Regional Economic Report
January – March 2019
Summary

During the first quarter of 2019, economic activity in Mexico contracted as compared to the previous quarter, deepening the weakness observed in late 2018. This evolution was due to both the moderation of the global economic rate of growth and a greater weakness of domestic demand, which heightened due to certain transitory factors that took place at different moments of the reported period, such as the fuel shortage, the blocking of railways in Michoacán and labor conflicts in Tamaulipas. In particular, manufacturing exports continued to decelerate during the first quarter of 2019. Nevertheless, despite the recovery of investment in January 2019 due to exclusively the performance of some components, for the remainder of the quarter it is expected to have remained weak. Since late 2018 and early 2019, private consumption has registered an unfavorable performance as a result of both a slowdown of services consumption and a weak consumption of goods. Regarding production, the decline of economic activity reflected both the contraction of the secondary and tertiary sectors. In contrast, primary activities expanded as compared to the previous quarter. As for industrial activity, manufacturing remained weak, while construction maintained a negative trajectory as it had been registering during most of 2018. In the same vein, the mining sector continued trending downwards.

The weakness of the Mexican economy was reflected in all regions.[1] Indeed, in the Central regions and in the South economic activity is expected to have contracted during the first quarter of 2019, while in the North it decelerated. The weak performance of manufacturing, the mining sector and tourism across all regions, except for the Northern region in the case of manufacturing and of the Central regions regarding the mining industry, contributed to such evolution. There was also a decline in retail trade in the Central region and a fall in the construction sector in the North-Central region.

During the period January – March 2019, average annual headline inflation declined as compared to the last quarter of 2018, just as anticipated, while core inflation lied slightly above expected figures. Indeed, the decrease in annual headline inflation was mainly caused by the fall in its non-core component. On the other hand, core inflation remained above 3.50%, it rose in April, even after controlling for seasonal effects, and within it, the price variations of different services and food merchandise were adjusted upwards. The decline in non-core inflation was largely related to the lower growth of energy prices, while certain fuel prices were adjusted at a lower rate than their international references. However, this behavior reverted in the second half of February 2019, putting non-core inflation under pressure once again. Core inflation has shown a resistance to decline, while risks associated to its performance continue to be perceived. These are related to certain inputs, such as commodity prices and wage increases, which could generate cost pressures.

The evolution of headline inflation at the national level was mirrored across all Mexican states. Indeed, between the last quarter of 2018 and the first quarter of 2019, average annual inflation registered low levels in all regions. These declines were largely due to the lower levels of non-core inflation in the four regions, as a result of lower increases in agricultural and livestock products' prices, especially in the center, and in energy prices. This was especially notable in the North, given that consumer energy prices in the border strip reflect more strongly their international references by being in line with the prices of their neighbor cities in the U.S. and where the VAT rate of 16% was reduced to 8%. Nevertheless, as stated above, higher energy prices began to be observed starting from the second half of

[1] Regionalization: Northern region includes Baja California, Chihuahua, Coahuila, Nuevo León, Sonora and Tamaulipas; North-Central region considers Aguascalientes, Baja California Sur, Colima, Durango, Jalisco, Michoacán, Nayarit, San Luis Potosí, Sinaloa and Zacatecas; Central region consists of Ciudad de México, Estado de México, Guanajuato, Hidalgo, Morelos, Puebla, Querétaro and Tlaxcala; and Southern region includes, Campeche, Chiapas, Guerrero, Oaxaca, Quintana Roo, Tabasco, Veracruz and Yucatán.

February, putting upward pressure on non-core inflation in all regions. In the case of gasoline, this effect was mitigated due to the federal government adjustments in the fiscal stimulus applied to this fuel, aimed at preventing gasoline from having increments in real terms with respect to the level observed as of November 30, 2018. Average annual core inflation declined between the last quarter of 2018 and the first one of 2019 across all regions. However, during such period this indicator was pressured by increases in merchandise and services' prices. As a result, in May, core inflation in all regions registered its highest level in 2019, except for April, when it spiked influenced by the Easter holiday.

Business agents interviewed in the four regions for this Report anticipate the demand for own goods and services to grow in the following twelve months. Nevertheless, this signal was weaker than during the previous quarter across all regions. Consistent with such developments, an expansion of hired personnel and physical capital are also anticipated, although for these two indicators the signal weakened with respect to the previous quarter in all regions, except for the Southern region. It is important to highlight that these business contacts' interviews were conducted prior to the US government's announcement of its intention to impose higher tariffs on Mexican imports and to Fitch and Moody's downgrading of Mexico's credit rating and reviewing the outlook for the country's sovereign debt to negative, respectively.

Interviewed business agents identified the following risks to regional economic activity. Some of the downward risks are: i) that public insecurity levels increase; ii) that the uncertainty environment (both external and domestic) faced by firms, prevails or deteriorates, and that it leads to decreased investment levels; and iii) that the process of ratifying the United States-Mexico-Canada agreement is delayed. Some of the upward risks are: i) the possibility of a prompt recovery of private investment, both national and foreign; and ii) a probable growth of public investment in infrastructure.

As for expected sales' prices of their own goods and services for the next twelve months, most interviewed business agents anticipate similar or lower annual changes as compared to last year. In line with that, most business agents interviewed in all regions expect wage costs and input prices to grow at an annual rate similar or lower than that registered in the previous twelve months.

To complement the analysis of regional economic activity, three analytical boxes are included in this Report. Box 1 indicates that a worsening of perception regarding safety conditions in Mexico among potential visitors in the U.S. negatively affects the inflow of international passengers to different travel destinations in Mexico. In addition, in the context of the Program to Boost the Financial Sector announced by the financial authorities on January 8th, which aims at attaining a greater degree of financial deepening to foster a more inclusive economic growth, Box 2 shows that indeed a greater channeling of commercial banks' financial resources to firms tends to be associated with greater economic growth in Mexico's states. Finally, Box 3 presents evidence that across all regional economies regular gasoline sales margins increased during the period when wholesale price reductions were observed by the end of last year. This implies that consumer prices did not fully mirror such reductions. In addition, it shows that sales margins increased to a greater degree in the Central and North-Central regions, followed by the Southern region, and, to a lesser degree, the Northern region.

The current environment still presents important medium- and long-term risks that could affect the performance of the country's regional economies. In this context, it is key to maintain a solid macroeconomic framework able to resist shocks in order to contribute to an environment of stability, conducive to growth. Specifically, it is key to encourage the adoption of measures to generate an environment of confidence and certainty for investment as well as higher productivity. Fostering the rule of law and fighting corruption and public insecurity in all regions of Mexico is equally imperative.