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ECONOMICS: LATIN AMERICA PERSPECTIVES

MEXICO: SLOW RECOVERY SHOULD KEEP CENTRAL BANK ON HOLD

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Recent data suggest the Mexican economy is recovering more slowly than expected. That probably means the negative output gap will take longer to close. It also increases the chances that the central bank will wait for the US Federal Reserve to lift interest rates before it starts to tighten its own monetary policy.

The Economy Grows—But Slowly

Mexico's economy slowed in the first quarter, expanding by just 0.4% on a seasonally adjusted basis in the January–March period compared to the prior quarter. Primary activity expanded by 3.0%, while services increased by 0.5% and industrial activity shrank by 0.2%.

A deeper dive into the details of the report revealed that the agricultural sector performed well, growing 6.8% quarter over quarter. The services sector—especially transportation and commerce—also turned in a solid, though not stellar, performance. The industrial sector, on the other hand, continues to act as a drag on overall activity, with the weakness concentrated in the oil industry.

The aggregate figure adds up to a 2.5% GDP increase year over year. The interannual comparison also shows that the primary sector led the increases at 6.8%, followed by services at 2.9% and secondary activity at 1.5%.

Although the annual GDP growth figure was a shade above expectations, it represented a change in the accelerating trend that we've seen since the second quarter of last year (*Display 1*). That fits with market expectations of less than 3.0% GDP growth this year and with the central bank's recent downward revisions to its growth projections.

A Dovish Inflation Report

In its recently released quarterly inflation report, the central bank said it saw no evidence of internal imbalances now that inflation has converged to the 3% medium-term target and is not expected to deviate from that mark over the next quarter. This is especially so because the slower-than-expected recovery in economic activity has kept production capacity slack.

What's more, inflation expectations are well anchored. The central bank suggested that there are no price pressures in goods and factors markets or on the external accounts. In summary, inflation risks appear to be contained at the present juncture in the eyes of the central bank.

Meanwhile, currency depreciation was tied largely to the drop in oil prices and market expectations that the Fed will soon begin normalizing US monetary policy. But the central bank pledged to remain vigilant and

Display 1
GDP Growth Stops Accelerating

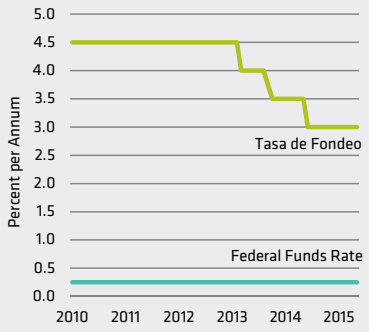
GDP at Market Prices
(YoY Percent Change)

	2014				2015
	1Q	2Q	3Q	4Q	1Q
GDP	2.0	1.7	2.2	2.6	2.5
Primary	2.8	2.6	7.1	1.4	6.8
Secondary	1.9	1.1	2.0	2.4	1.5
Manuf.	4.5	2.7	3.3	4.6	2.9
Oil	(1.3)	(0.6)	(2.7)	(4.7)	(5.8)
Tertiary	2.0	1.9	2.1	2.9	2.9

Through May 21, 2015
Source: Inegi and AB

Display 2
Banco de México Likely to Wait for the Fed Before Hiking

Federal Funds Rate and Tasa de Fondeo



Through May 21, 2015
Source: Banco de México Bloomberg and AB

to watch for any evidence that a weaker currency was starting to push up domestic prices, a process known as inflation pass-through. So far, low pass-through is in line with central bank expectations.

Other reasons that inflation has declined this year, according to the central bank, include lower telecom and energy prices and the bank's own current monetary policy stance.

Meanwhile, policymakers chalked up the weakness in first-quarter economic activity mainly to soft external demand and only a slight improvement in domestic demand. They also said uncertainty about the start of the Fed's US rate-hiking cycle, commodity prices and Greece all contributed to market volatility.

Policymakers did acknowledge that the macro framework should be tightened, ideally by adjusting public spending in order to reduce debt-to-GDP ratios

Revising the Outlook

The central bank did not change its inflation forecasts, with the headline number expected to be near 3% this year and core inflation a bit lower. Both the headline and core measures were seen at close to 3% in 2016. The upside risks to inflation are associated with the exchange rate, while downside risks are related to more energy and telecom price reductions, as well as possible peso appreciation.

As for the growth outlook, it was mainly changes in the external environment, including weaker US demand, that prompted the central bank to cut its 2015 GDP projection to a range of 2%—3% from the previous 2.3%—3.5%. For 2016, it marked its projection down to 2.5%—3.5% from 2.9%—3.9%.

The bank also adjusted its expectations for formal job creation and now expects the economy to create 580,000 to 680,000 jobs this year and 600,000 to 700,000 in 2016.

Policymakers also urged the development of domestic sources of growth to make Mexico less dependent on US economic activity and oil prices. That was seen as a vote of support for the government to complete its ongoing structural reforms.

The central bank now expects the current account deficit to be US$27.7 billion (2.3% of GDP) this year, US$1 billion lower than its previous estimate, and US$29.7 billion (2.3% of GDP) in 2016, down US$2 billion from its earlier estimate.

The downward growth revision together with the message of stable inflation and no major imbalances reinforces our view that Mexico's central bank is in no rush to increase its reference interest rate (*Display 2, previous page*). Unless there's a dramatic and sudden weakening of the peso, the bank is not likely to move before the Fed does.

Our models suggest that Mexico's real exchange rate is currently undervalued, but the combination of soft economic activity and the expected holding pattern for monetary policy suggest it may be a while before we see significant currency appreciation.■