

# The Mexican Economy: Tackling the problems

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Bank of Japan, Tokyo, March 31, 2015



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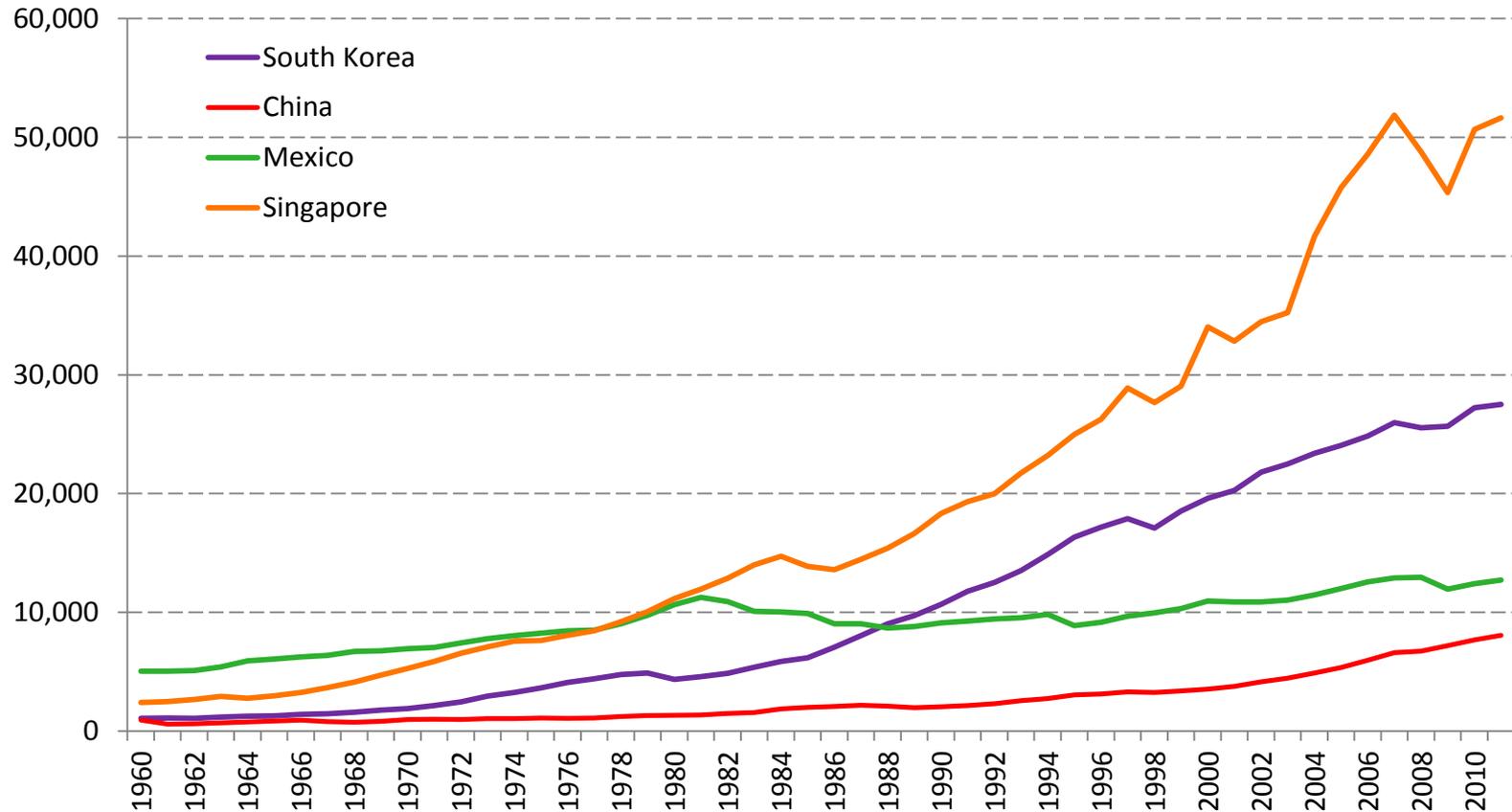
**1** The problem of long-term growth

**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<sup>1</sup>  
2005 U.S. dollars

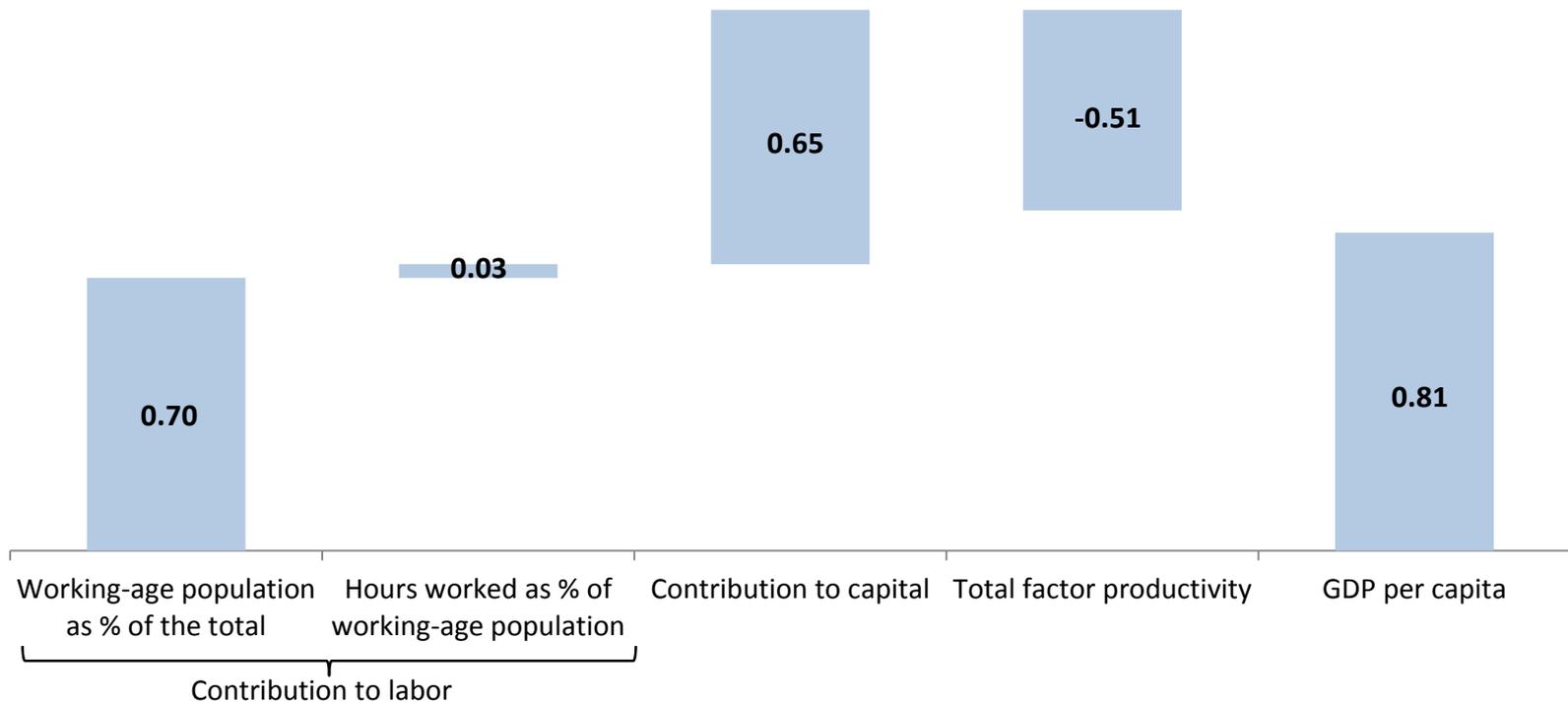


1/ GDP per capita at current dollars in 2014 was US\$10,837

Source: Penn World Table 8.0

# The key problem is stagnant total factor productivity

Mexico: Growth accounting from 1981 to 2013<sup>1,2</sup>  
Annual average % change



1/ Own calculations with data from the World Development Indicators, International Financial Statistics, Conference Board Total Economy Database and data and theory from Kehoe, T.J. and F. Meza, (2011), "Catch-up Growth Followed by Stagnation: Mexico, 1950-2010," *Latin American Journal of Economics*, 48(2)

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

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**1** The problem of long-term growth

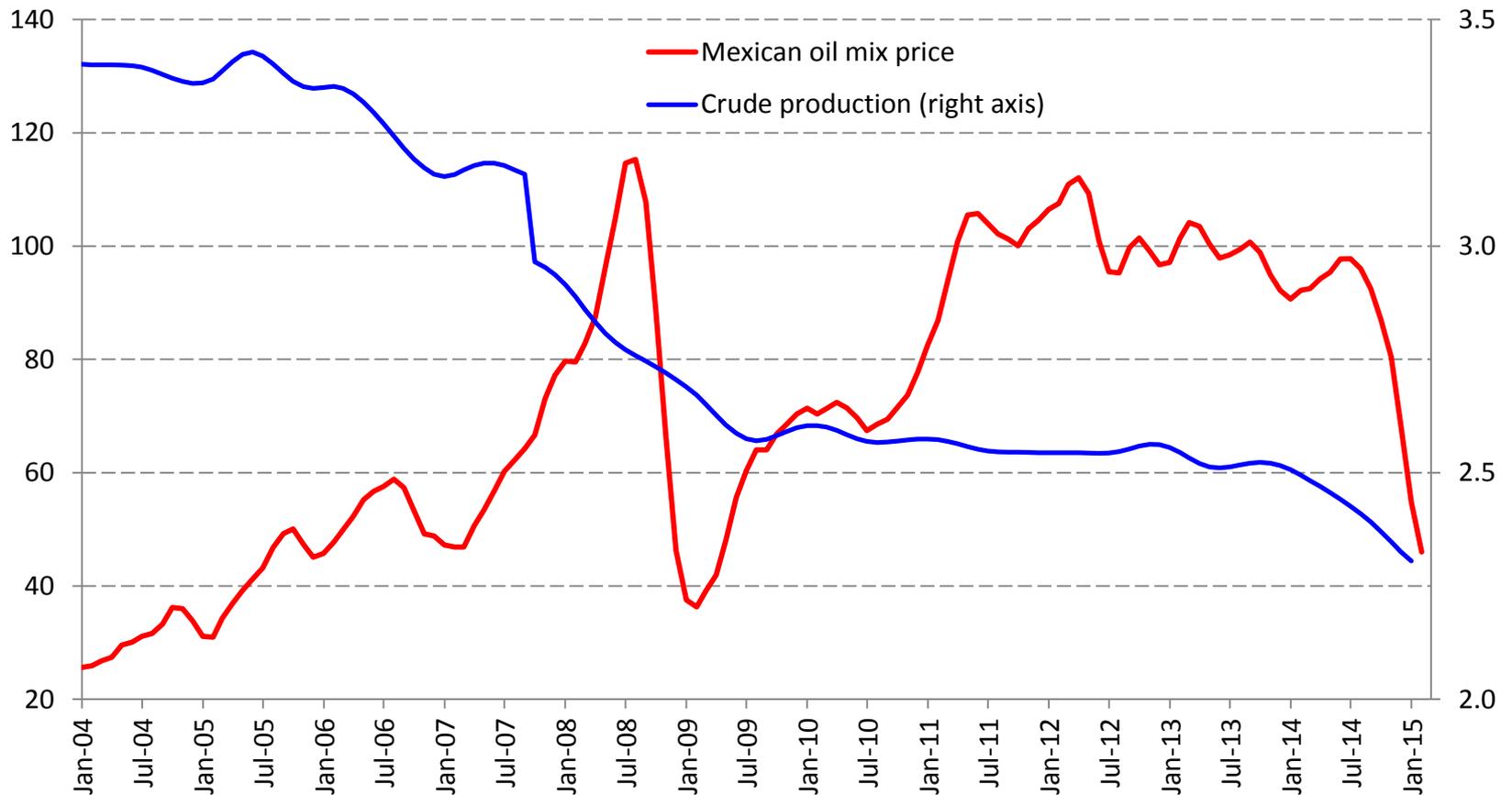
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# The first challenge comes from lower oil prices and declining production

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

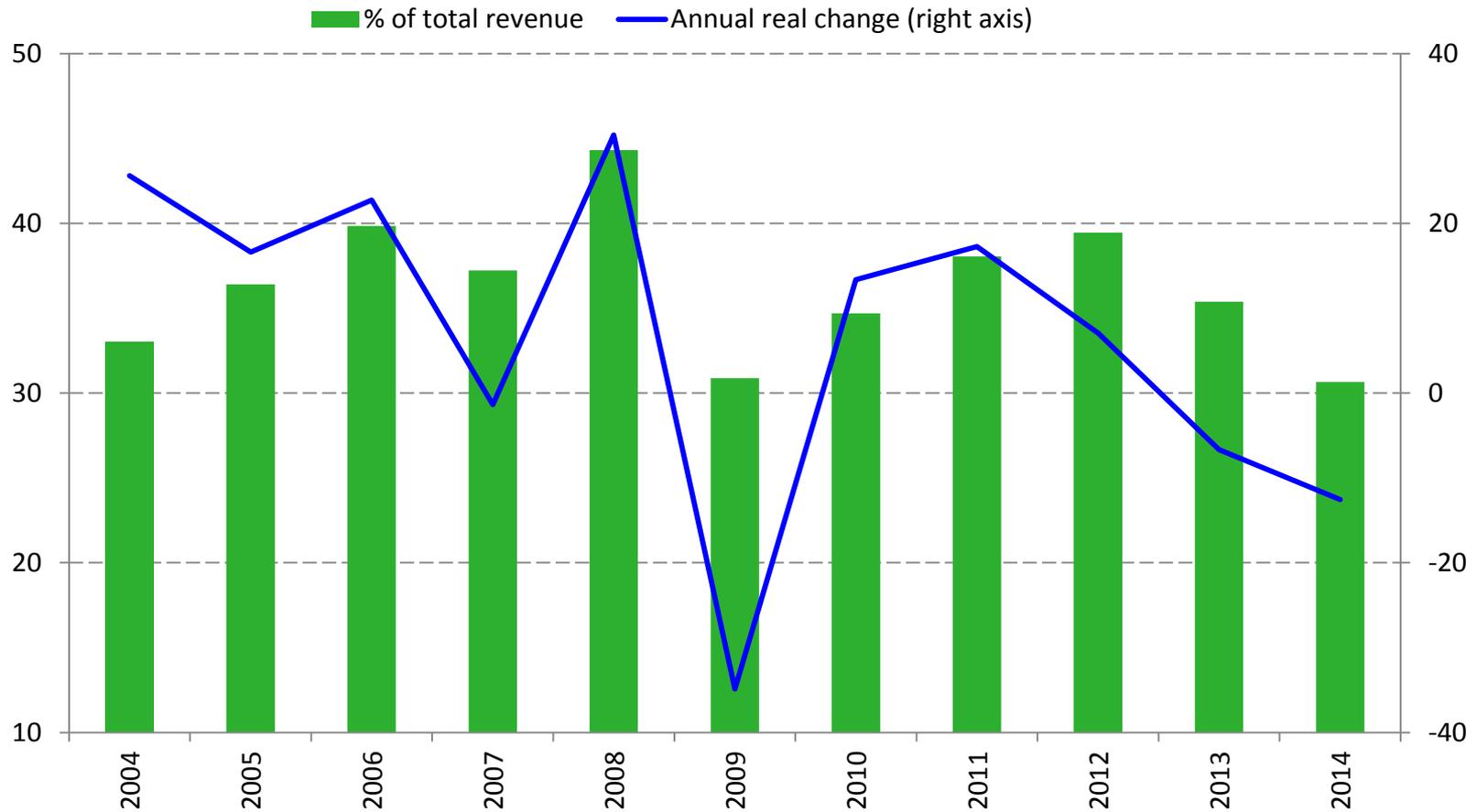
Dollars per barrel, 3-month moving average; millions of barrels on a daily basis, trend



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

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

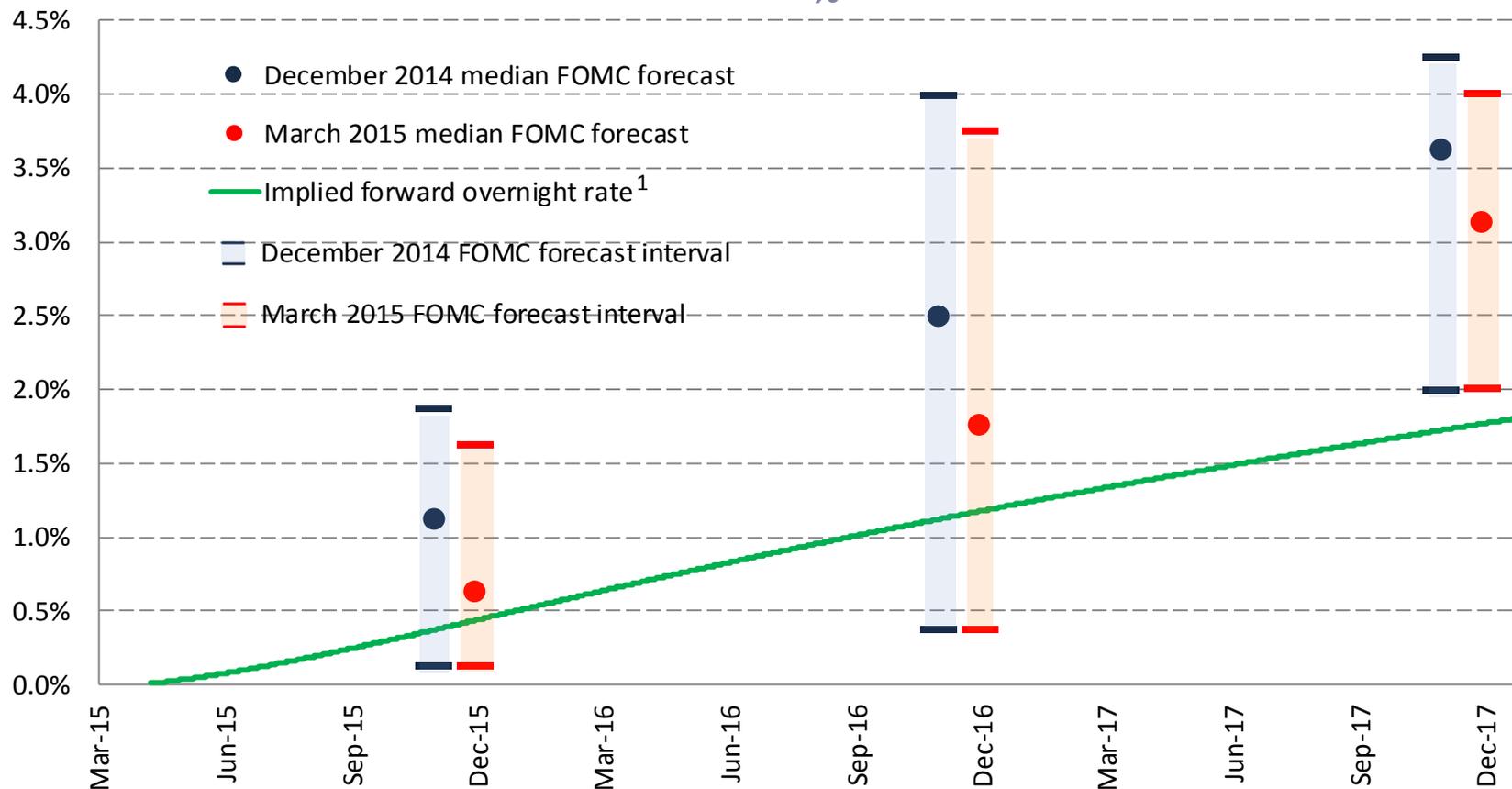
\* / January-February, except oil production, which is to January

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

%

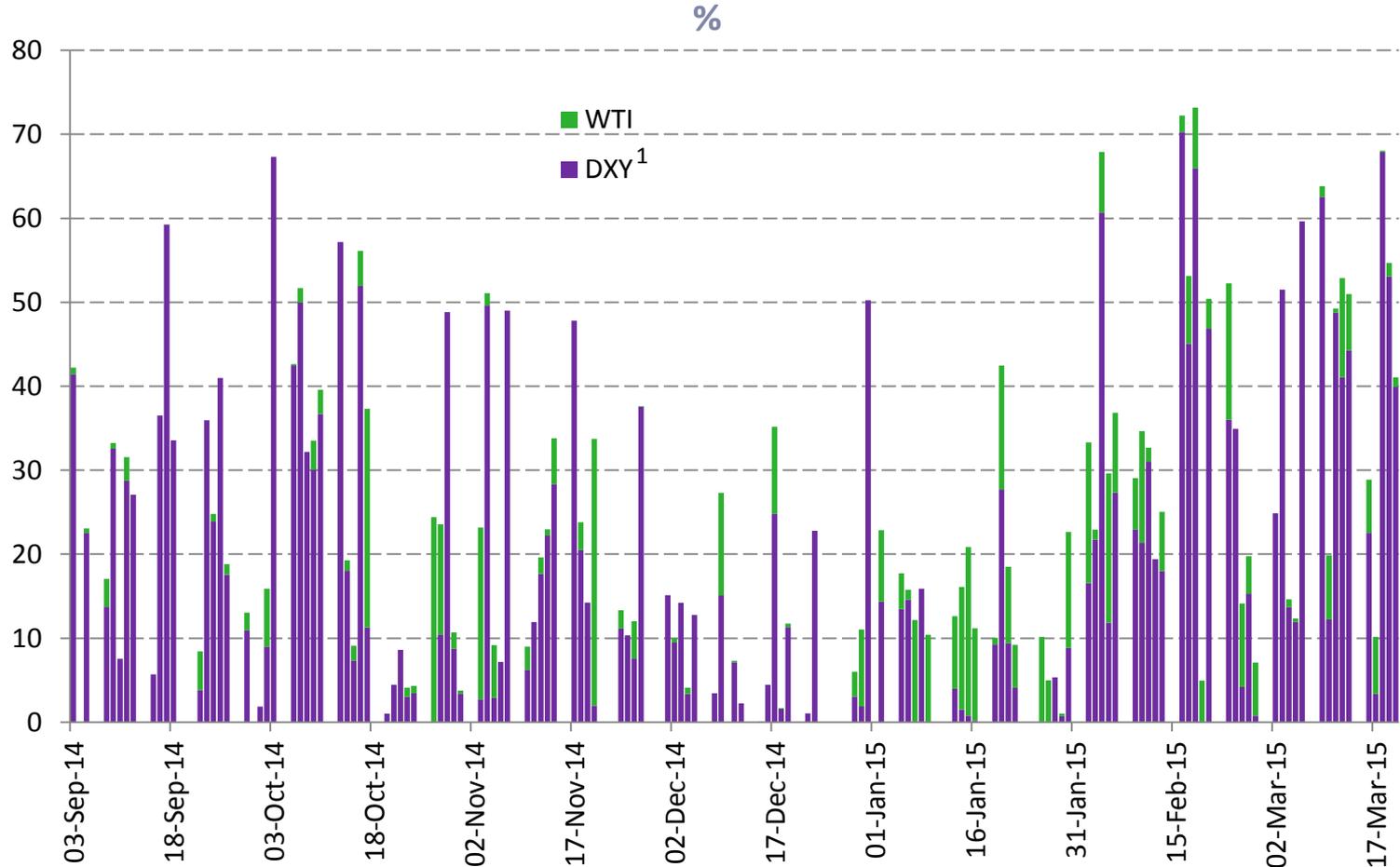


1/ As of March 20, 2015

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

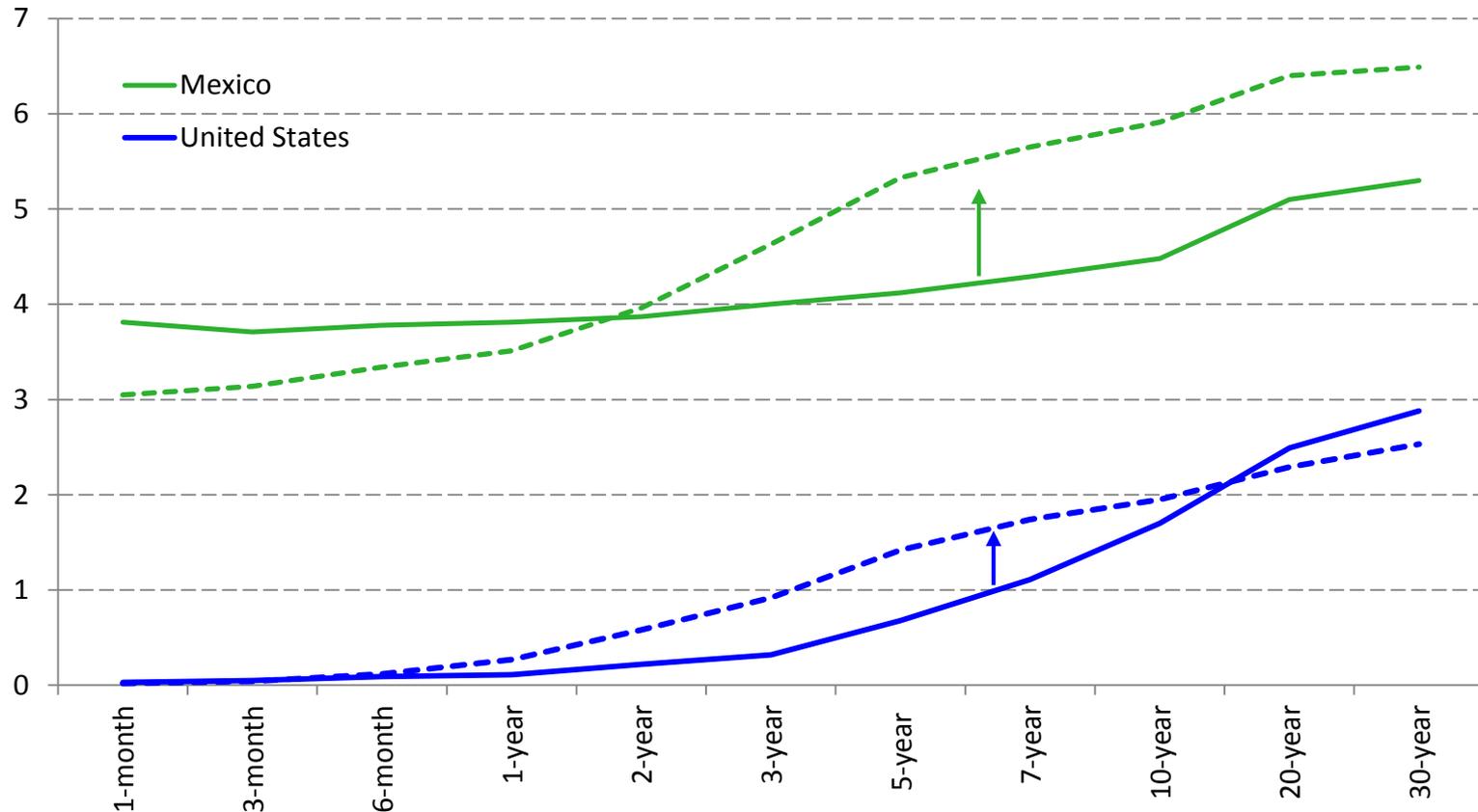


1/ The DXY is a weighted average of the dollar's value relative to the euro (57.6%), Japanese yen (13.6%), pound sterling (11.9%), Canadian dollar (9.1%), Swedish krona (4.2%), and Swiss franc (3.6%)

Source: Own calculations based on a first difference of logarithms linear regression with Bloomberg data

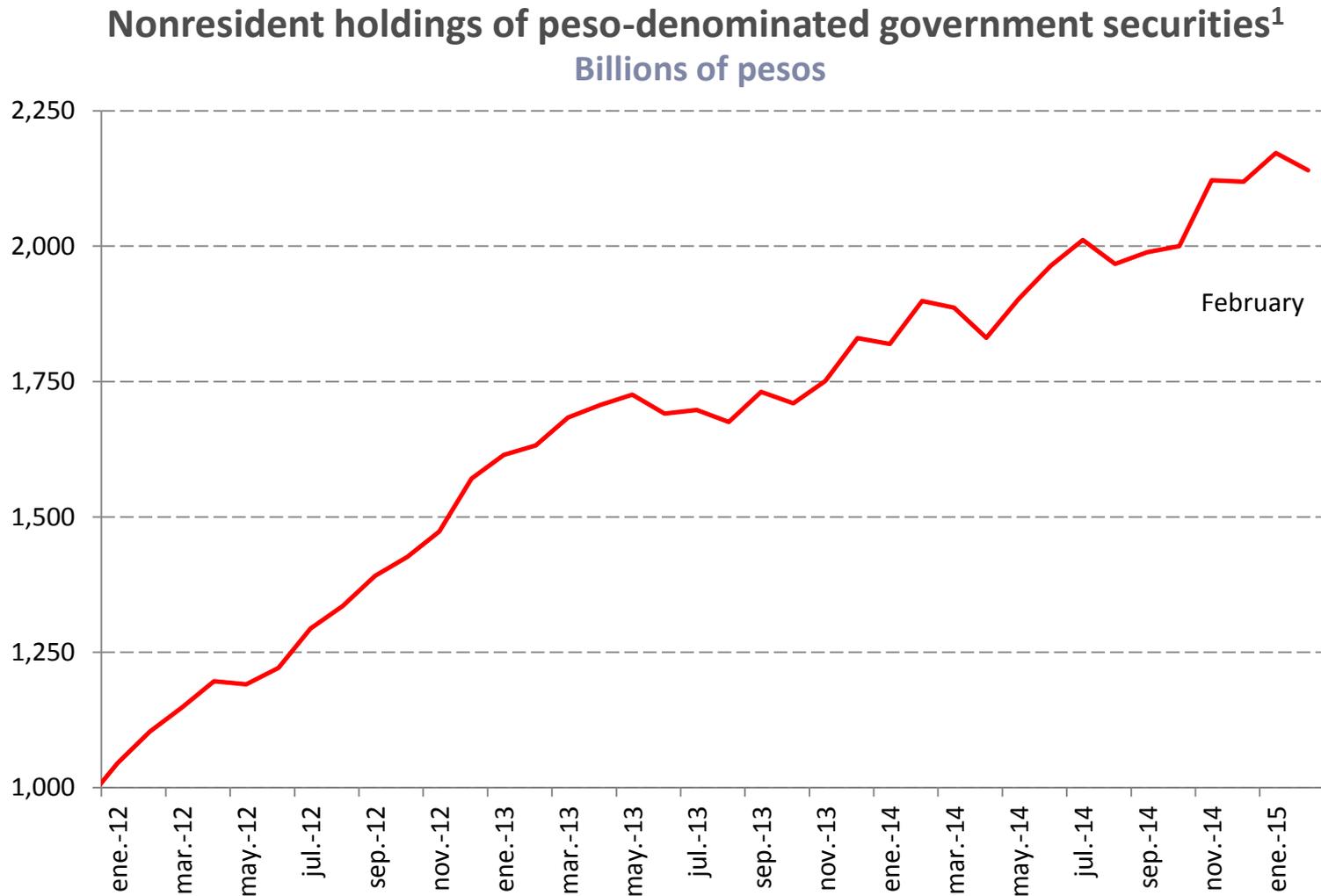
# The yield curve has shifted upward, largely along with that of the United States

Government securities yield curve<sup>1</sup>  
%



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



1/ Cetes, Bondes D, Bonos and Udibonos

Source: Banco de México

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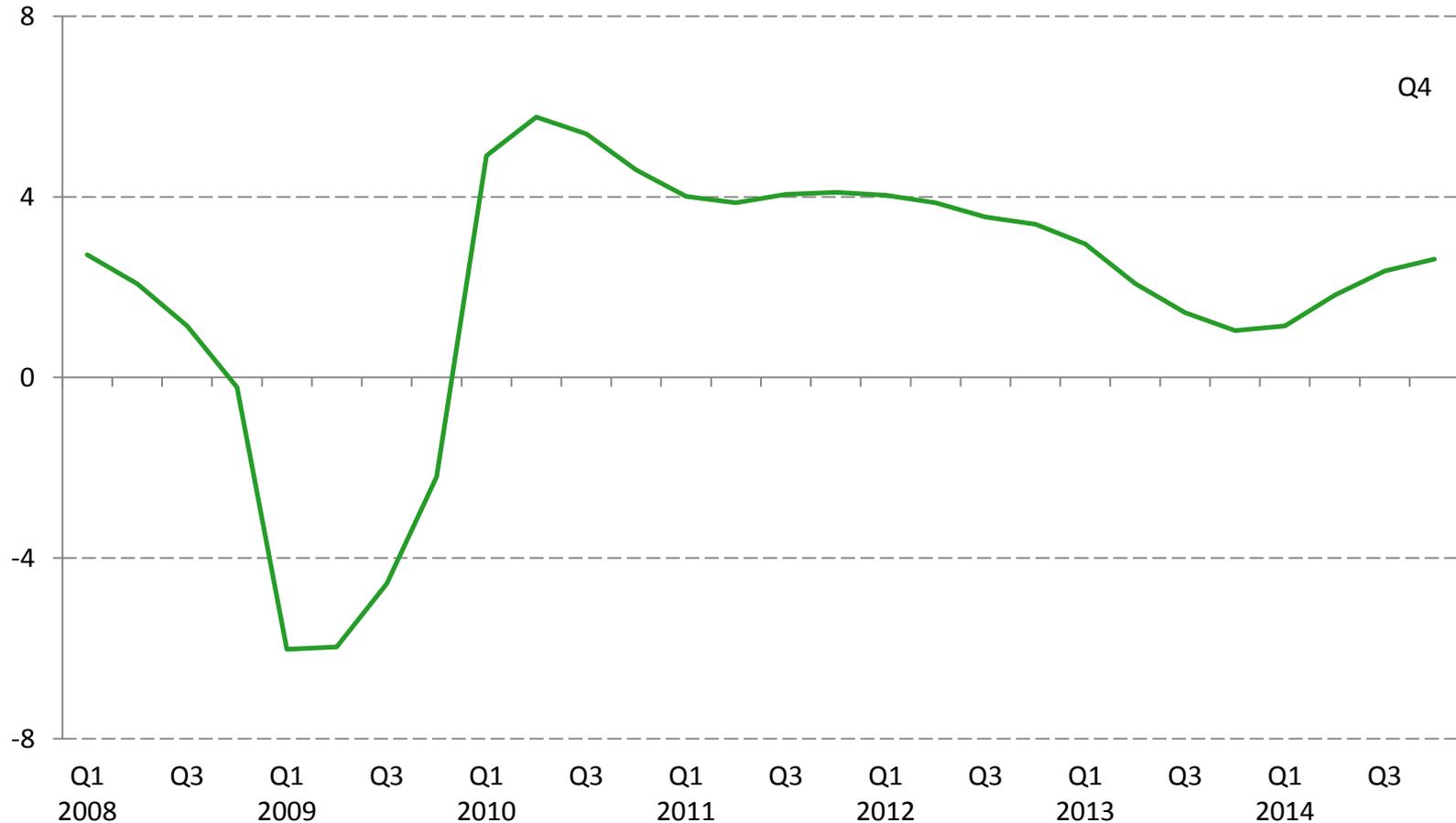
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# In Mexico, economic activity has begun to gain some steam

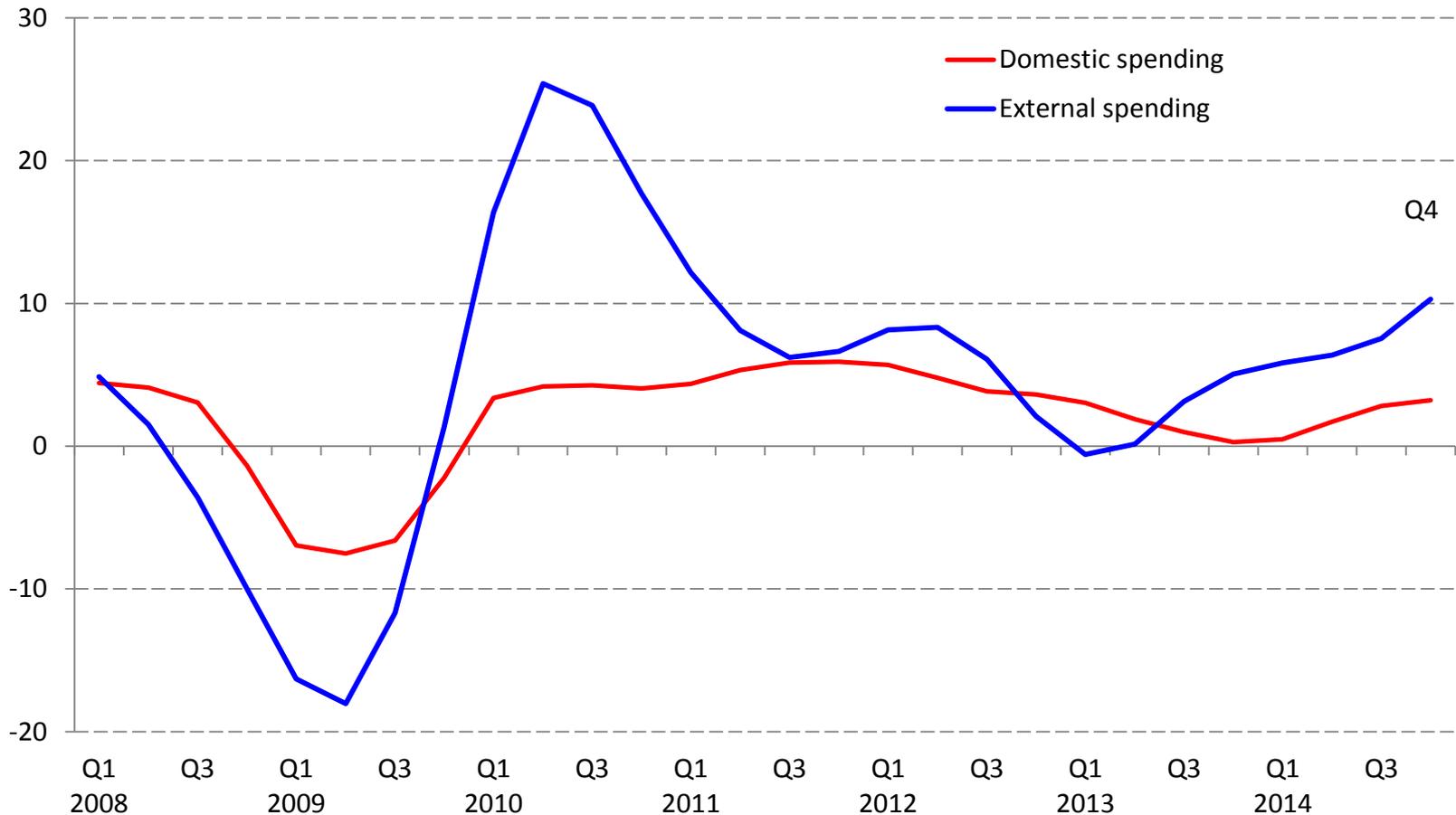
Mexico: GDP growth  
Annual % change, trend



Source: INEGI

# The current upturn has been driven largely by external demand

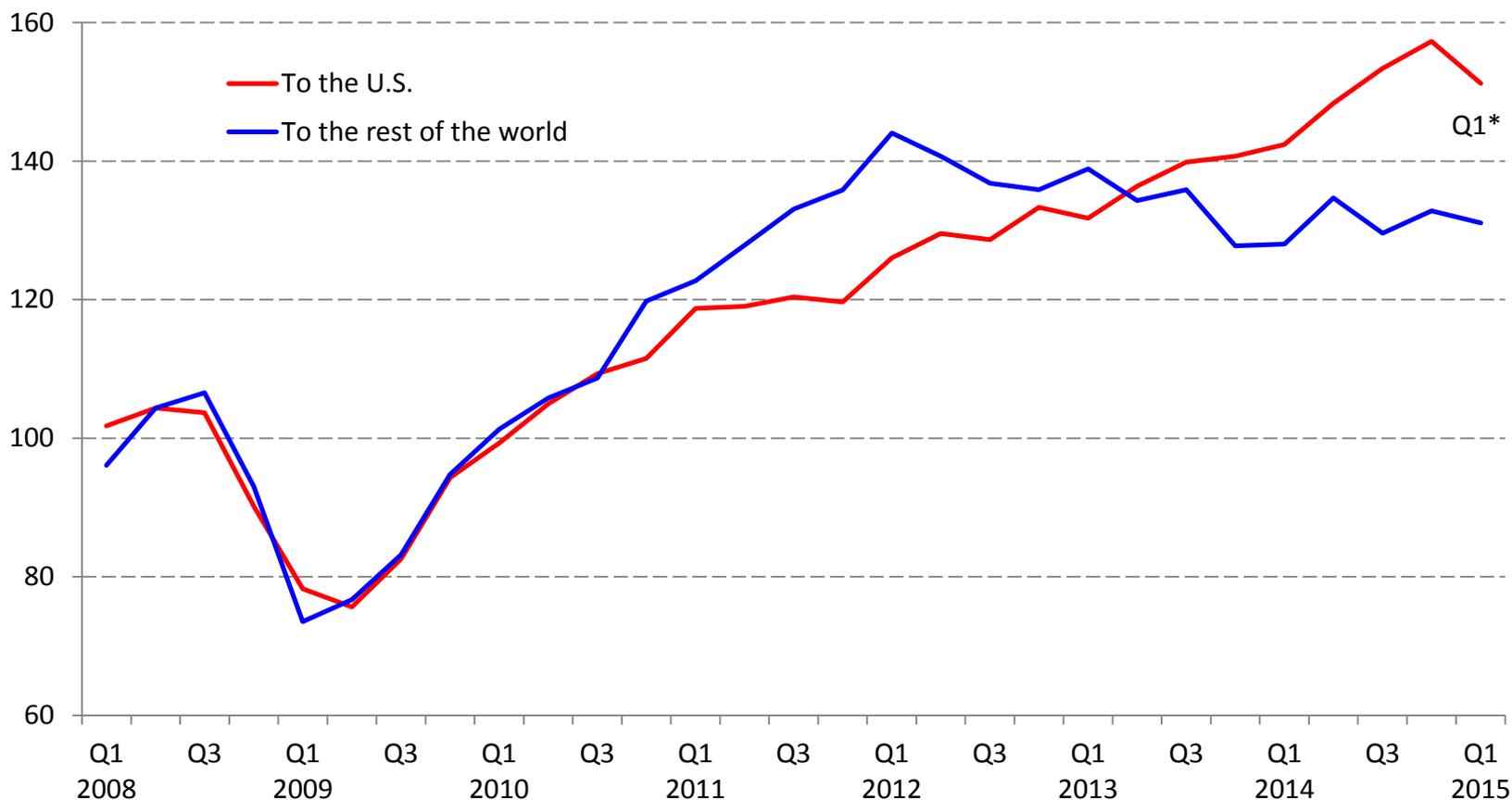
Mexico: Aggregate demand  
Annual % change, trend



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 YoY % change

	2014	2015	2016
U.S. Blue Chip	2.3	3.1	2.9
Mexico Blue Chip	2.1	3.1	3.7
Mexico Banxico	2.1	2.5 – 3.5	2.9 – 3.9

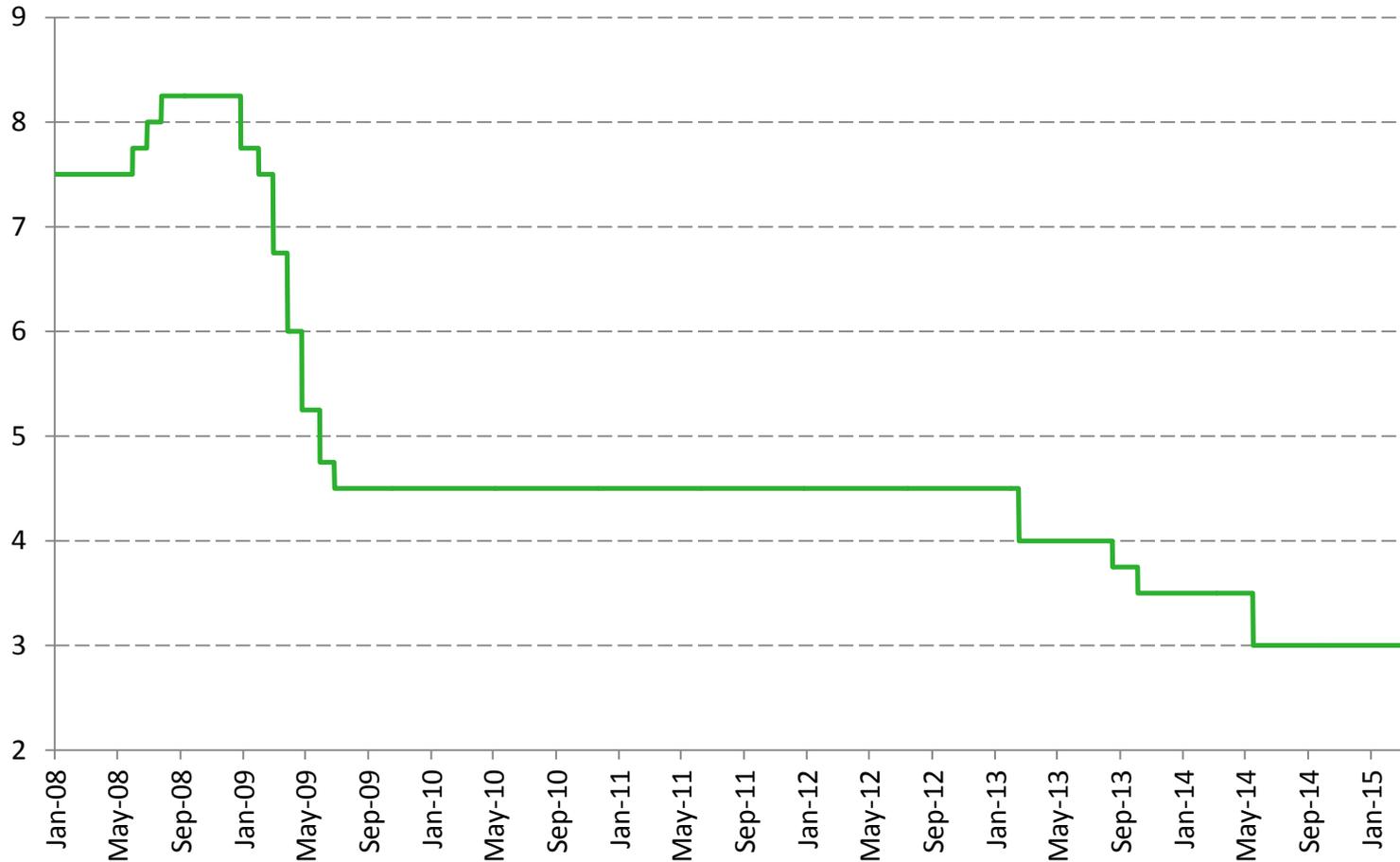
Source: *Blue Chip Economic Indicators*, March 2015 and Banco de México (2015), *Quarterly Report, October-December 2014, Summary*, February

# 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

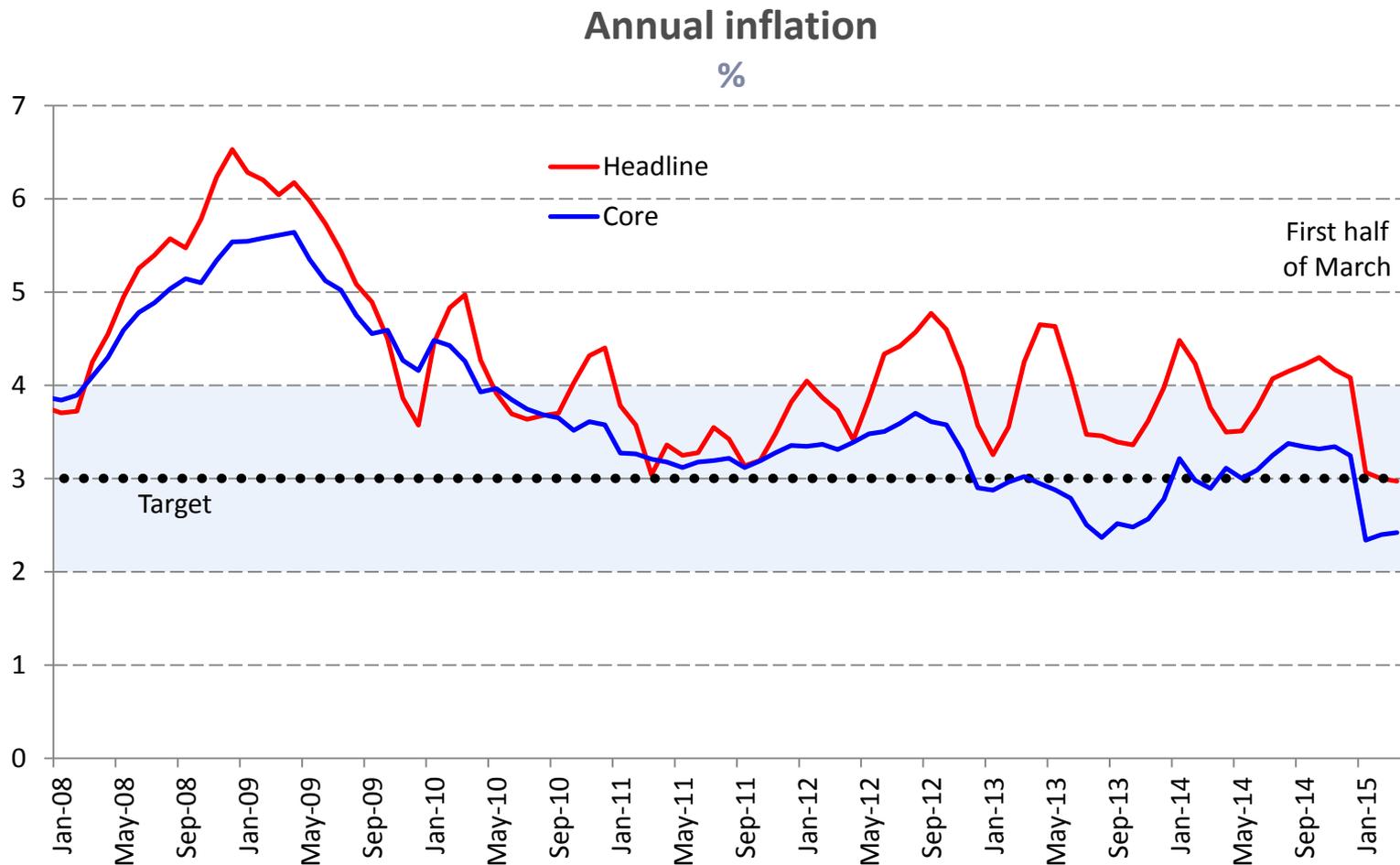
# In the wake of soft economic activity, Mexico's monetary policy accommodation increased

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



Source: INEGI

# 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



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