

British Embassy

Mexico City

Economic Overview: December 2014

Summary

* Economic activity in 4Q2014 closes with stronger signs of recovery. The construction sector has started to grow, with significant positive impacts on employment. 2014 growth forecast from Finance Ministry between 2.2% and 2.5%, but independent analysts and the Bank of Mexico expect a slightly lower figure around 2%. Expected growth rate for 2015 remains high at 3.5%, even allowing for energy sector suffering from falling oil prices. The Government faces a complex scenario for 2015, after ending 2014 with three outstanding economic concerns: the ongoing fall in oil prices and its effects on economic performance, pressure on the Central Bank to adjust its monetary policy in the near future, and a weak recovery during 3Q2014. However, if it manages these well, Mexico should perform better than the majority of emerging markets in Latin America.
* The price of the Mexican oil barrel has been decreasing daily since October 2014. Government revenues have been affected by this fall. Not all the effects of this depreciation will be negative: the depreciation of the exchange rate, paired with good economic performance of the American economy in Q4 2014, could boost exports in the short term. However there are potential significant long term effects for the Mexican energy reform.
* On January 4, President Peña Nieto released a Forward Look for 2015 via his website. He used the message to announce seven policy actions to improve the welfare of Mexican households. The purpose of these measures is to deliver concrete results in order to compensate for the underperformance of the economy. Overall, these actions could bring some gains in certain specific sectors such as manufacturing and telecoms, but they won’t compensate for the lack of sustained growth in overall income per capita.



Macroeconomic Overview: the year ends with some challenges

1. The Mexican Government faces a complex scenario for 2015, including dealing with three outstanding economic concerns from 2014; the ongoing fall in oil prices and its effects on economic performance, pressures on the Bank of Mexico to adjust its monetary policy in the near future, and a weak recovery during 3Q2014.
2. The current fall in commodity prices has changed the economic outlook for all emerging markets; Mexico has not been excluded. Since October, the price of Mexican oil barrel has been decreasing day by day. The monthly average price of the mix fell 20% from October to December. The consequences of cheaper oil prices can be seen already in the Mexican exchange rate and in Government revenues. However, the impact of these has been much reduced by the Government’s foresight due to its policy of ‘hedging’ the price it buys/sells oil. It has had this policy in place in 2011 and hedged the price from the second half of 2014 at USD$79, protecting Government from the biggest shocks, but meaning that the Government will not receive any revenue surpluses from high oil prices for the foreseeable future.
3. The capital outflow from emerging markets is not arbitrary: it is focused mainly on oil producers, and it is closely related with the fall in oil prices. From the beginning of September to the end of 2014, in comparison with the US dollar, the Mexican peso depreciated 11.1%, the Brazilian real 15.2%, the Norwegian kroner 16.9%, and the Russian rouble 35.5%. As Graph 1 shows, there is a close relationship between both variables, and only the intervention of the Mexican Central Bank to auction USD200m on 12 December smoothed the depreciation rate of the currency. Agustin Carstens, Governor of the Bank of Mexico, justified this intervention by stating that this volatility in capital markets could cause exchange rate overshooting and therefore could affect price stability. The correlation between daily exchange rate and the price Mexican oil barrel for the 4Q2014 is -0.98 and statistically significant.
4. In addition, government revenues have been affected by the fall in prices. As Graph 2 shows, some of the impact of the fall in oil revenues has been offset by two policies: the hedging of the oil prices (which prevented a larger decrease in revenues in 2H2014) and new tax revenues brought by the fiscal reform. Hedging oil revenues has been a sensible decision, however if this trend in prices remains in 2016, public debt could increase significantly. Moreover, if oil companies perceive this negative trend as something that will be maintained in the long term, the energy reform could attract less investment than expected, since the expected profit margin would decrease and projects for deep water and shale require a significant amount of initial investment. In order to remain as an attractive destination for foreign investors, the Mexican authorities would need to check its tax scheme for profit sharing contracts in order to offer better conditions to maintain the interest. However, this will mean less government revenues, which was the original purpose of the reform.
5. The Bank of Mexico has also take into account short term depreciation into its inflation targets. Even when evidence suggests that the exchange rate pass-through is low for the general price level, yearly inflation is already over the benchmark established by the Bank (3 +/-1%) as it could reach 4.07%. Most of the increase is due to non core inflation caused by recent increases in petrol and livestock prices. Paired with an imminent increase in interest rates in the US for 1Q2015, the Bank will have to discuss its interest rate target, set in 3%.
6. Not all the effects of this depreciation will be negative: the depreciation of the exchange rate, paired with good economic performance of the American economy for the last quarter of 2014, could boost exports in the short term. This will help the weak recovery of the economy. The recovery started back in April 2014, but it hasn’t been strong enough to drive the economy to its potential. According to the latest survey from Bank of Mexico, the expected GDP growth rate is 2.2%.

Policy in Focus 1: Peña Nieto announces seven actions to improve household’s welfare

1. On January 4, President Peña Nieto published a message for the end of the year and the challenges for 2015. He also used the message to launch seven initiatives to “improve the welfare of Mexican households”:

1) As a result of the energy reforms, government will lower the cost of electricity prices for 2015 for both firms and households (likely through the payment of additional subsidies, although this hasn’t been formally confirmed); 2)There will be no further increases in petrol prices; 3) Telephone fees in the country will be lower as a result of the telecoms reform; 4) In order to provide access to digital TV, the government will provide digital TVs to 10 million poor households; 5) As a result of the financial reform, young entrepreneurs between 18 and 30 years will receive credits to open their own businesses; 6) The government plans to launch a fiscal package to foster the housing sector In order to promote economic recovery and access to housing services. 7) A special fiscal regime for Chiapas, Guerrero and Oaxaca.

1. The Government has been slowly increasing the prices of petrol and gas over the last five years by gradually removing huge, regressive, subsidies. Fixing (or even lowering) the petrol price as announced as the second ‘initiative’ is actually feasible; however, this would actually be thanks to the drop in international oil prices, rather than the result of the energy reform, since implementation will take some time.
2. The initiative to give TVs represents a significant opportunity cost for the Government. The total cost of the programme is MXN$19b, which could be use to invest in public infrastructure or social programmes. In addition, in 2013, only 25.8% of the population had access to digital TVs, and only 30.7% of the households had home internet access. This means that most of the families benefitting from this initiative will not be able to fully use the functions of the TVs. The majority of poor households have far more pressing issues, such as low wages, lack of access to healthcare and social security, etc, and approximately 21.2% of the total population of the country has no access to basic domestic white goods and assets.
3. The housing policy has been one of the major problems behind the economic slowdown: the crisis in the construction sector in 2013 was triggered by an excess of supply of houses that no one wanted because there were constructed in zones far away from the main cities and industrial centres without basic infrastructure (the reason behind Mexico’s problem of abandoned houses). In addition, only workers in the formal sector can access Government support to buy a house. Only 40% of the labour force will therefore be able to benefit from this initiative, not those who most need it (see July economic report).
4. Finally, the fiscal regime for the south will need a set of complementary policies to be successful: larger investments in social infrastructure, transparency in the allocation of budget for the states, and policy coordination between the Ministry of Trade and Ministry of Social Development.
5. Overall, these initiatives could foster growth in certain sectors such as manufacturing and telecoms, but they won’t compensate for the lack of sustained growth in income per capita, nor really having a permanent effect on individuals’ or households’ income. GDP per capita actually decreased in 2013, since the economy grew around 1.09%. Preliminary figures show that economy grew 2.1% in 2014, meaning that GDP per capita for 2014 remains at levels similar to 2012.

Monthly Economic Monitor

1. Banxico’s December survey maintained its 2014 GDP growth expectations in 2.19% compared to last month’s. The new forecast of the Ministry of Finance is consistent with this figure. Whilst the November survey had a 3.51% forecast for 2015, in December this forecast slightly decreased to 3.50%. In order to deliver growth rates above 3%, the domestic demand must recover from 2013 slowdown. The latest data for the US economy for 4Q2014 suggests that exports could help the economy to grow for the 1Q2015.
2. The end year general inflation forecast for 2014 decrease to 4.06% and for 2015 it increased to 3.54%. The inflation for 2014 is still slightly over Banxico’s benchmark (3%+/-1). Some of the increase in general inflation is explained by non core inflation from energy and commodity prices. The current depreciation of the Mexican peso means that the Central Bank will have to keep stabilising the currency to avoid overshooting and pass-through.
3. Forecasts for the Mexican peso (MXN) reflect the effects of oil prices explained above. The Central Bank has a sufficient amount of foreign reserves to deal with current volatility in financial markets. The USD/MXN year-end expected exchange rate for 2014 is 14.23.

| **Consensus Forecast**  **(November 2014)** | **2014** | **Vs. October 2014** | **2015** | **Vs. October 2014** |
| --- | --- | --- | --- | --- |
| GDP (growth) | 2.19% | = | 3.50% | ⇩ |
| Inflation | 4.06% | ⇩ | 3.54% | ⇧ |
| Exchange Rate (year-end) | 14.23 | ⇧ | 13.74 | ⇧ |
| Source: Bank of Mexico survey on private sector expectations | | | | |