# ECONOMIC ANALYSIS FOR COMPANY PLANNING

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**ECONOMIC REPORT ON MEXICO – JULY 2014**

**SUMMARY AND CONCLUSIONS**

The US expansion continues to be sustainable, even after the Fed made a downward revision in its forecast of growth for 2014 to 2.1% - 2.3%, in light of a bad first quarter. Such revision has one implication, i.e. that interest rates will remain low for longer than has been thought, with worldwide repercussions, one of them being a stronger peso to the dollar for the rest of this year.

**Table I**
**Mexico: Changes in Economic Environment**

| | |
|---|---|
| US monetary policy | Fed revising growth down to 2.0%; low rates reaffirmed |
| US economy | We expect growth between 2.0% and 2.5% for 2014 |
| Mexican oil prices | Prices up now, on Iraq rebellions |
| Mexican activity | Our growth estimate of 2.3% has now a significant downwside |
| Mexican inflation | Headline forecast at around 3.5% for December |
| Mexican interest | Banxico lowered interest rate to 3.0% with inconsistent guidance |
| Peso exchange rate | Peso stable at around 13 to $1 as Fed extends low interest |
| Bolsa | Possible rise with energy reform, continued world liquidity |
| Business climate | Confidence still weak; energy investment projects will lift it up |

Source: Ecanal

When reducing from 3.5% to 3.0% its policy interest rate on 6 June, the Bank of Mexico mentioned that the growth outlook was less positive than it had thought “only two weeks ago”. The index of overall activity for April rose slightly, but this and surveys for May are not enough to change the central scenario of a second year in a row of surprisingly low growth.

The split decision by the Bank’s board to make an unexpected reduction in its funding rate from 3.5% to 3.0% has reduced rates at the short end, but we doubt it will have a large impact on growth, as demand for loans is weak and banks are concerned with overdue loan portfolios. It may, however, help prevent a stronger peso in the short term. The decision by the Bank was not consistent with its own earlier indications, which may hurt its credibility.

In the first quarter the lower current account deficit reflected weakness of domestic demand. An adjustment to capital inflows has materialized, led by lower foreign direct investment and debt repayments by commercial banks. International reserves continued to rise owing to much lower asset outflows.

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## GLOBAL ECONOMY

With the fall in GDP in the first quarter, largely based on bad weather and weak housing, the Fed revised down its estimate for growth this year from 2.8% - 3.0% to 2.0% - 2.3%, while leaving its 3% estimate for 2015 unchanged. Later on Chairwoman Janet Yellen indicated that the policy interest rate may remain low through 2016. This has a significant effect on world liquidity, exchange rates, and equity markets, and in particular on the peso, which is likely to maintain its 13 to $1 rate through this year or even to strengthen if energy reform (still under discussion in the Congress) causes large capital inflows.

The downward revision to US growth is still consistent with continued recovery, which gives support to a positive outlook. For one thing, there will be no fiscal drag as in previous years, forced by automatic cuts in public spending. For another, auto sales and other indicators of consumption and investment continue up.

US inflation has risen slightly in May to 2.1% and the core sub-index to 2.0%, with markets watchful over the risk that the first fed funds rate increase may happen before the Fed expects, i.e. if economic growth accelerates. Aside from this, however, the Fed's willingness to keep rates low for a long time is clear enough, with no pressure on wages, even as employment and house prices rise. Household wealth has increased $26 trn since 2009 to $82 trn, which explains increasing confidence and increases in personal consumption.

The Fed stance to keep rates low for a long time will also keep the dollar low, which would help net exports and the potential for growth during a period of global weakness.

There are problems and risks in China, with the real estate market; the euro zone is far from a sustainable recovery; and Latin America will be hit by lower Chinese demand for raw materials.

## OUTPUT

Inegi released figures for output during the first quarter, as is shown in table II below.

**Table II.- GDP growth by sector 2011-2014**

(Annual rates %)

| | 2011 | 2012 | 2012 | | | | 2013 | | | | 2014 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 |
| **GDP** | **4.0** | **3.8** | **4.6** | **4.2** | **3.1** | **3.3** | **0.6** | **1.6** | **1.4** | **0.7** | **1.8** |
| **Primary sector** | **-1.9** | **6.3** | **5.5** | **13** | **-0.7** | **7.5** | **-2.2** | **2.6** | **0.8** | **-0.2** | **4.9** |
| **Industry** | **3.2** | **2.8** | **3.7** | **3.4** | **2.9** | **1.3** | **-1.6** | **-0.3** | **-0.5** | **-0.4** | **1.6** |
| Mining | -0.4 | 1.7 | 1.3 | 1.2 | 2.8 | 1.4 | -1.8 | -2.1 | -1.8 | -0.9 | **0** |
| Electricity | 5.1 | 2.1 | 3.5 | 2.3 | 1.8 | 0.9 | -1.1 | 0.1 | 0.8 | 0.7 | **1.4** |
| Construction | 4.0 | 2.0 | 2.7 | 3.4 | 1.9 | -0.1 | -3.0 | -3.6 | -6.6 | -4.6 | **-2.8** |
| Manufacturing | 4.6 | 3.9 | 5.4 | 4.6 | 3.6 | 2.0 | -1.0 | 2.0 | 2.9 | 1.9 | **4.3** |
| **Services** | **4.8** | **4.2** | **5.1** | **4.2** | **3.4** | **4.2** | **2.1** | **2.6** | **2.5** | **1.3** | **1.8** |
| Trade | **9.7** | 4.6 | 6.6 | 5.0 | 2.3 | 4.3 | 0.5 | 3.7 | 4.4 | 2.4 | **2.1** |
| Transport | 4.1 | 4.5 | 6.5 | 4.6 | 3.5 | 3.3 | 0.6 | 1.8 | 2.3 | 1.3 | **1.6** |
| Media information | 6.7 | 14.1 | 15.9 | 12.8 | 10.5 | 17.1 | 10.9 | 6.3 | 4.9 | -0.1 | **3.1** |
| Finance, Insurance | 7.2 | 7.8 | 9.2 | 8.6 | 7.5 | 5.7 | 3.8 | 7.2 | 3.1 | 1.4 | **1.8** |
| Real estate | 2.9 | 2.4 | 2.5 | 2.3 | 2.6 | 2.3 | 1.8 | 1.6 | 1.5 | 1.0 | **2.2** |
| Education | 1.6 | 1.4 | 2.6 | 0.9 | 0.9 | 1.2 | -0.2 | 1.8 | 1.3 | 1.5 | **2.7** |
| Hotels, restaurants | 1.7 | 4.2 | 4.3 | 3.9 | 4.1 | 4.4 | 3.9 | 1.1 | 1.7 | 1.8 | **1.8** |

Source: INEGI

Though the annual growth rate was 1.8%, this year's first quarter had more working days as the Easter holiday was in April and not in March, as it was the case in 2013. Correcting for this effect, annual growth was only 0.6%, a situation close to stagnation, as weakness appears to have intensified this year.

The increase of 0.6% is close to our estimate of domestic demand growth, of only 0.4% on an annual basis, explained by falling disposable incomes from tax reform, lower average wages and weak employment growth.

Table III below shows the increase from the last quarter of 2013 to the first of 2014 adjusted for seasonality, with a low growth of 0.28% and near stagnation in industrial output. In this table the high annual growth in the primary sector, shown in Table II above, becomes in fact a reduction from quarter to quarter. The table confirms two quarters in a row with very weak momentum including negative growth in one out of three sectors in each quarters.

**Table III.- GDP growth 2010-2014**

Quarter-on-quarter seasonally adjusted changes %

| | GDP | Primary sector | Industry | Services |
|---|---|---|---|---|
| **2011** | **1.04** | **0.38** | **0.91** | **1.16** |
| Q1 | 1.03 | -0.93 | 0.28 | 1.41 |
| Q2 | 0.92 | -6.93 | 1.35 | 0.92 |
| Q3 | 1.41 | 15.35 | 0.75 | 1.56 |
| Q4 | 0.80 | -5.96 | 1.27 | 0.75 |
| **2012** | **0.83** | **2.05** | **0.23** | **1.09** |
| Q1 | 0.70 | 5.13 | 0.77 | 1.09 |
| Q2 | 1.62 | -0.41 | 0.71 | 1.28 |
| Q3 | 0.08 | 1.32 | -0.33 | 0.61 |
| Q4 | 0.91 | 2.17 | -0.23 | 1.37 |
| **2013** | | | | |
| Q1 | 0.25 | -5.11 | -0.22 | 0.44 |
| Q2 | -0.74 | 4.69 | -0.99 | -0.54 |
| Q3 | 0.97 | -0.75 | 0.91 | 1.21 |
| Q4 | 0.13 | 1.00 | -0.05 | 0.10 |
| **2014** | | | | |
| T1 | 0.28 | -0.01 | 0.07 | 0.20 |

Fuente: Inegi

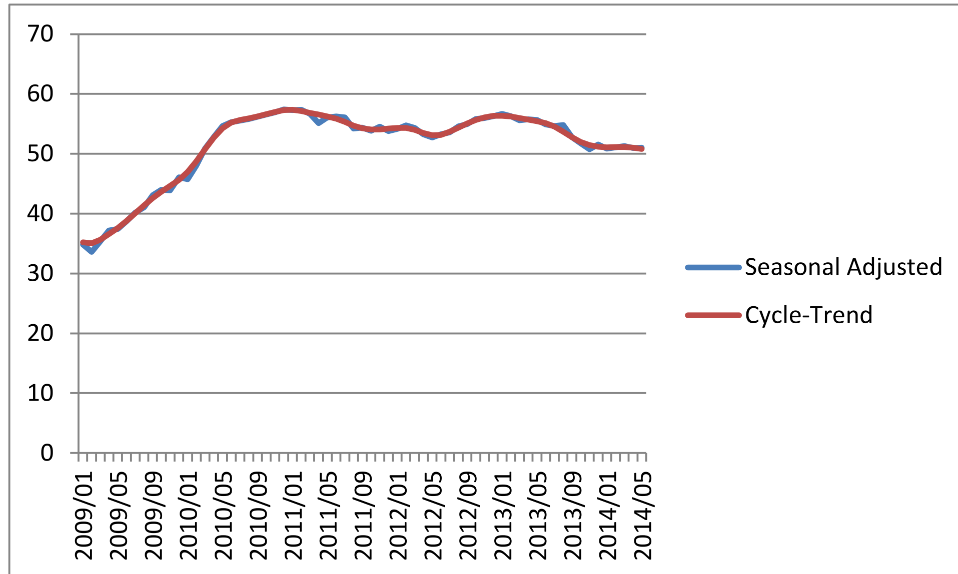
The index of overall activity rose in April 0.5% on an annual basis and 1.25% monthly based especially on a jump in services, which is largely related to the Easter holiday. The two indices used by Inegi to represent the cycle trend of activity had already suggested a slight improvement in April and May. This is not, however, enough to represent a significant change of trend. The coincident index, recording current indicators was on its 22$^{nd}$ monthly reduction in March with no indication of improvement.

The second index, of leading indicators, with only partial data for May, shows an increase that month in interest rates and consumer confidence, but continuing negative changes for businessmen confidence.

With regards to surveys, that of manufacturing orders remained stagnant in May and has been so since January. The index shows weakness in expected orders and expected production, hiring and inventories of inputs.

The survey of manufacturing producers' expectations is significant, as its trajectory since 2012 has followed actual trends in output, only with a short lag. Table IV below shows that seasonally adjusted trend peaked in December 2012-January 2013 and was followed by a continued slowdown through November 2013. Since then the trend is stagnant, at a low level of confidence, only slightly above the threshold that signposts contraction, through May 2014.

**Table IV. - Seasonally Adjusted Manufacturer Confidence Index Cycle Trend 2009-2014**




It can be seen that last January, manufacturers' confidence was close to contraction, at only 1 point above the threshold of 50. This was a similar level as was last recorded in early 2010, when the economy was emerging from a deep recession in 2009. The index has not improved significantly since then.

The manufacturers' confidence index is made up of sub-indices showing:

- Whether this is a good time for investing in Mexico (stagnant since January, after falling)
- The economic situation of the country (stagnant since November and only rising slightly in the sub-index of the situation expected a year from now), and
- The situation of the company (stagnant since September).

Outcomes have been consistent with this confidence indicator. Inegi' retail sales fell -0.1% on an annual basis in the first quarter. More recently, the retailers' association (Antad) recorded a fall of -3.5% through May, led by supermarkets (-4.3 percent). Domestic auto sales of the dealers' association (Amda), recorded a fall of -0.5% through May.

The implication is that consumption has been falling, which makes any short-term recovery depend on investment. Producers' confidence survey is thus highly significant. At this stage confidence is not only influenced by negative sentiment from tax reform, but it has also been affected by the slowdown since late 2012 and by continued security problems.

The government's task to reassure the private sector has now become more difficult than it was last year, when we think it should have attempted specific measures to boost confidence. In the absence of that, other issues have emerged over time, which complicate this issue, as producers and

consumers have felt the effect of a protracted slowdown and continued violence, now affecting 15 states. These sectors will now wait for evidence of clear improvement in these areas before confidence can be regained in full, which is unlikely to happen this year.

The Bank of Mexico has now reacted to the risks to growth from lack of confidence. In its quarterly report for the first quarter, released only two weeks before cutting its policy interest rate from 3.5% to 3.0%, it mentioned that:

> "In the context described, there are downside risks in the scenario of growth for 2014 and 2015. Among the main risks, there are:
>
> i. That consumer and producer confidence fails to improve sufficiently quick and, hence, that private sector expenditure does not recover at the central scenario forecast rate; and
>
> ii. That the process of monetary policy normalization in the United States is not orderly."

The Bank's assessment of the continued slowdown now goes beyond its own earlier evaluation which had considered it a transitory patch, for it now includes weak confidence as a risk to growth. This assessment is also at variance with the government's which makes no mention of confidence and explained the poor first quarter growth as resulting from: (1) weak US economy; (2) "transitory" weakness in consumption; and (3) lower oil revenue.

We attribute top importance to lack of confidence, as a major cause of deferred consumption and investment and trace its deterioration to excessive expectations at the start of the new government in December 2012 and bad policy decisions since then. These include government neglect of the fall in construction and in public spending and an ill-timed tax increase.

## PRICES AND WAGE COSTS

In May consumer prices rose by 3.5% and core inflation remained at 2.9% on an annual basis, suggesting that in the short term this is likely to be the lowest level, mainly because of a weak base of comparison in the few months to come. This was confirmed by data for the first fortnight of June, when prices rose only 0.08% and yet the annual rate hit 3.71 percent.

A pick-up in the annual rate is now foreseeable for the following few months, probably through October. From then and through December the annual rate would converge downwards towards our projected 3.6 percent. As the economy remains weak, inflation above 4% is not a serious risk, apart from government-dictated gasoline and diesel price increases. These are now mainly motivated by the need for fiscal revenue, as some US gasoline prices are now below Mexican prices.

One aspect we have considered in these reports is the weakness in producer prices, in fact one of the causes of falling confidence among businessmen, as we have seen in surveys of expectations by Inegi. In our report for May we commented that producer prices were close to deflation at the end of the first quarter.

That is, taking into account that electricity, water and gas producer prices had risen 9.1% in the year to March while all producer prices rose 2.2%, it was clear that non-energy producers were reducing prices or maintaining them against rising costs.

In May the annual rate of producer-price inflation of electricity water and gas moderated to 4.3% (given the reduction in summer rates), while the index of all producer prices rose slightly to 2.8%, suggesting a slight improvement in pricing of non-energy producers. This was largely the result of a jump in prices in the primary sector of 3.3% and a decrease in prices of energy of -3.97% in that month, as is shown in Table V below.

**Table V**
**Producer price inflation by sector of origin and type of good or service sold**

| | Monthly change May % | | | Annual change May % | | |
|---|---|---|---|---|---|---|
| | Intermediate goods | Final goods | Total | Intermediate goods | Final goods | Total |
| General Index | 0.84 | 0.01 | 0.27 | 3.51 | 2.54 | 2.84 |
| Primary sector | 3.43 | 3.23 | 3.33 | 3.13 | -0.99 | 1.11 |
| Industry | 1.05 | -0.13 | 0.23 | 4.59 | 2.53 | 3.17 |
| Mining | 1.85 | -0.58 | 0.64 | 8.63 | 1.50 | 5.01 |
| Electricity, water, gas | 0.09 | -15.89 | -3.97 | 5.36 | 0.92 | 4.34 |
| Construction | na | 0.26 | 0.26 | na | 2.27 | 2.27 |
| Manufacturing | 1.11 | 0.12 | 0.45 | 4.20 | 2.67 | 3.17 |
| Services | -0.08 | -0.05 | -0.06 | 1.91 | 2.87 | 2.59 |

Source: Inegi

We thus see some weak evidence of a change in relative prices for non-energy producers, though at least part is owed to the seasonal reduction in electricity.

Apart from the primary sector, there are some price increases in other activities. For example, annual rates of increase in construction and manufacturing are higher by 0.7 and 1.3 percentage points respectively than they were in March. In manufacturing the increase in May was relatively high, which we take as a sign of improvement, but will need more data before confirming an improved trend.

## BANK OF MEXICO POLICY

In our report last month we mentioned that the Bank of Mexico saw headline inflation falling, though its core rate was stable at around 3 percent. And although there was evidence of pricing weakness, we have seen this before without the Bank responding with interest rate reductions. In its report for the first quarter, the Bank had emphasized that uncertainty over US monetary policy raises the risk of a disorderly unwinding of QE3. Furthermore, as the Bank expected that the period of economic weakness would end in the second semester, the implication was that no change in interest rates would be warranted.

Later on, in May, the Bank announced a reduction in its estimate of GDP growth for this year from 3.0% to 4.0% to 2.3% to 3.3%, arguing that weakness in domestic demand and confidence of consumers and producers were having a protracted effect on output. This would be lower during the second quarter than it had thought. Yet, growth during the second semester would strengthen.

Only two weeks after this announcement, the Bank reduced its policy interest rate from 3.5% to 3.0%, explaining as a reason that inflation was falling on the weak economy, while expectations of inflation for 2014 had fallen below 4 percent.

We find the series of Bank indications and policy inconsistent for the following reasons:

(1) There has not been a significant reduction in inflation and in fact the headline index rose slightly from 3.50% to 3.51% between April and May, even after two monthly reductions in electricity rates;
(2) Moreover, inflation usually picks up after summer electricity rates have their effect felt;
(3) Core inflation just fell to 3.0% in May from 3.1% in April and is again 3.1% in the first fortnight of June, when the headline index rose to 3.7%, and likely to rise in the short term, as the equivalent base of 2013 is low;
(4) In March 2013, when the Bank reduced its rate from 4.5% to 4.0%, it indicated that there would be no further reductions; in reality there have been other tree reductions. This is even as the Fed warned, in May 2013, that it was ready to start reducing the monetary stimulus of QE3. The Fed has maintained the same stance;
(5) This time the Bank indicated again that "further reductions would not be appropriate", which makes it lose credibility and raises doubts as to what caused the reduction of 50 basis points. One risk that cannot be discarded is that the government may begin to exert political pressure on the monetary authority, as it seeks ways to counter economic weakness with non-fiscal measures.

## BALANCE OF PAYMENTS DURING THE FIRST QUARTER

At the end of the first quarter the size of the current account deficit (-$4.533 bn) reflected the economic slowdown, as imports and exports grew at about one half the rate recorded in the same period of 2013. The increase in manufactured exports offset the fall in oil exports and permitted modest growth for the total. The overall rate of increase in exports was thus only slightly below the rate of increase in imports. The latter was led by non-oil intermediate imports.

The low deficit has been largely owed to extraordinarily low (3.0% in current dollars) growth in imports, well below the rate during 1996-2008 (10.9%) and much lower than during the recovery of 2010-12 (16.9 percent).

Thus, the low current account deficit faced no problem being financed by capital inflows (a net $9.533 bn), even as these inflows were also smaller than they have been since 2010, when government peso bonds started to become popular among foreign investors.

In 2013, however, it became clear that the long period of abundant international liquidity created by central banks would be coming to an end, even if gradually. The balance of the financial account, shown in Table VI on page 8 shows a reduction in those inflows by about one half between 2013 and 2014.

The reduction applies to foreign direct investment (FDI): foreigners' investment in Mexico fell from $8.129 bn in the first quarter of 2013 to $5.820 bn in 2014. Investment of Mexicans abroad

had fallen in anticipation in 2013 and remained low, at $2.249 bn and $2.264 bn respectively. The net FDI flow was down from $5.880 bn to $3.177 bn.

Portfolio inflows remained at the same level of 2013, but this resulted from a fall in public peso securities, offset by an increase in issues abroad of public dollars securities.

**Table VI.- Balance of Payments 2011-2014**
**$ bn and percentage change**

| | 2011 | 2012 | 2013 | First Quarter | | Annual change % | | |
|---|---|---|---|---|---|---|---|---|
| | | | | 2013 | 2014 | 12/11 | 13/12 | 14T1/13T1 |
| Goods Exports | 349.9 | 371.4 | 380.9 | 88.5 | 91.1 | 6.1 | 2.9 | 2.9 |
| Goods Imports | 351.2 | 371.2 | 381.6 | 89.5 | 92.2 | 5.7 | 3.0 | 3.0 |
| **TRADE BALANCE** | **-1.3** | **0.2** | **-0.7** | **-0.9** | **-1.1** | -118.0 | 18.0 | 18.0 |
| Remittances | 22.8 | 22.4 | 21.6 | 4.8 | 5.3 | -1.6 | 10.5 | 10.5 |
| Service imports | 30.4 | 30.7 | 31.8 | 7.2 | 8.0 | 1.1 | 9.9 | 9.9 |
| Investment income | 30.0 | 36.4 | 44.4 | 12.2 | 8.7 | 21.3 | -28.9 | -28.9 |
| Profits remitted | 3.6 | 8.1 | 10.5 | 2.8 | 0.3 | 125.4 | -90.1 | -90.1 |
| Profits reinvested | 8.7 | 8.0 | 10.7 | 5.1 | 3.5 | -8.5 | -30.2 | -30.2 |
| Interest | 17.7 | 20.3 | 23.2 | 4.4 | 4.9 | 14.7 | 11.1 | 11.1 |
| **CURRENT ACCOUNT** | **-12.6** | **-15.1** | **-25.9** | **-7.1** | **-4.5** | 19.9 | -36.3 | -36.3 |
| **FINANCIAL ACCOUNT** | **50.5** | **51.3** | **59.6** | **16.3** | **9.5** | 1.5 | -41.6 | -41.6 |
| Foreign Direct Investment | 10.7 | -4.8 | 25.3 | 5.9 | 3.2 | -145.2 | -46.0 | -46.0 |
| Portfolio Investment | 45.9 | 72.7 | 48.3 | 13.0 | 12.9 | 58.2 | -0.7 | -0.7 |
| Issued by public sector | 37.0 | 56.9 | 33.2 | 11.9 | 10.1 | 53.8 | -15.2 | -15.2 |
| Securities issued in $ | 5.3 | 10.2 | 11.2 | 2.5 | 5.6 | 92.0 | 120.6 | 120.6 |
| Money market | 31.7 | 46.6 | 22.0 | 9.3 | 4.5 | 47.4 | -51.8 | -51.8 |
| Issued by private sector | 3.6 | 24.3 | 17.2 | 1.3 | 2.5 | 566.8 | 88.4 | 88.4 |
| Assets | 5.3 | -8.5 | -2.1 | -0.2 | 0.4 | ns | -302.3 | -302.3 |
| Other investment | -6.1 | -16.6 | -14.0 | -2.6 | -6.6 | 170.4 | 155.9 | 155.9 |
| Assets | -3.7 | -6.3 | -27.3 | -16.8 | -3.3 | 70.8 | -80.0 | -80.0 |
| **ERRORS AND OMISSIONS** | **-9.8** | **-18.7** | **-16.0** | **-3.6** | **0.0** | 90.8 | -101.4 | -101.4 |
| **GROSS RESERVE FLOW** | **28.6** | **17.8** | **13.2** | **4.2** | **5.3** | -37.7 | 24.0 | 24.0 |
| Adjustment to reserve value | -0.4 | -0.3 | 4.6 | 1.3 | -0.2 | -28.1 | -116.2 | -116.2 |
| **Official reserves[1]** | **142.5** | **163.5** | **176.5** | **167.0** | **182.8** | 14.7 | 9.5 | 9.5 |
| **Memorandum:** | | | | | | | | |
| **Total oil exports $ bn** | **56.4** | **52.9** | **49.6** | **12.9** | **11.5** | -6.2 | -10.8 | -10.8 |
| **Oil average Price $ per barrel** | **101.1** | **101.8** | **98.5** | **103.0** | **92.3** | 0.7 | -10.4 | -10.4 |

1: End of period
Source: Banco de México

In the case of public sector peso instruments, the fall was significant, from $9.339 bn to $4.503 bn, in line with similar falls of local currency instruments in other emerging markets. The government then resorted to increases in issues of dollar instruments.

Other liabilities showed a sharp fall from $14.184 bn to -$3.235 bn in the same period, led mainly by commercial banks, whose foreign transactions have responded largely to the need of resources of their parent companies abroad.

As capital inflows have fallen, so has the net outflow in assets, from -$6.274bn to -$27.279 bn in 2012 and 2013. The flow remained negative in the first quarter of 2014 at -$3.348 bn.

The trade deficit has remained modest owing to resilient oil prices, but above all to low economic growth. Similar to macroeconomic policy in Asian countries after their crisis of 1997, Mexico has tried to avoid high external deficits since the peso devaluation of 1995, with a few

exceptional years when oil prices fell. The difference has been that Asian countries achieved their new ‘equilibrium’ with trade surpluses, while Mexico did it with low economic growth.

This explains that the average current account was -$10.082 bn during 1996-2000, -$10.782 during the next administration, of Vicente Fox, and -$12.387 bn during the Calderón administration.

One difference between these different periods is that oil prices rose after 2000 and have remained high since 2010. This means that higher oil revenue has been offset by higher imports. The latter were during 1996-2000 $119.124 bn on average; $197.403 bn during the Fox administration; and $308.528 bn in the next administration.

Such higher absorption of imports without higher economic growth suggests structural problems in key sectors (e.g. energy) and a combination of excessively open trade during a period of weak Asian currencies (especially China’s) and problems of competitiveness.

If economic growth accelerates, higher imports are likely, which may lead eventually to a higher non-oil trade deficit,

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