



# Mexico: Economic integration, challenges and outlook

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United States-Mexico Chamber of Commerce, Los Angeles

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BANCO DE MÉXICO

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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 States<sup>1</sup>

- 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

1/ For a discussion of the U.S.-Mexico economic relationship, see Villarreal, M.A. (2015). *U.S.-Mexico Economic Relations: Trends, Issues, and Implications*. Washington, DC: Congressional Research Service, pp. 1-9

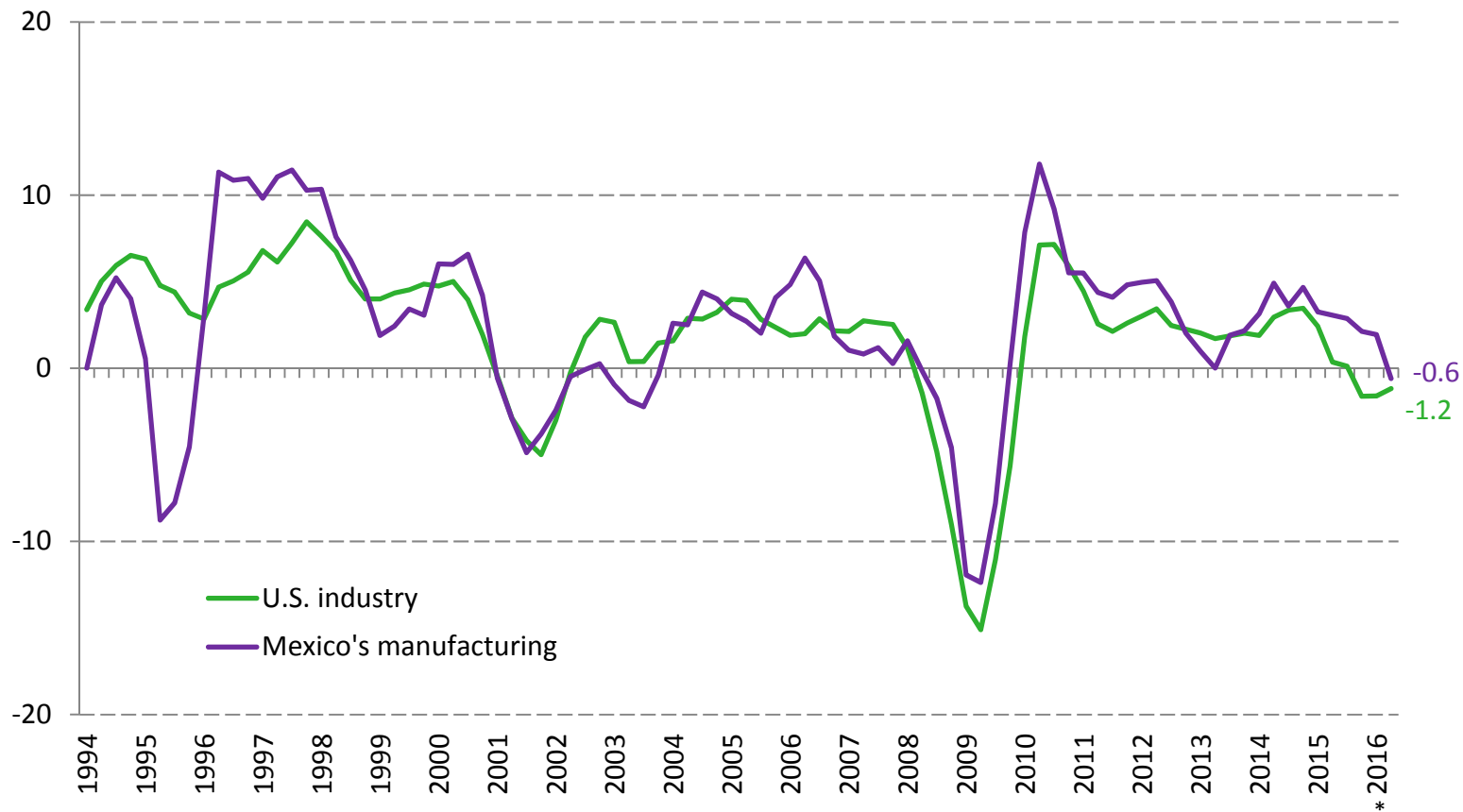
# California and Mexico have long been important trade partners



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 opportunities<sup>1</sup>

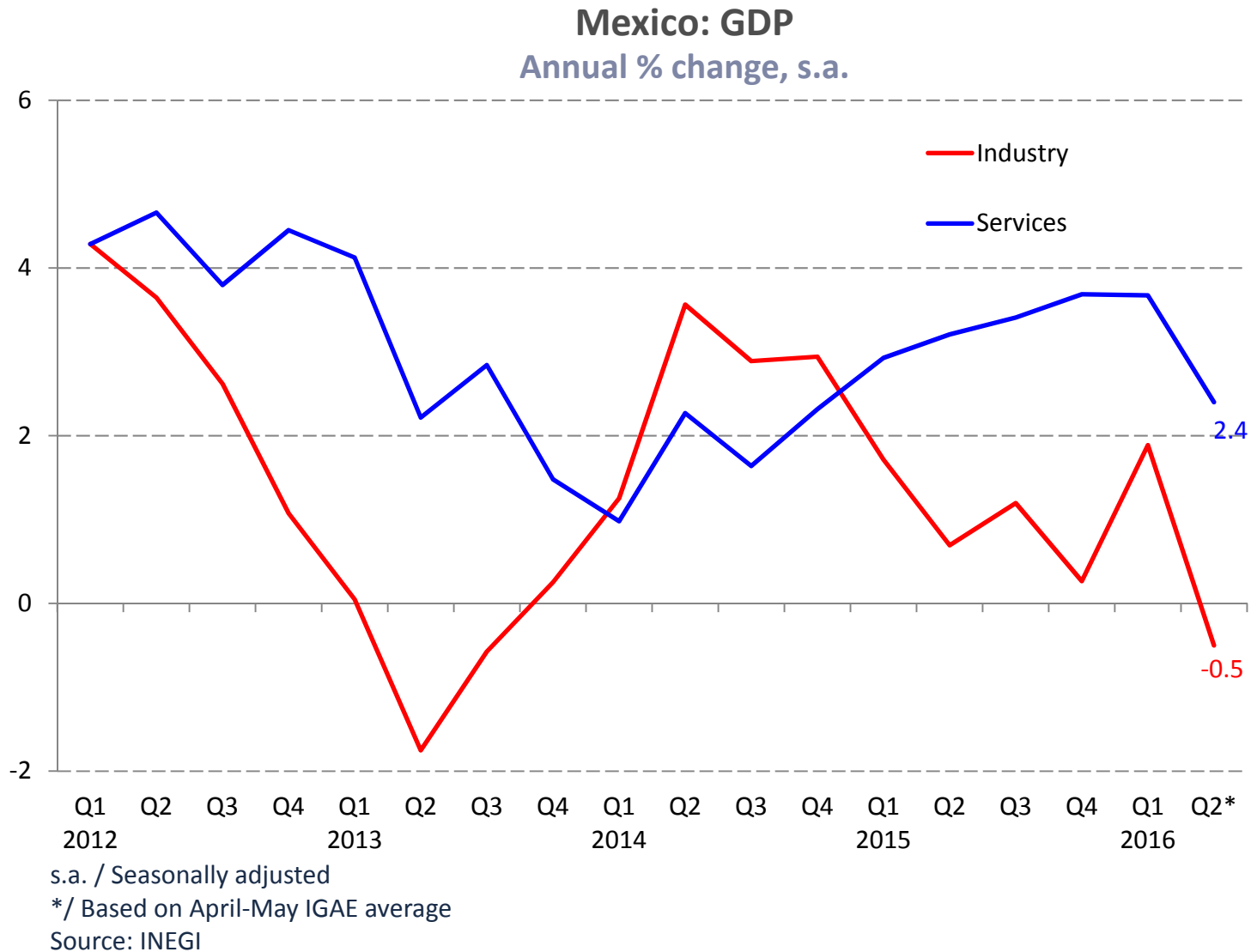
- Hiring and firing flexibility should benefit labor productivity
- Wider and cheaper access to telecoms services is already resulting from the entrance of new players
- The unprecedented opening of the energy sector to private investment will yield lower key input prices
- An enhanced rule of law, better 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/>

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

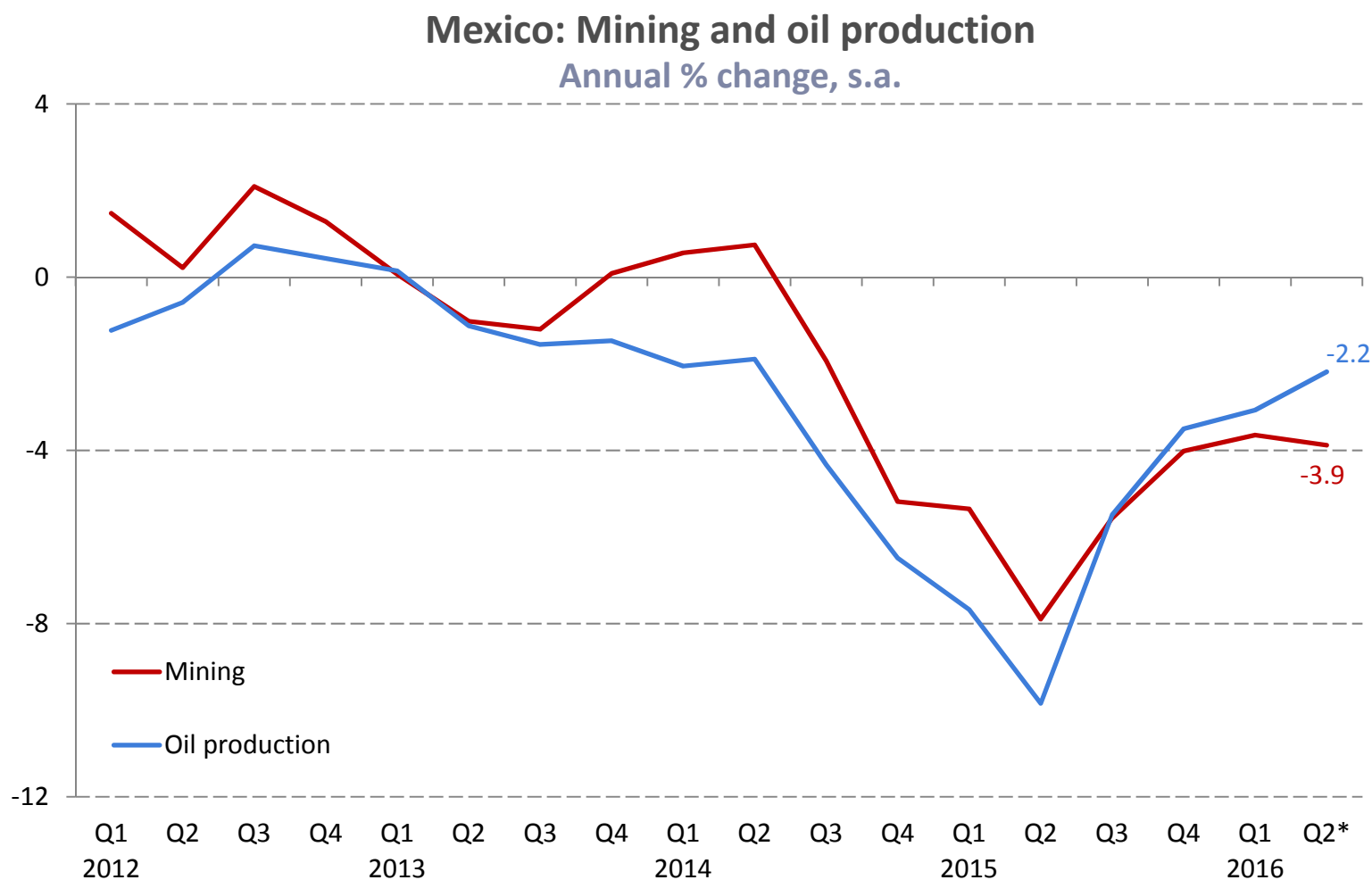


# In the past two and a half years, an expanding services sector has been offset by slowing industrial production





## Softer Mexican industry has been affected by two shocks: a contraction in oil extraction ...



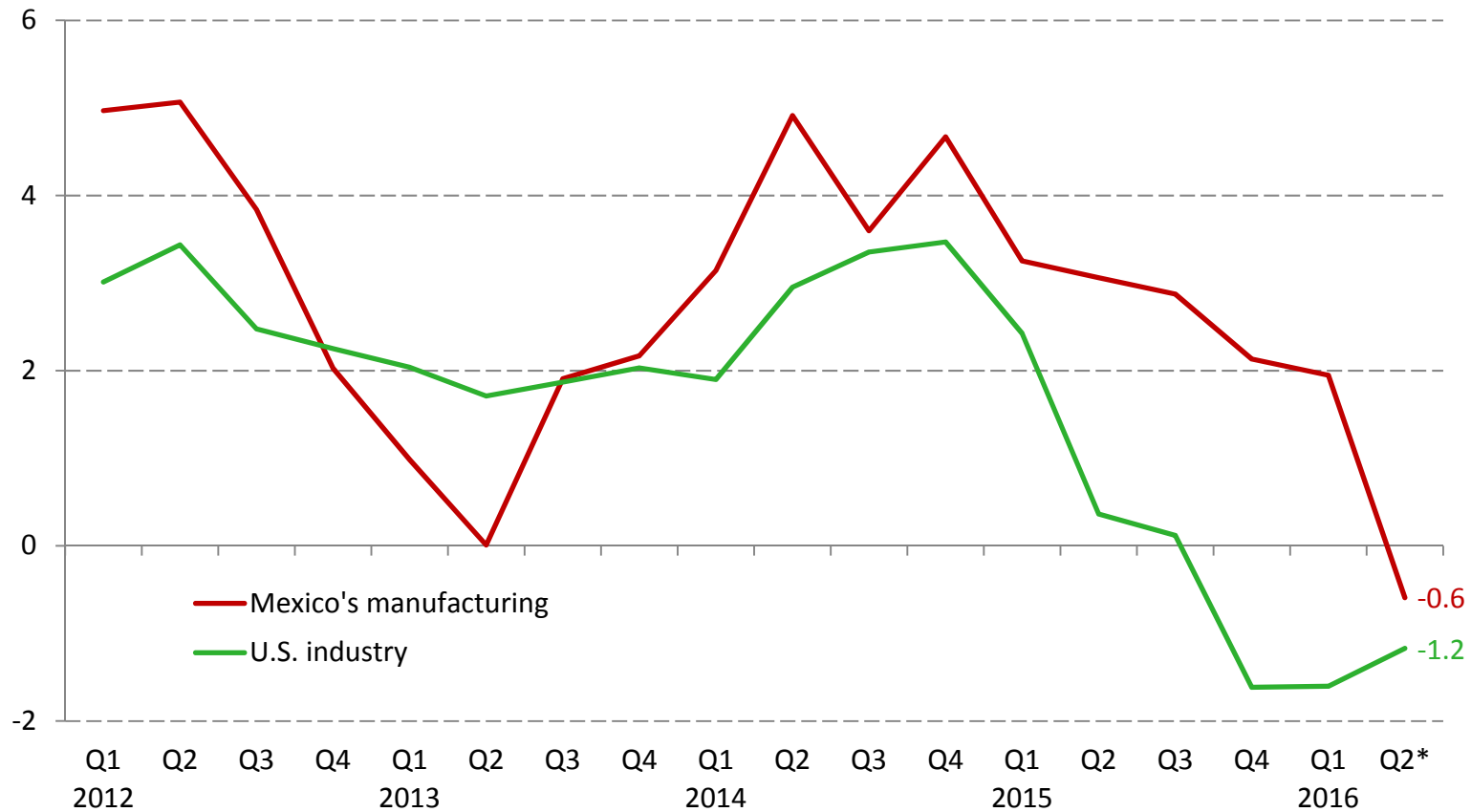
s.a. / Seasonally adjusted

\*/ 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.



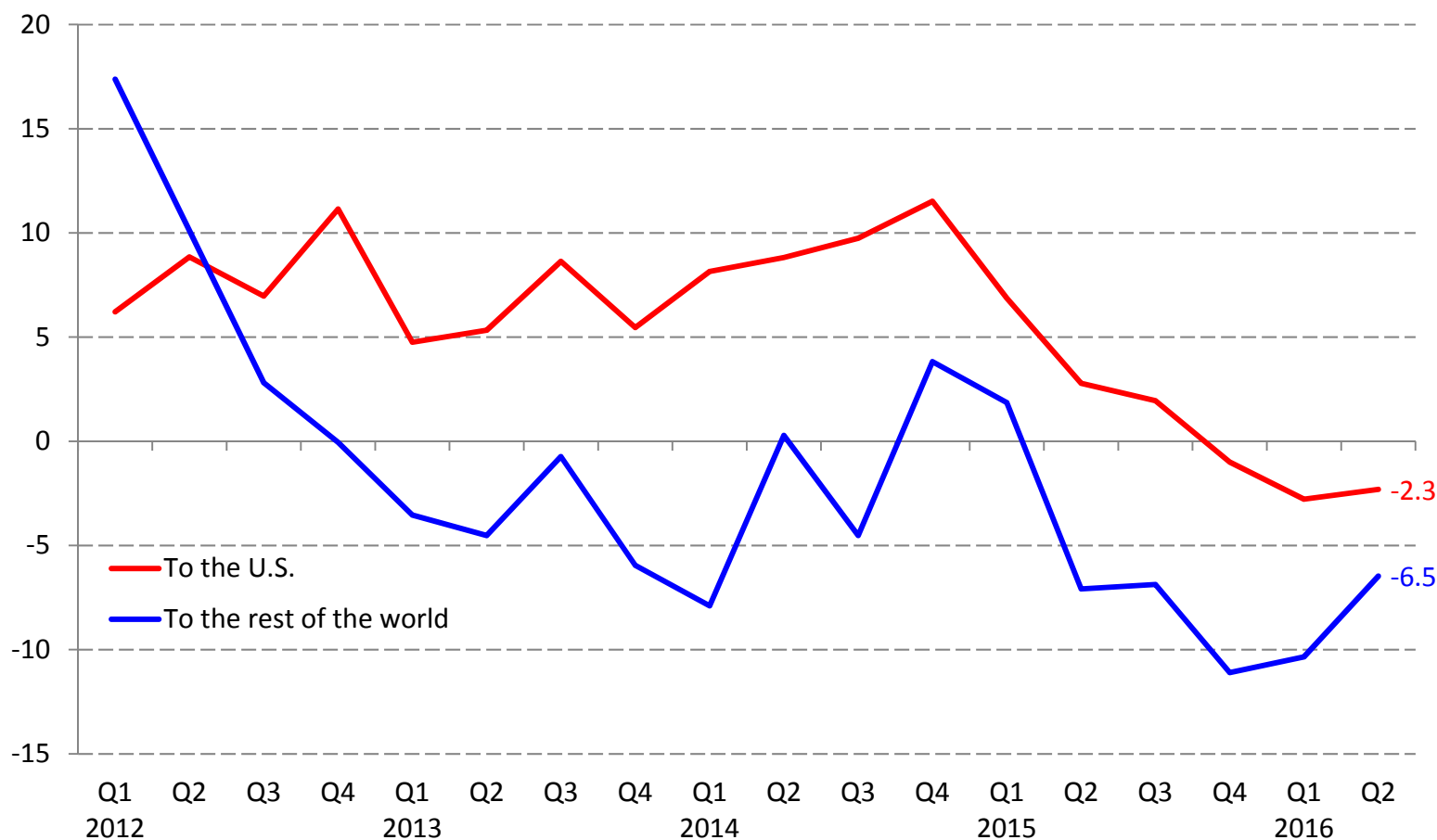
s.a. / Seasonally adjusted

\*/ 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.

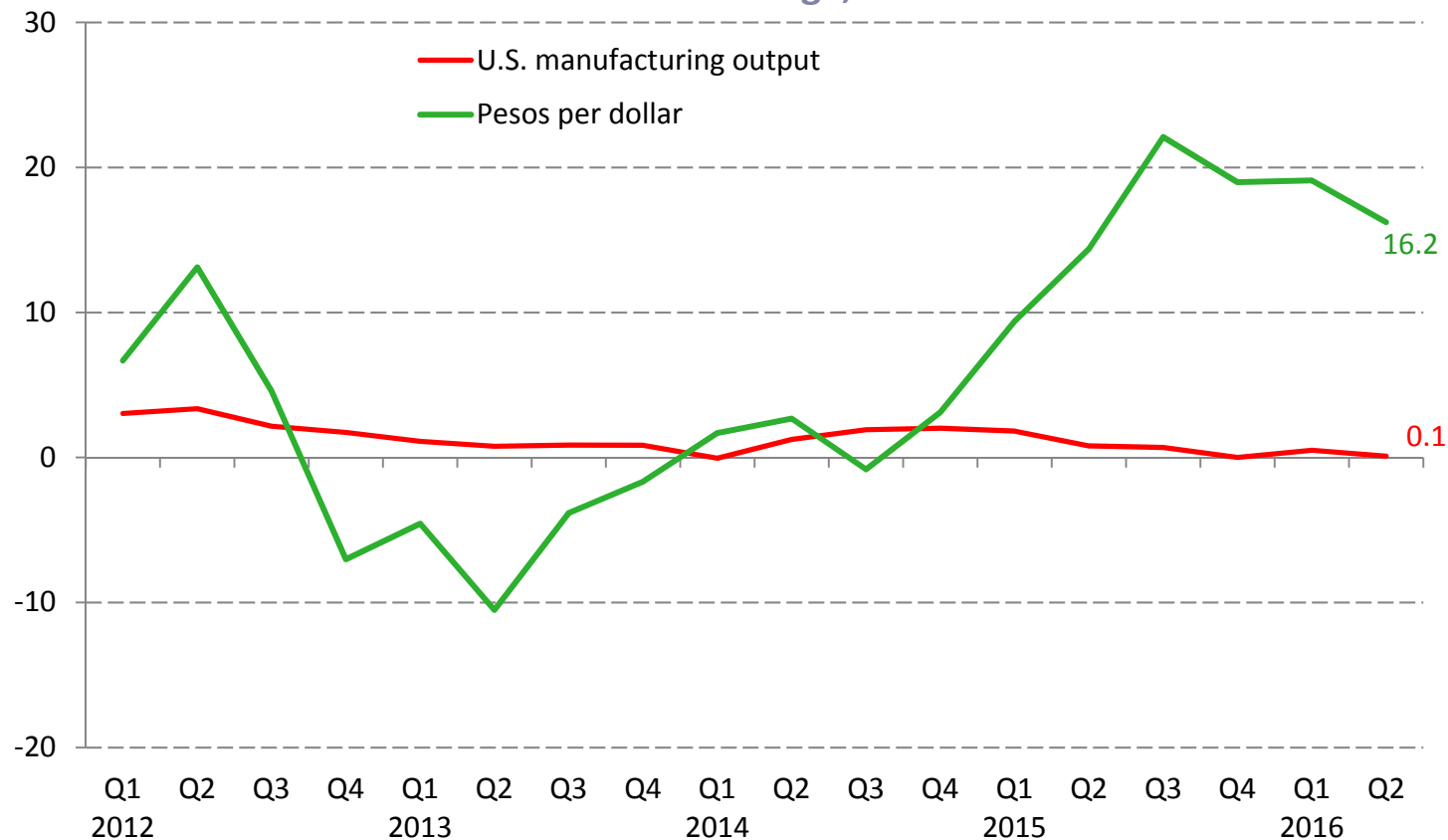


s.a. / Seasonally adjusted. Source: Banco de México with data from the Ministry of Finance (SAT), Ministry of Economy (SE), Banco de México, INEGI. Merchandise Trade Balance. SNIEG. Information of National Interest

# 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

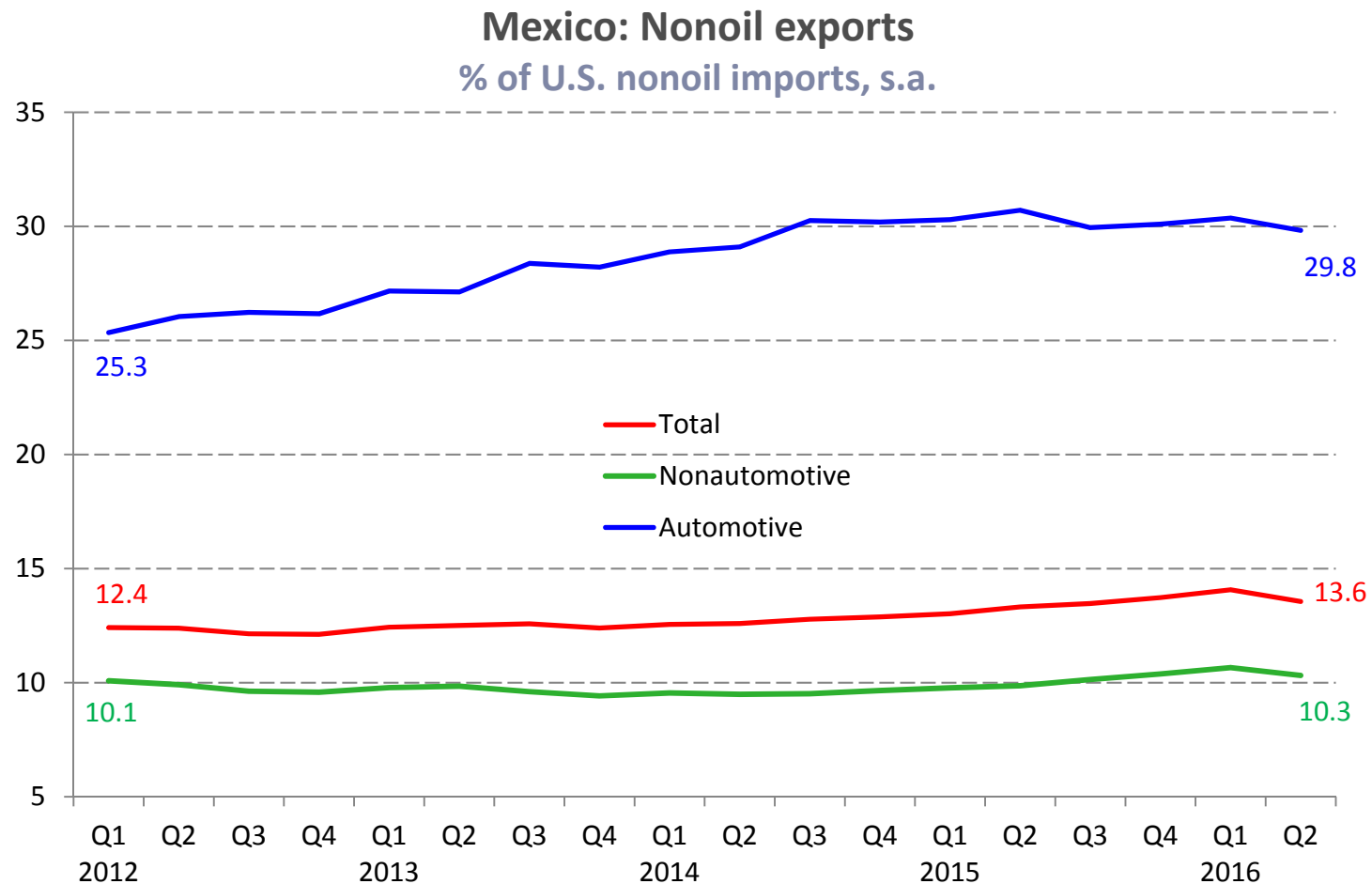
Annual % change, s.a.



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

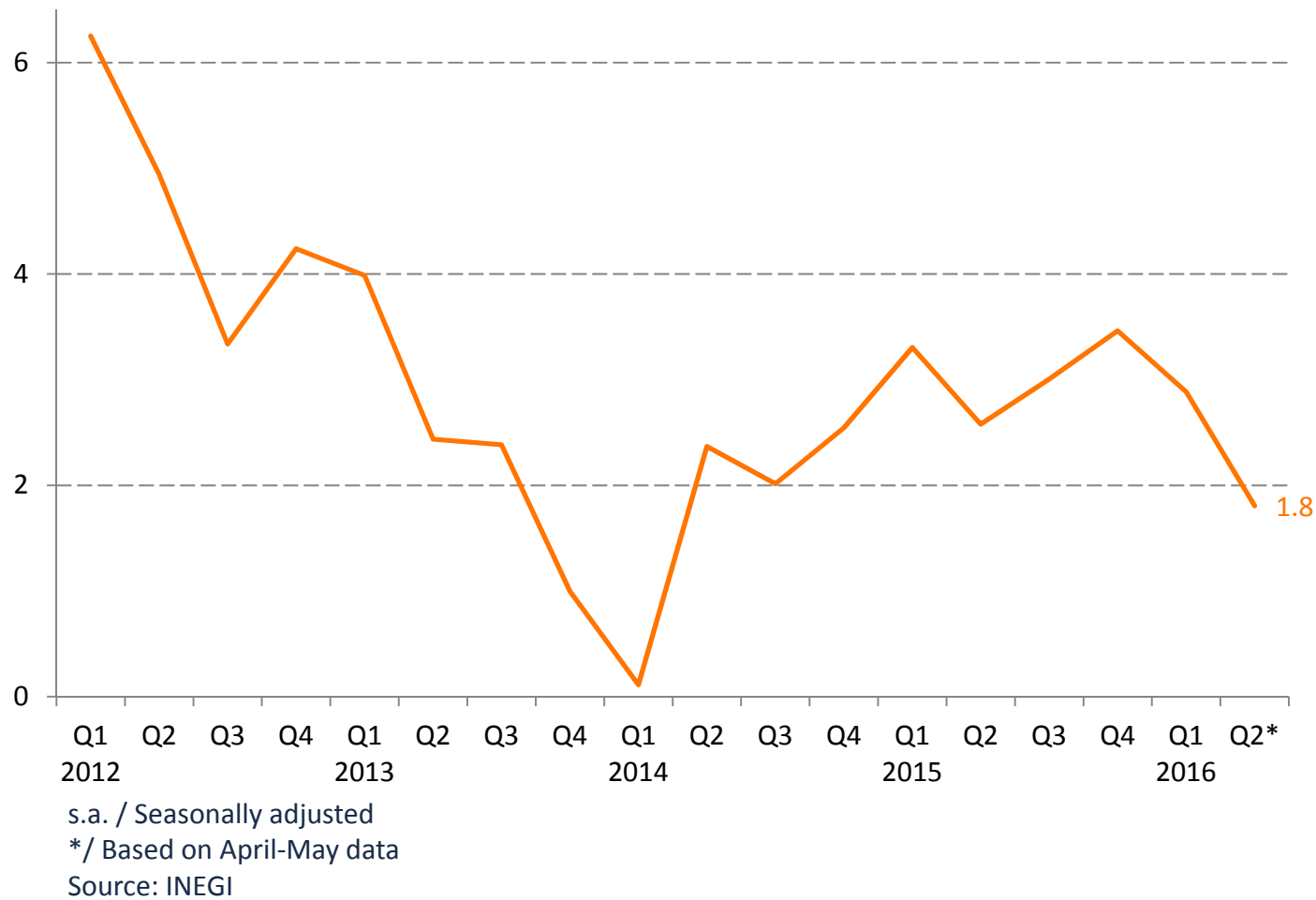


s.a. / Seasonally adjusted

Source: Own calculations with data from the United States Department of Commerce

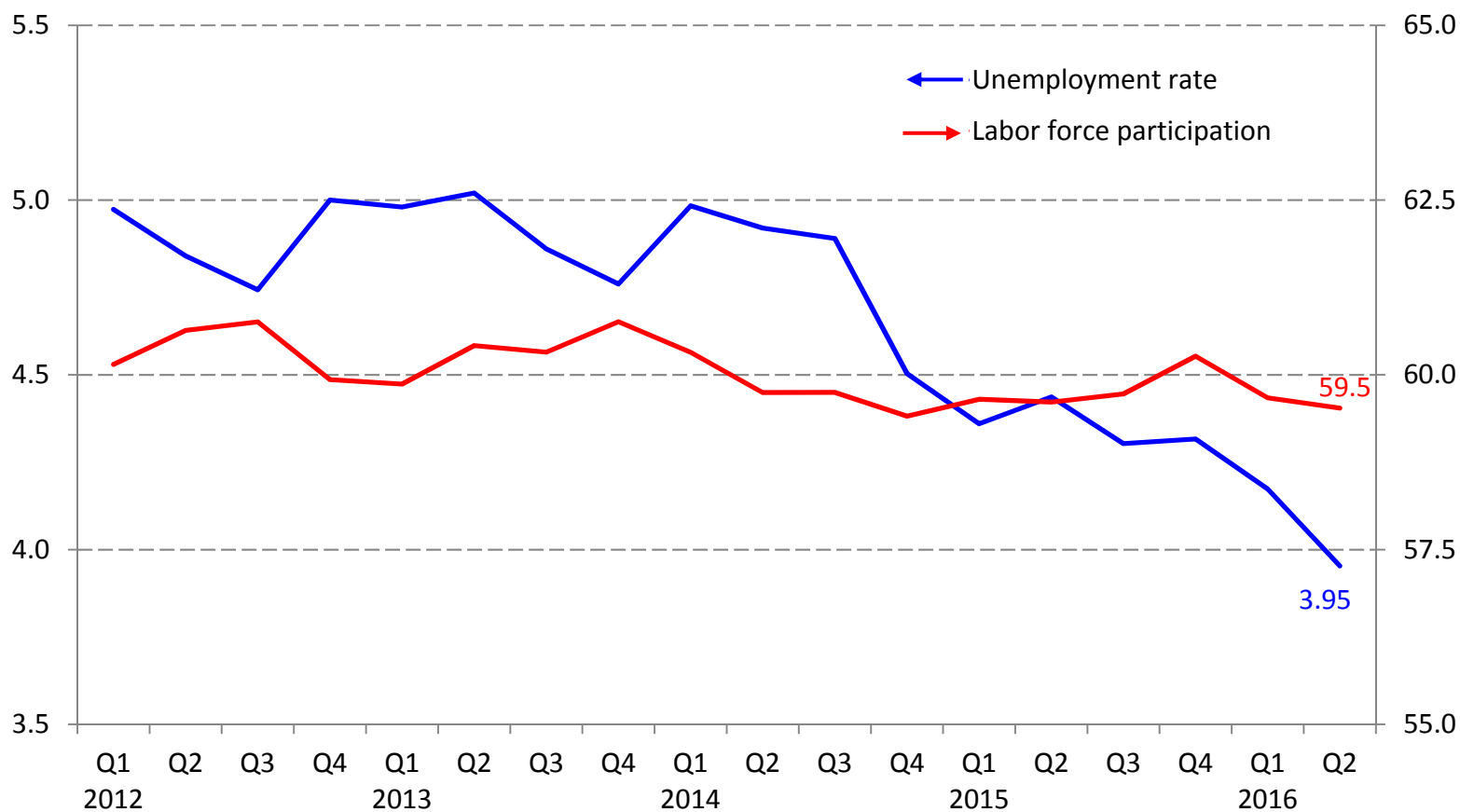
# Private consumption has been a driver of recent economic expansion

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



## This performance coincides with better labor market indicators

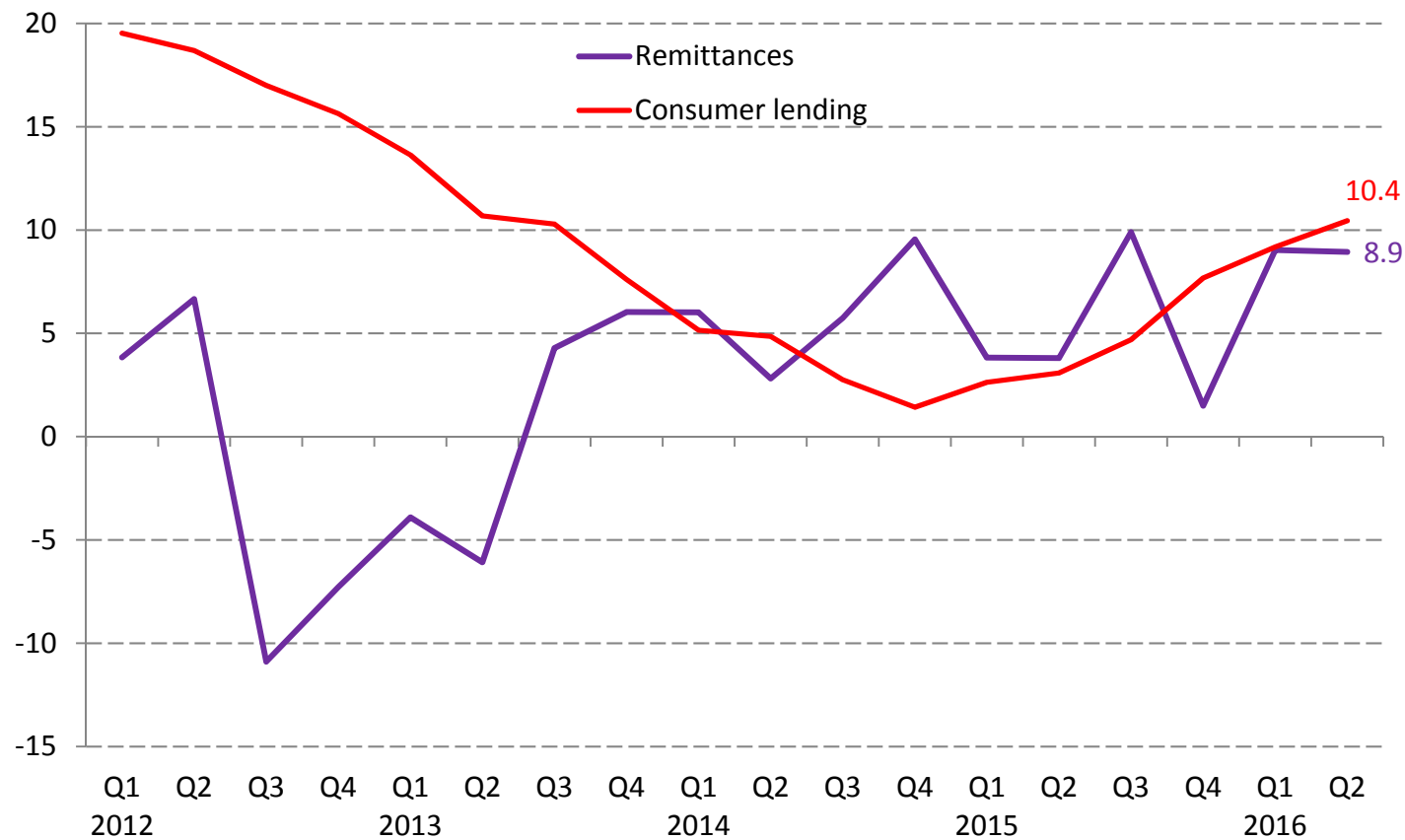
Mexico: Unemployment and labor force participation  
% of EAP and % of population, s.a.<sup>1</sup>



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.



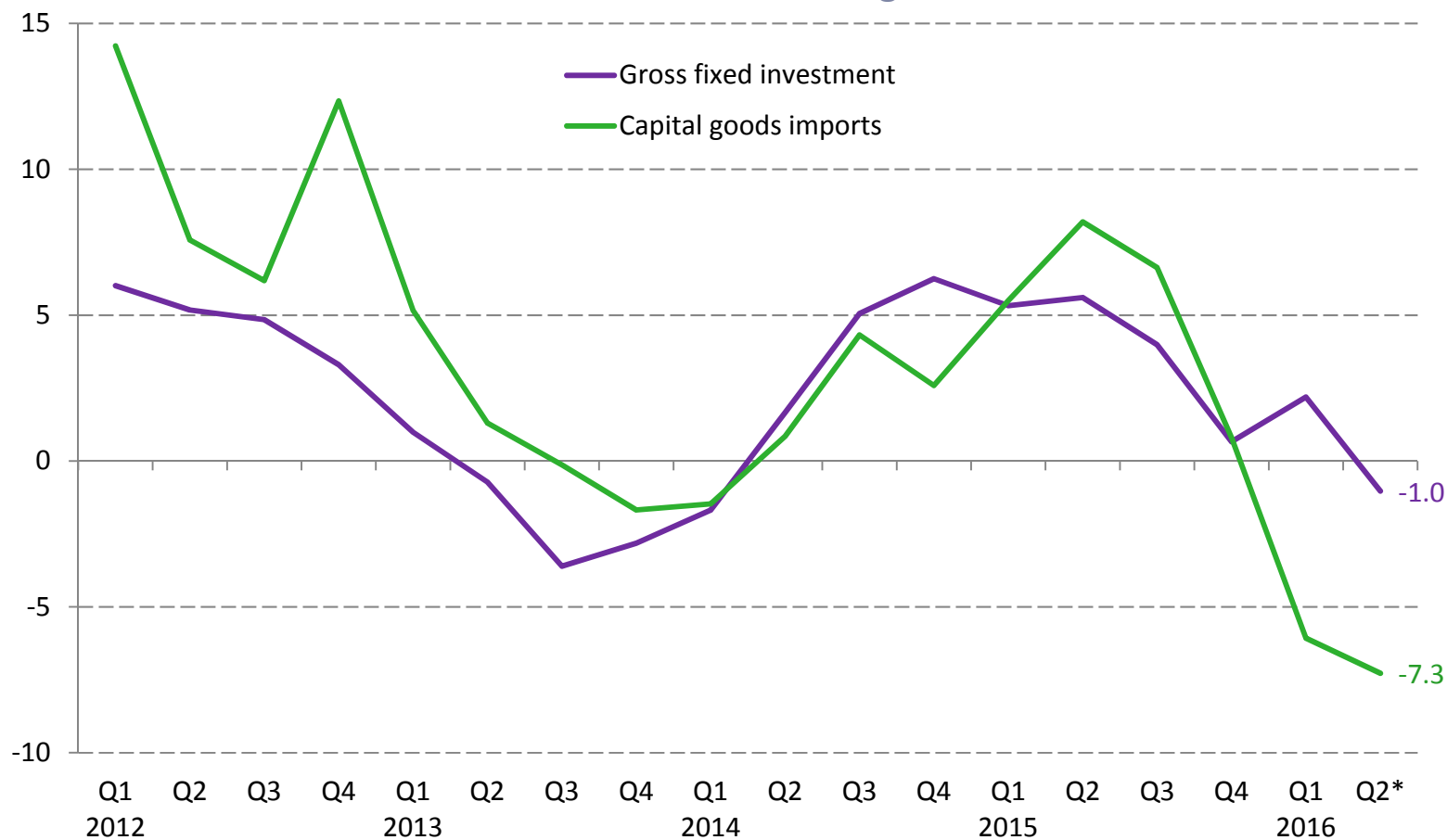
s.a. / Seasonally adjusted

Source: Banco de México



## In contrast, investment has stumbled

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

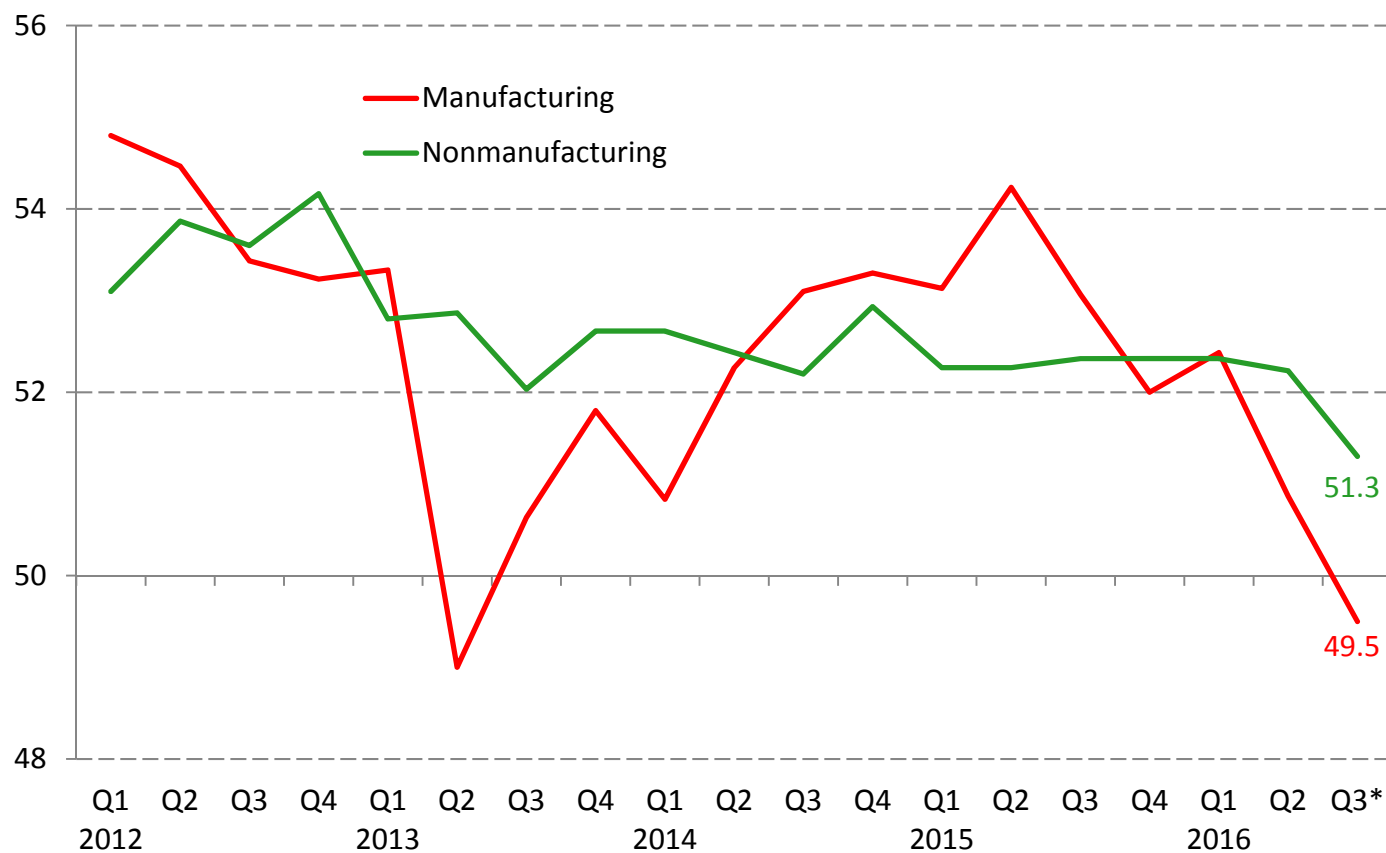


s.a. / Seasonally adjusted. \*/ Gross fixed investment is based on April-May average

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<sup>1</sup>



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

	2015 <sup>1</sup>	2016	2017
The United States	2.4	1.9	2.2
Mexico	2.5	2.3	2.6

1/ Observed

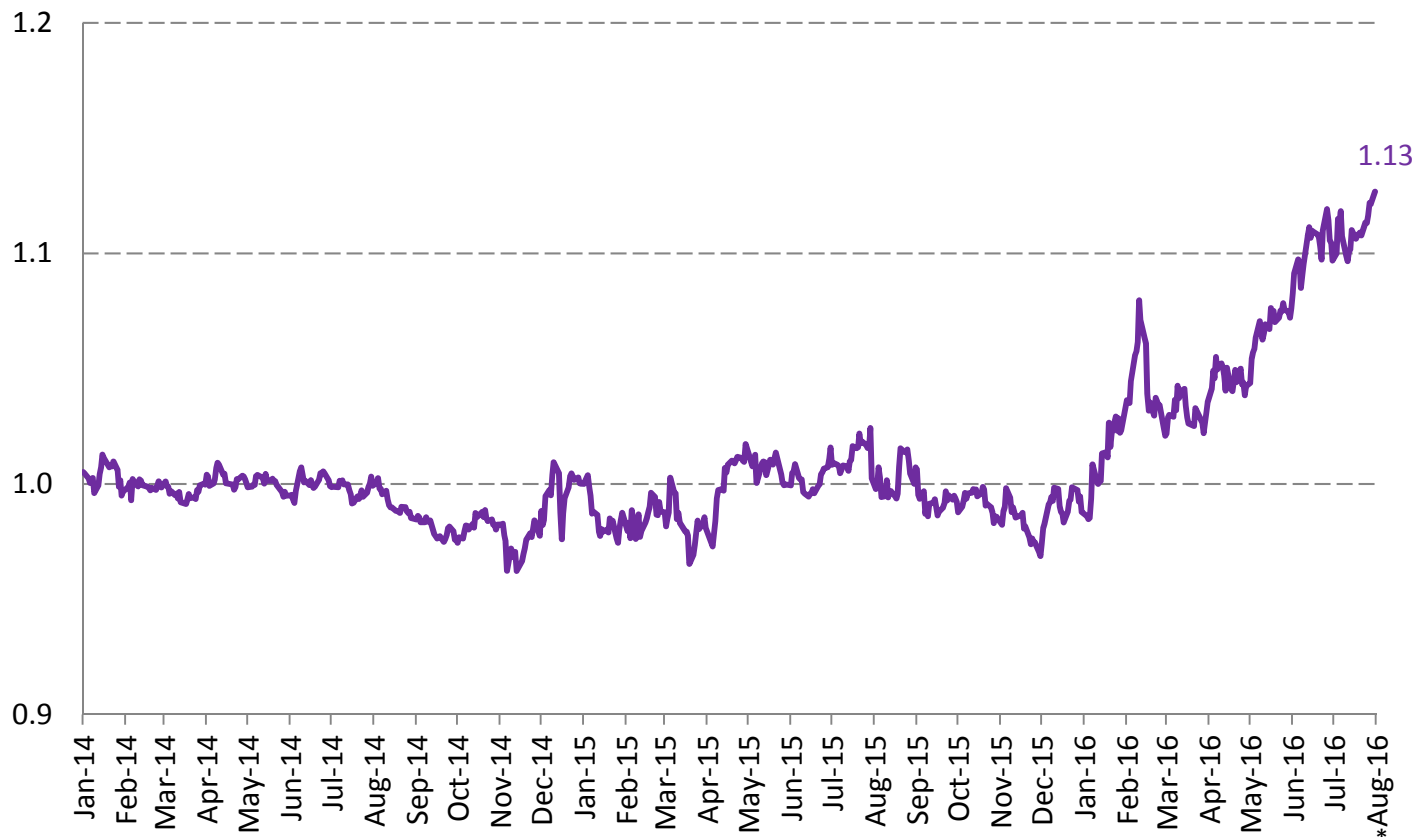
Source: Consensus Forecasts and Latin American Consensus Forecasts, July 2016

## 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<sup>1</sup>  
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

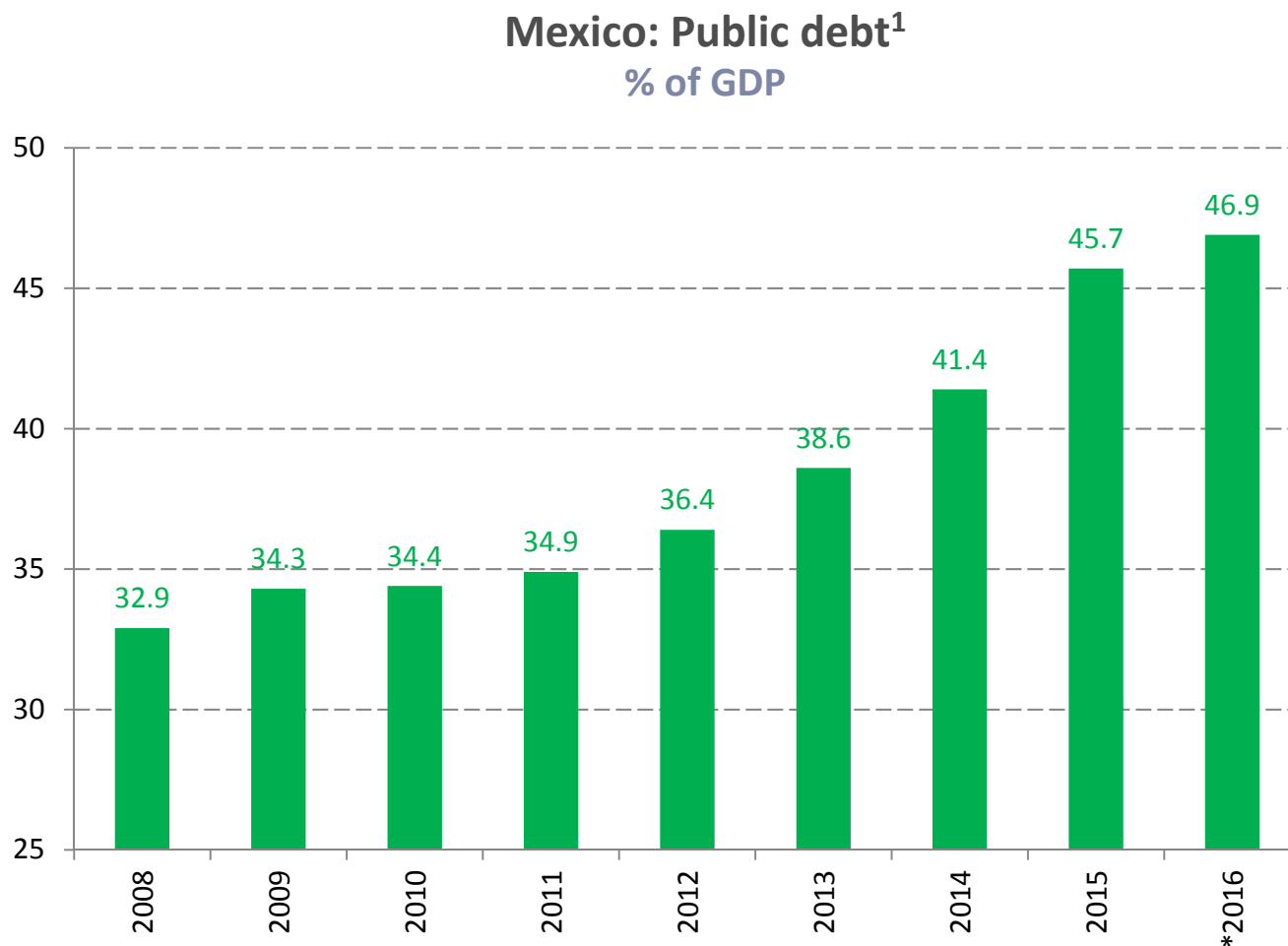
\*/ To August 1. Source: Banco de México with data from Bloomberg

## Exacerbated peso depreciation may stem from several factors

- The role of the Mexican peso as an international hedge mechanism<sup>1</sup>
- 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

1/ See BIS (2014). “Triennial Central Bank Survey of foreign exchange and derivatives market activity in 2013,” detailed tables

# A stronger fiscal stance is necessary given increasing public debt

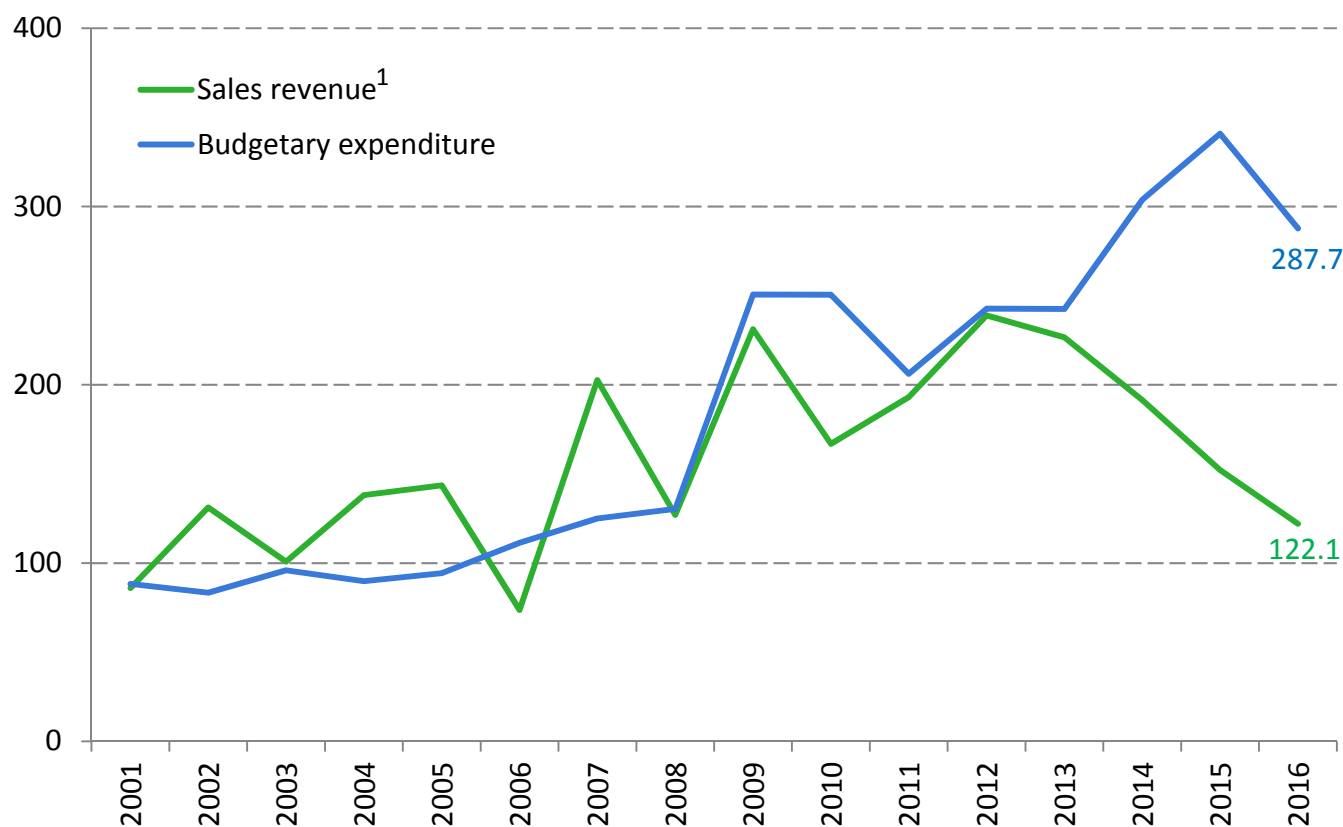


1/ Historic balance of public-sector borrowing requirements. \*/ To June

Source: SHCP (2016). *Informes sobre la Situación Económica, las Finanzas Públicas y la Deuda Pública*, Segundo trimestre de 2016

## ... 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



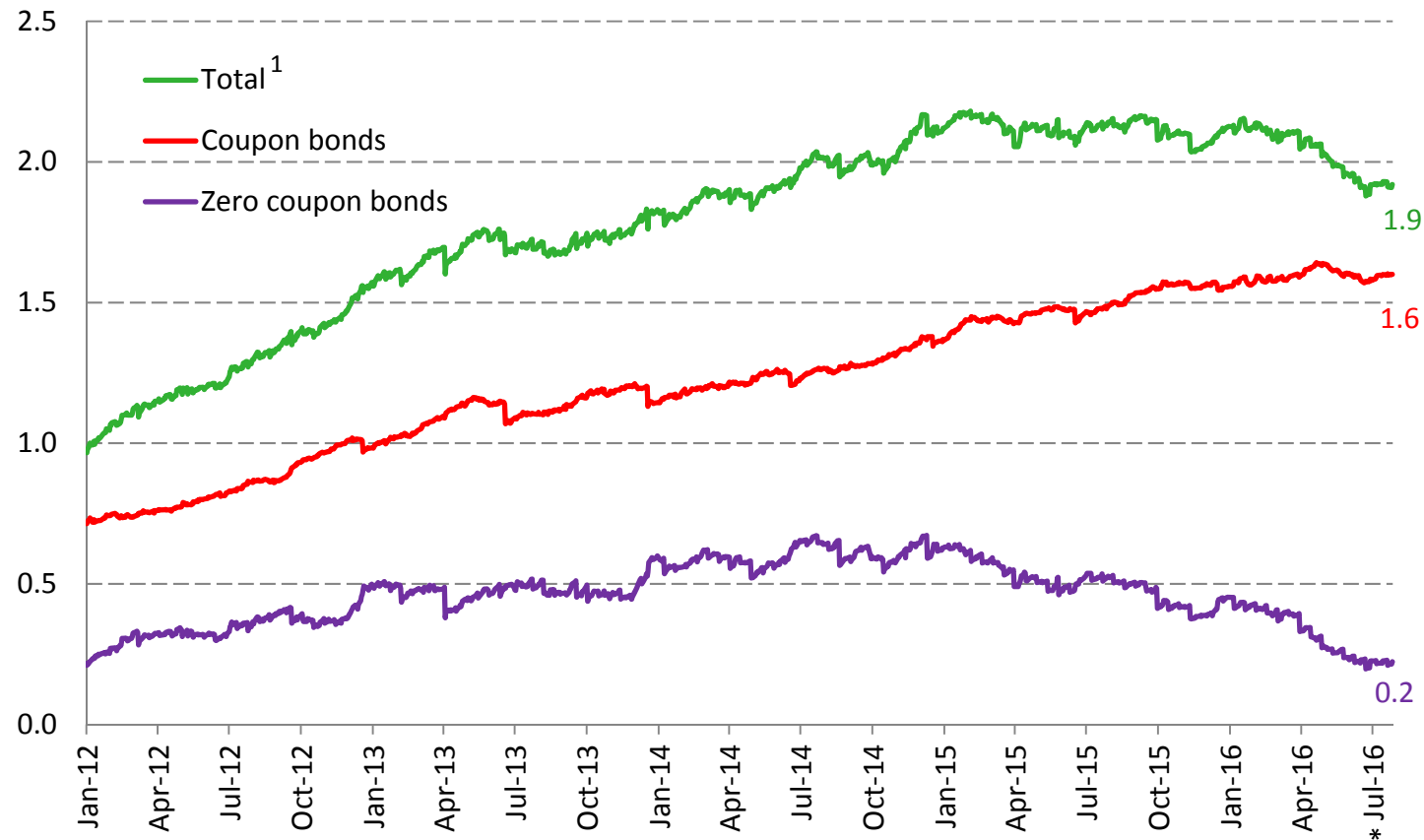
1/ Revenue from net foreign and domestic sales, minus taxes paid by Pemex. Excludes various sources of income, such as federal government transfers

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

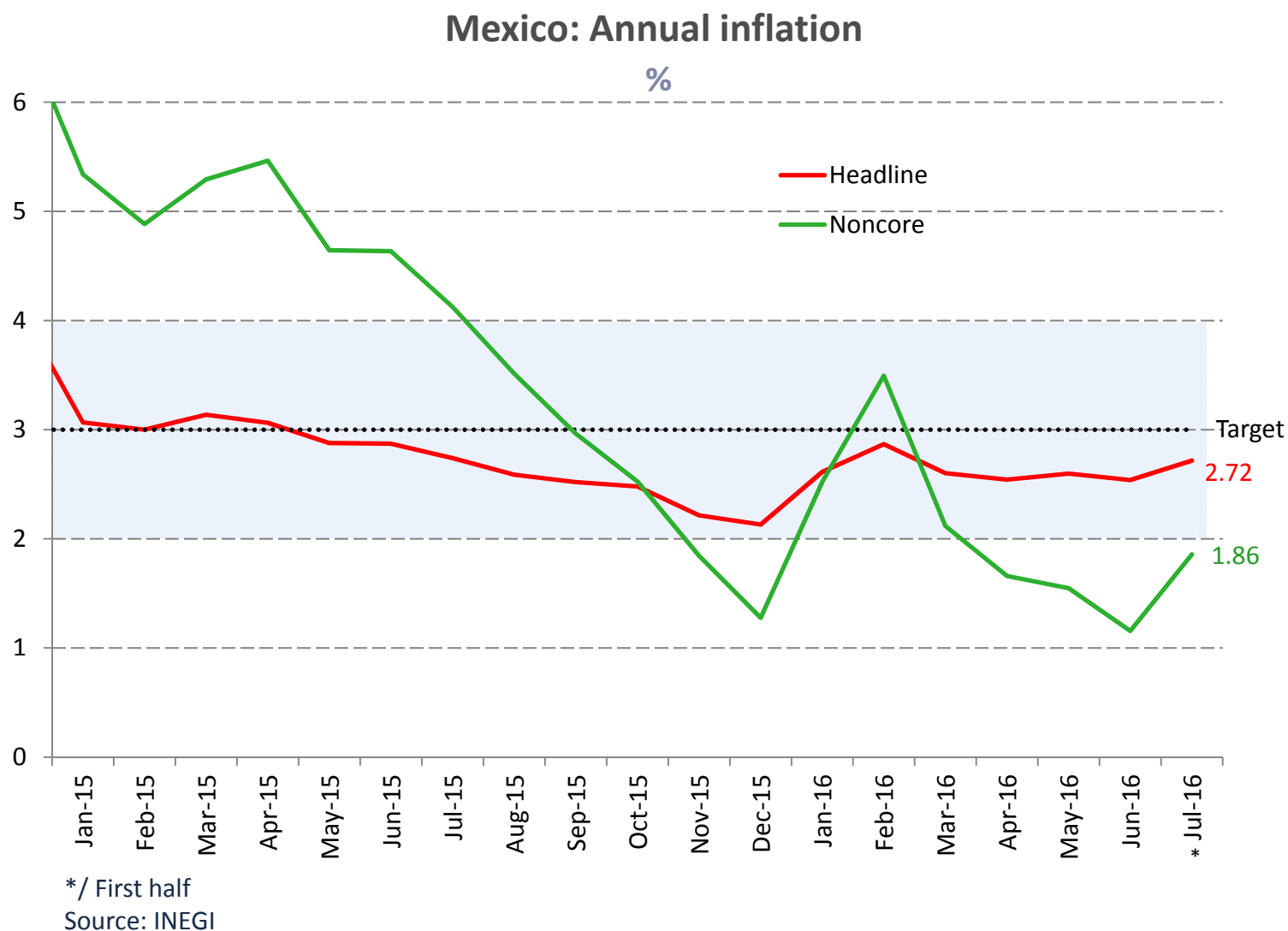
Source: Banco de México

## Further bouts of international financial volatility could easily occur

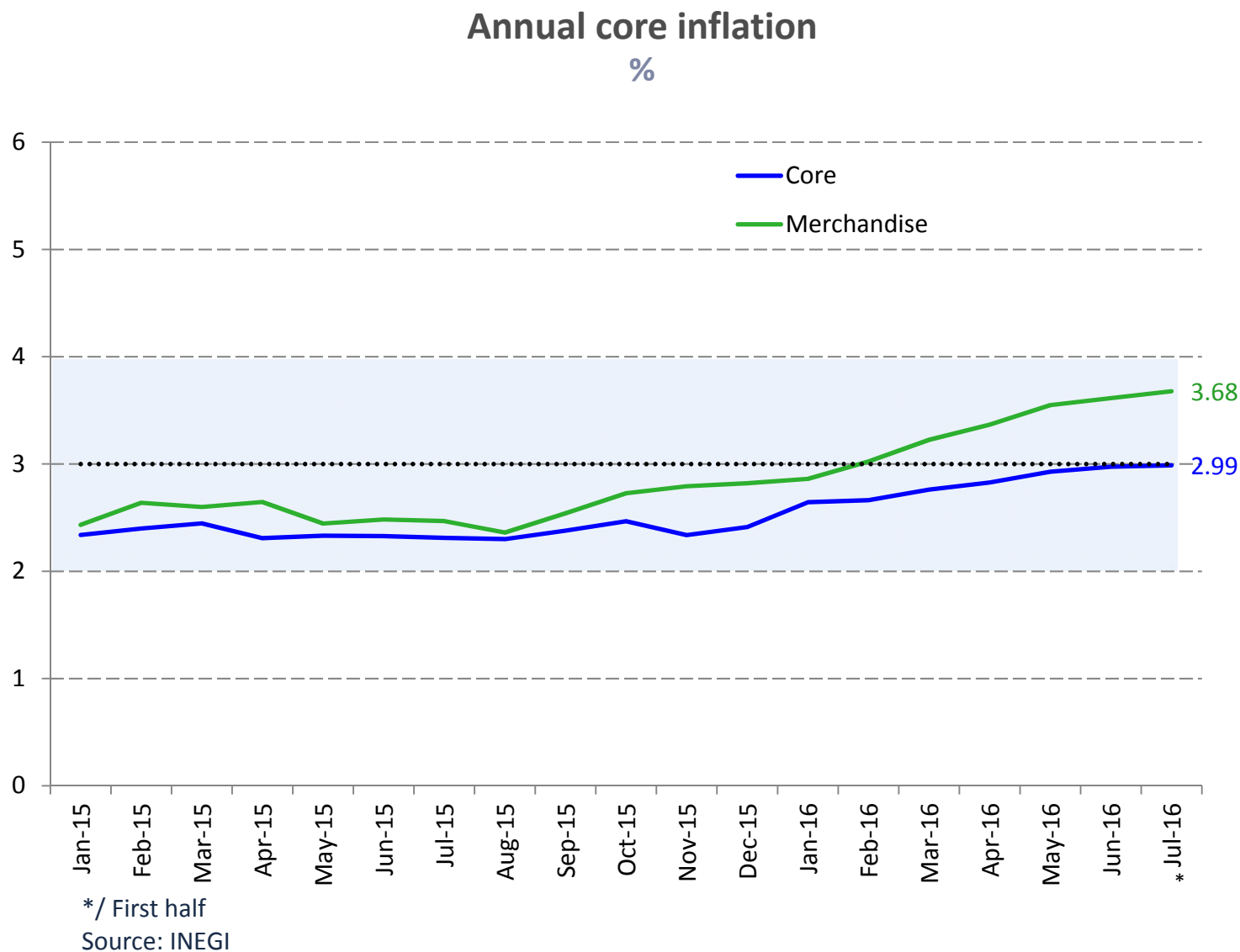
- In the wake of Brexit, deeper monetary accommodation is foreseen in most developed countries
  - ✓ Rising leverage worldwide<sup>1</sup>
  - ✓ Increasing proportions of debt with negative yields in advanced nations
- European banks face fragile financial conditions
- Concerns persist on Chinese economic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

1/ See BIS (2016). *BIS Statistical Bulletin*, June

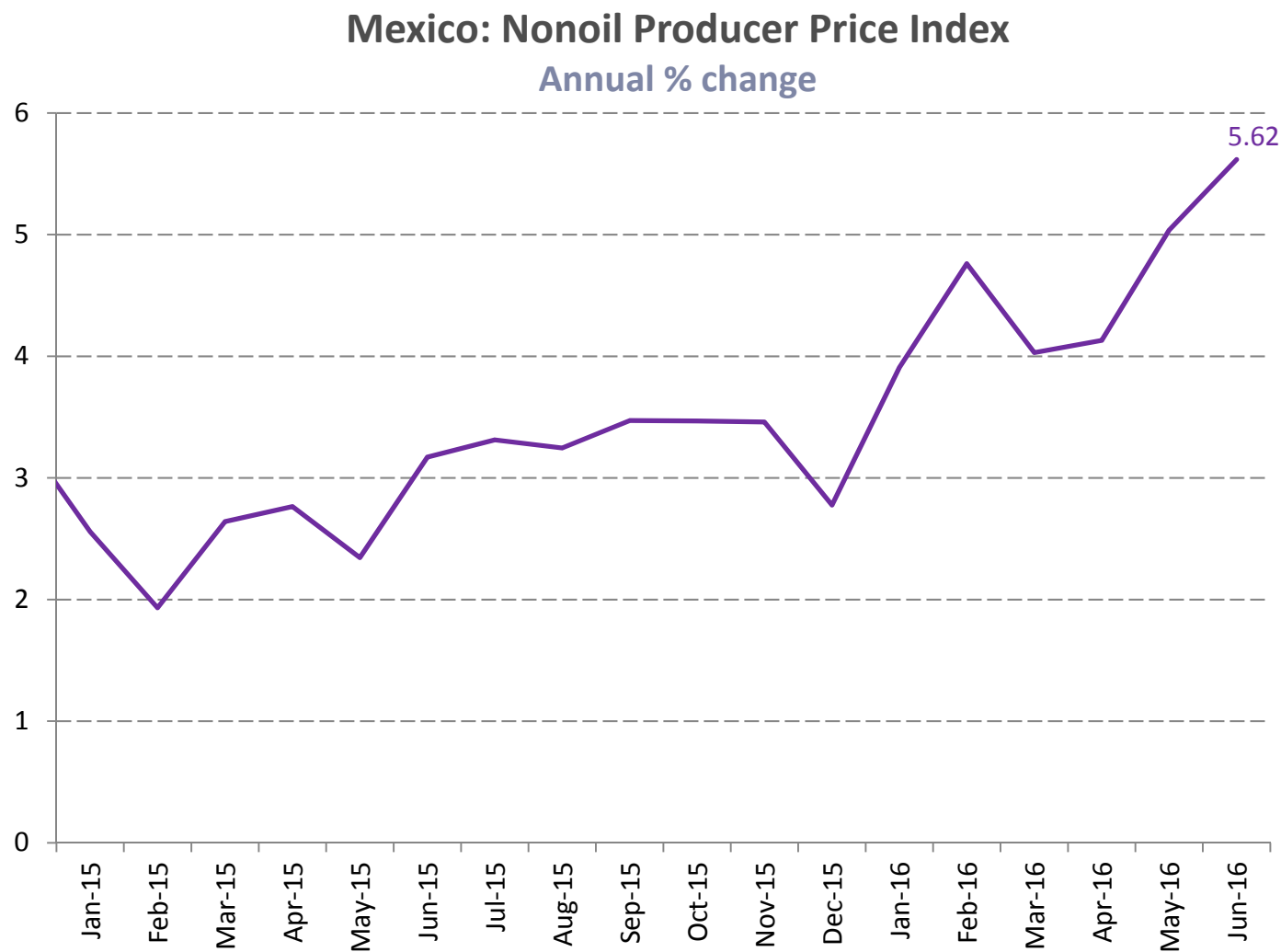
Since last year, annual inflation has remained moderate, largely supported by unusually low noncore inflation



# The rising path of core inflation reflects the effect of the exchange rate on tradable goods prices



## An accelerating rise in the producer price index also reveals an impact from peso depreciation



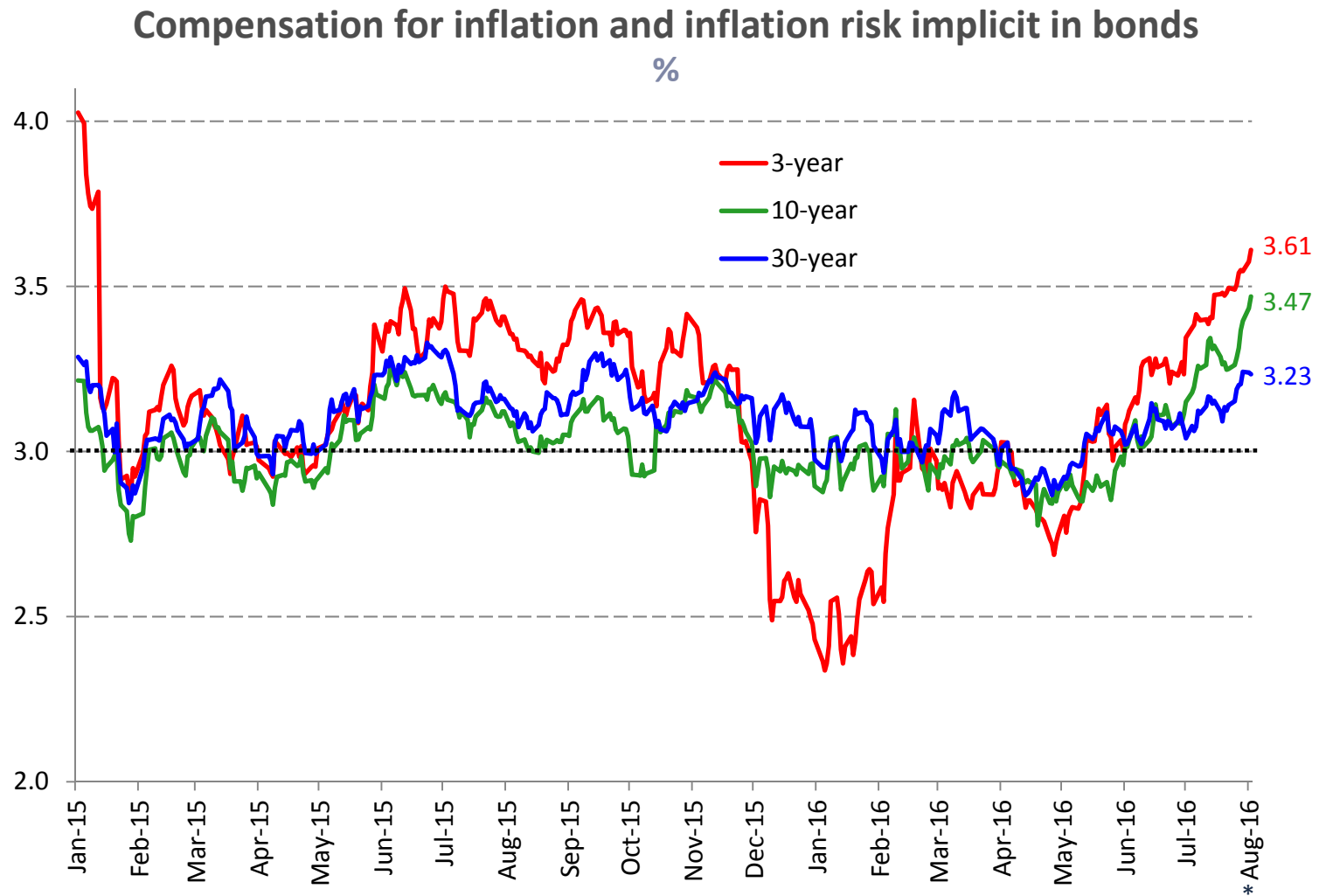
Source: INEGI

## Medium-term inflation expectations as measured by analysts' surveys have remained relatively stable, albeit above the target



Source: Banco de México, *Encuesta sobre las Expectativas de los Especialistas en Economía del Sector Privado*

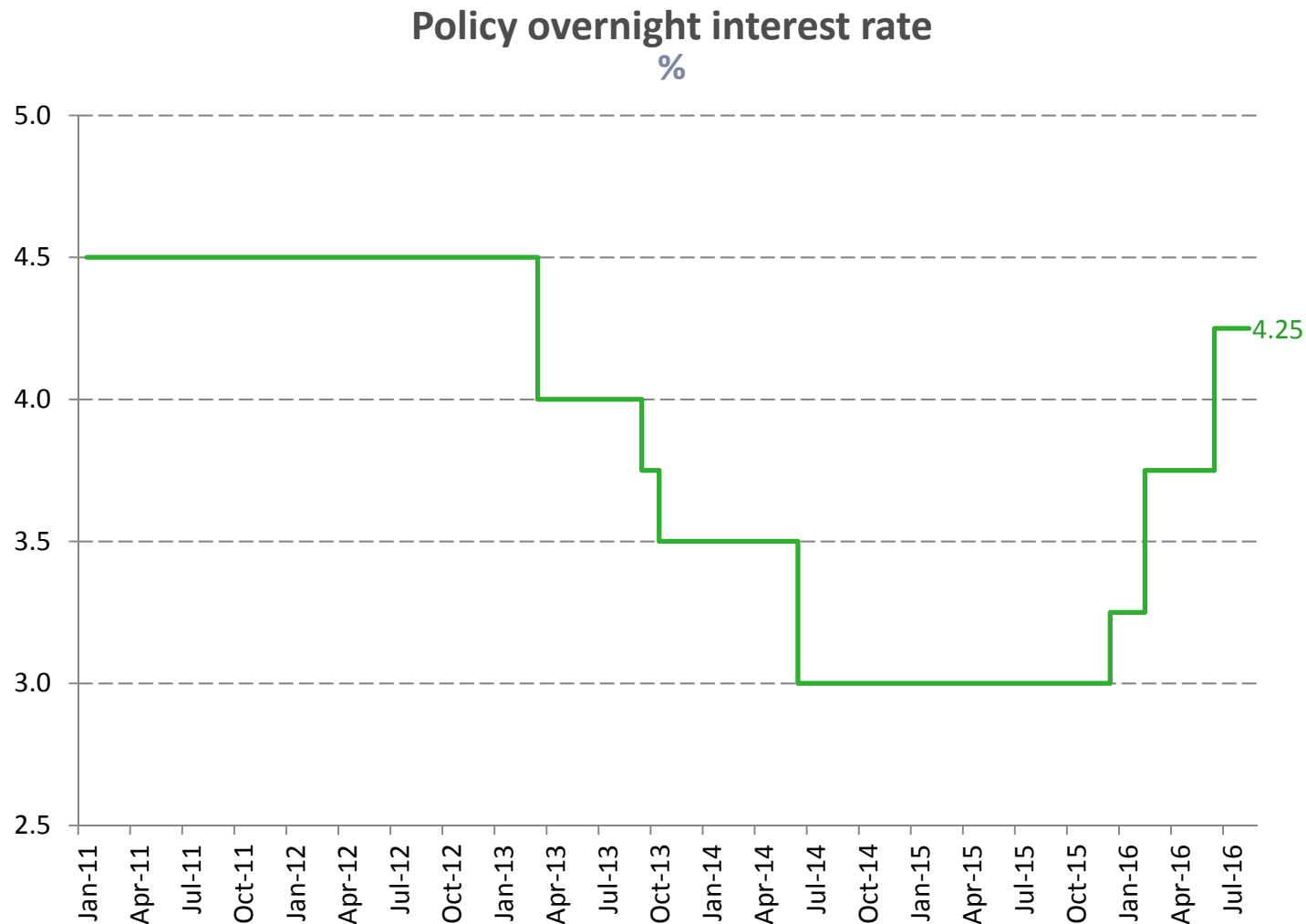
## Also, market-derived expectations appear to show a recent spike



\*/ To August 2

Source: Own calculations with data from PiP

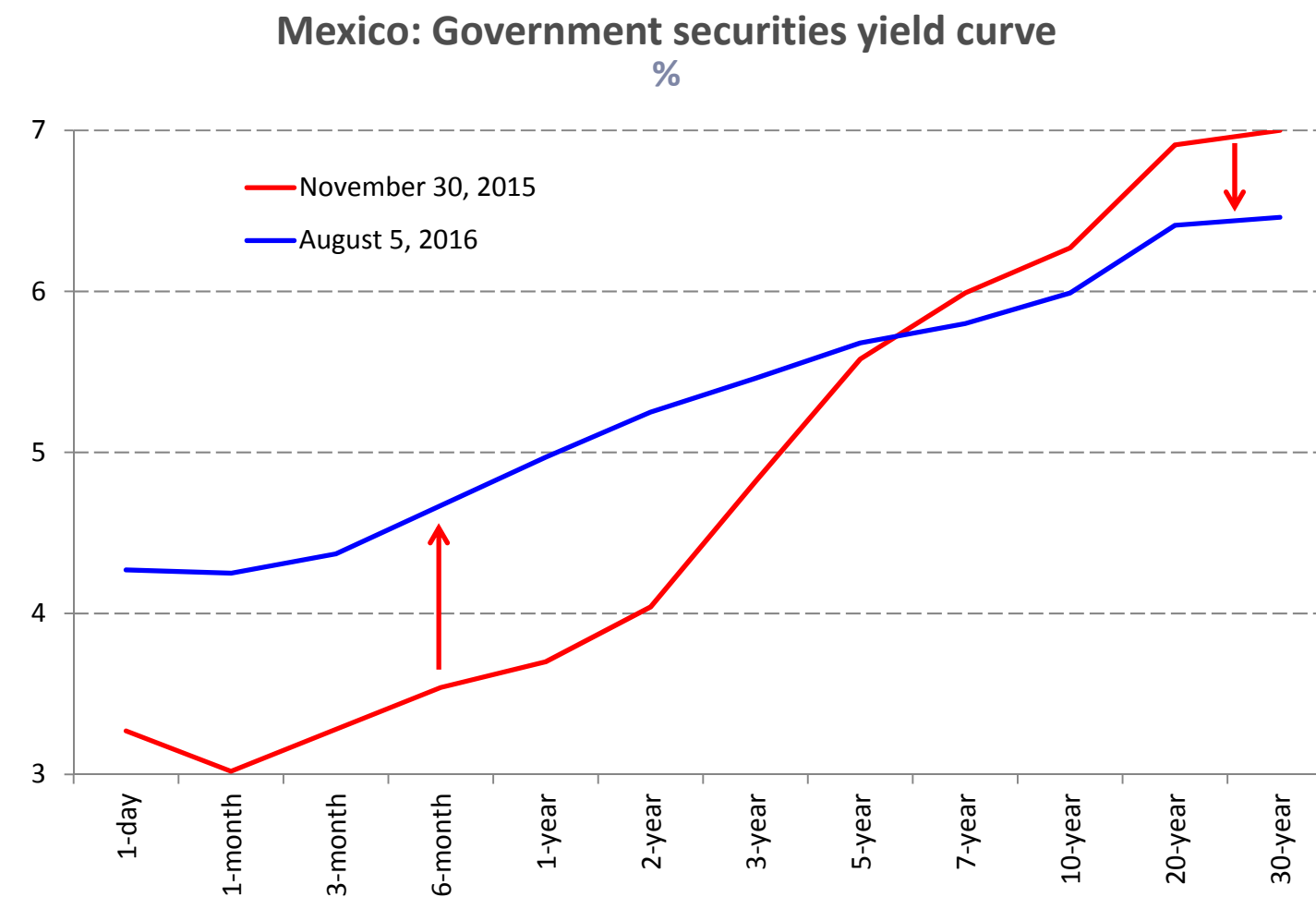
# Policy interest rate hikes have sought to avert deviations of inflation expectations and to anchor them on the target



Source: Banco de México



## The resulting flattening of the yield curve seems to reflect confidence that inflation will continue to be contained



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



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