U.S. and Mexican GDP forecasts**

<table>
<thead>
<tr>
<th></th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Blue Chip</td>
<td>2.3</td>
<td>3.1</td>
<td>2.9</td>
</tr>
<tr>
<td>Mexico Blue Chip</td>
<td>2.1</td>
<td>3.1</td>
<td>3.7</td>
</tr>
<tr>
<td>Mexico Banxico</td>
<td>2.1</td>
<td>2.5 – 3.5</td>
<td>2.9 – 3.9</td>
</tr>
</tbody>
</table>

However, the growth scenario faces some risks

- To the downside
  - Consumer and producer confidence potentially remaining stagnant
  - The risk of a negative impact on economic activity from social unrest
  - Possibly continuing declines in oil production and prices

- To the upside
  - Stronger-than-foreseen U.S. economic recovery
  - Greater-than-expected push from structural reforms
In the wake of soft economic activity, Mexico’s monetary policy accommodation increased.

Mexico: Monetary policy rate

Source: Banco de México
After an off-track period reflecting mainly noncore components, inflation has returned to a path toward the 3 percent permanent target.

**Annual inflation**

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

**Source:** INEGI

**First half of March**

**Target**
In this context, inflation risks should be carefully monitored to consolidate convergence to the target

- **Risks**
  - Despite low pass-through in recent years, substantial currency depreciation may have a wide impact on inflation
  - Renewed substantial rises in noncore price components
  - Eventual aggregate demand pressures

- **Challenges**
  - Relative monetary stance vis-à-vis the United States
  - Analysts’ long-term inflation expectations remain above the target
Concluding remarks

- Mexico has undertaken an ample reform agenda to tackle the problem of low productivity growth

- Success depends on the degree the reforms actually bring about market flexibility, investment, and effective competition

- In the short term, financial challenges stem from lower oil prices and upcoming U.S. monetary normalization

- Further bouts of volatility may occur, and thus authorities must remain on alert

- The Mexican economic recovery is picking up steam, although there are risks to the growth scenario

- Inflation risks should be carefully monitored to make convergence to the target a permanent phenomenon
Mejoran las perspectivas económicas mundiales