Regional Economic Report
October – December 2018
Summary

During the fourth quarter of 2018, Mexico's economic activity decelerated significantly vis-à-vis the previous quarter, a process that may extend to the early part of 2019. Such deceleration was influenced by the slowdown of the global economy as well as by a greater weakness of several components of domestic demand and by transitory factors. Exports, in particular, and, to a lesser extent, consumption, exhibited a lower dynamism during the reported period, while the negative trend of investment became more evident. On the production side, the decline of secondary activities stands out, as tertiary activities remained on a positive trend -albeit characterized by a slightly weaker growth at the end of the year- and primary activities rebounded, in contrast with the previous quarter. As for industrial activity, manufacturing exhibited a weak performance, after having recovered during the first half of 2018, while construction remained on the same negative trend shown since the early part of that year, and mining, quarrying, and oil and gas extraction continued on a downward trend.

The weakening of domestic economic activity during the quarter was perceived across most regions of the country.[1] Indeed, the Southern region is estimated to have contracted and the Northern and Central regions are estimated to have stagnated, after the expansion recorded in the previous quarter. These results were reflected in the fall exhibited by most sectors in these regions, except for agricultural production and mining, quarrying, and oil and gas extraction in the Northern region; and tourism, which recovered slightly, after having exhibited weak results during the previous quarter. In contrast, the North-Central region is expected to have grown at a faster rate during the reference quarter, largely due to the growth of construction, the rebound in tourism, and the positive performance of agricultural production in that region.

Average annual headline inflation fell from 4.91 to 4.82% between the third and fourth quarters of 2018, and then further to 3.94% in February. This reduction was mainly due to the lower levels of annual non-core inflation, given that annual core inflation continued showing a resistance to decline. In particular, between the above mentioned quarters, annual non-core inflation fell from an average of 8.78% to 8.32%, and then to 5.25% in February, mostly due to the lower annual growth rates of energy prices. In contrast, average annual core inflation registered 3.64 and 3.68% during the reference quarters, and attained 3.54% in February. The performance of the latter component was influenced by the magnitude and simultaneity of several shocks, among which the following stand out: the indirect effects stemming from the rising prices of several energy goods; the performance of the exchange rate and real wages during most of 2018; and the relative absence of slack conditions in the economy. Similarly, core inflation has also been affected indirectly by the price increases in some agricultural products observed since the fourth quarter of 2018, although such shocks have started to reverse in early February. In this regard, the type of shocks that have affected core inflation, together with the relatively high levels that it still exhibits, may be contributing to the greater persistence and difficulty this subindex has shown to converge to 3%.

The evolution of headline inflation was reflected in all regions of Mexico. Indeed, the lower annual rate of change of energy prices led to lower inflation in the four regions of the country, especially in the Northern region, which was driven by the price dynamics in the

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

northern border. In particular, this zone exhibited greater gasoline price reductions than other regions, which became more evident since the VAT rate reduction from 16 to 8% was implemented in the northern border on January 1, 2019, in a context where international references have decreased. Core inflation showed certain resistance to decline. It is worth noting that the Central region continued exhibiting the highest levels of inflation, largely due to factors related to demand in the services sector, in which the annual rate of change of housing prices stands out.

In addition to the fiscal stimuli implemented in the northern border, in early 2019 there were other factors that also influenced the performance of regional economies. The minimum wage level doubled in the northern border strip, while it was revised upwards from 88.4 to 102.7 pesos per day in the rest of the country. In this context, several calls to strike and demands for wage increases and bonuses spread throughout the country, with those in Matamoros, Tamaulipas standing out, partly because the collective labor agreements of several companies in that city were indexed to the minimum wage level. Similarly, there were blockades in railway lines in Michoacán by a group of teachers, which affected the transportation of inputs and merchandises in that region of the country. Finally, some central states registered fuel distribution problems, due to the strategic closing of pipelines as part of the government's efforts to fight fuel theft. In this regard, evidence shows that the impact of fuel distribution problems on headline inflation was limited; nevertheless, the interviewed business agents stated that such problems did affect economic activity in certain northern and central states.

Business agents consulted in the four regions anticipate the demand for their goods and services to increase in the following twelve months. Nevertheless, demand signals were weaker than the ones observed during the previous quarter in all regions, except for the North-Central one, where they strengthened. In line with the above, an increase in hired workforce and in physical assets is also expected, although, for both cases, the signals weakened vis-à-vis the previous quarter.

The referred interviewed business agents listed the following risks to regional economic growth. Among those to the downside, they signaled: i) that public security deteriorates; ii) that new episodes of fuel supply shortage or conflicts, such as the blocking of railway lines in Michoacán, take place or that the blockades they were already experiencing extend for a longer period; and iii) that uncertainty concerning the public policies of the new administration persists or increases, which could reduce investment to levels below the expected. Among the risks to the upside, they highlighted the following: i) that the announcements of the new trade agreement between Mexico, the U.S. and Canada contribute to reactivate investment; and ii) that the new programs and projects of the federal government are properly implemented, which would also contribute to lower the uncertainty prevailing among business agents and to boost investment.

With regard to the expected development of sales prices for the following twelve months, most interviewed business agents anticipate the sales prices of their own goods and services to grow at an annual rate lower or equal to that observed during the previous year. In line with the above, most interviewed business contacts expect their wage costs and input prices to increase at a rate similar or below the one registered during the previous twelve months. Nevertheless, regarding labor costs, except for those of the North-Central region, the percentage of business agents that anticipates a greater variation as compared to the previous quarter increased in all regions, especially in the northern border strip and in the Southern region.

To complement the analysis of regional economic activity, three analytical boxes are included. Box 1 analyzes the relations among the different sectors of the Mexican economy in order to determine groups of related industries known as clusters. It also provides empirical evidence suggesting that the number of clusters that a federal state specializes in tends to be positively related to labor productivity. Box 2 offers insight into the interregional patterns of mobility of internal skilled and non-skilled migrants in Mexico. It was found that the Central region became a more attractive destination for skilled migrants during the 2010 – 2015 period vis-à-vis the 1995 –

2000 period, partly due to the greater contribution to regional growth of the most skilled labor-intensive industries as compared to the rest of the regions. Finally, Box 3 presents business agents' outlook on the factors restricting growth of regional economic activity over the next six months and analyzes the regional differences of this outlook.

The current environment continues to exhibit significant medium- and long-terms risks that may affect the potential growth of Mexico's regional economies. Therefore, in addition to continue strengthening the macroeconomic framework, it is key to adopt measures aimed at achieving higher levels of productivity and that would generate an environment of confidence and certainty for investment. Strengthening the rule of law and tackling corruption in all regions are equally imperative.