Mexico Stands to Benefit From Reforms and Navigate Fed’s Tapering With Relative Ease

Jesus Cañas
Federal Reserve Bank of Dallas
Laredo, Texas
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Outline

– Mexico and Fed’s Tapering
– 2013 worst than expected
– Economy back on growth track in 2014
  • Why we care about Mexico
– Reforms will help, but ...
  • Fiscal
  • Energy
– The potential of the energy reform (*The Texas example*)
– Conclusions
Peso holding up well despite tapering

Source: Banco de México and Bloomberg.
Foreign investors hold on to their Mexican government debt

Source: Banco de México & CME.
Mexican economy decelerates in 2013

Q4/Q4 Annualized growth, real and s.a.

SOURCE: Instituto Nacional de Estadística y Geografía.
Deceleration of the Mexican economy in 2013

• Slowing preceded tapering

Due to:

– Low growth, weak trade in the global economy
– Lower public spending as new administration takes office
– Gas shortages slowing manufacturing in central Mexico
– Deep seated weakness in the construction sector
Economy Back on Growth Track in 2014

Index, January 2000 = 100*

*Seasonally adjusted, three-month moving average.
SOURCE: Instituto Nacional de Estadística y Geografía.
Mexico’s Growth Picks Up Pace

2014 GDP growth: 3%

Annualized Percent Change in GDP

Q1 2014: 1.9%
Q2 2014: 2.7%
Q3 2014: 3.4%
Q4 2014: 4.0%

Source: Banco de Mexico Survey of Economic Forecasters, April 2014.
Total Exports Improve while Oil Exports Continue Falling

Index, January 2000 = 100*

*Seasonally adjusted, three-month moving average; real dollars.
SOURCE: Banco de México.
Industrial Production Improving in 2014

*Seasonally adjusted, three-month moving average.

SOURCES: Instituto Nacional de Estadística y Geografía; Federal Reserve Board.

Binational Center Library/ Texas A&M International University
Job Growth Improves in February and March

*Month/month; seasonally adjusted, annualized rate.

SOURCE: Instituto Mexicano del Seguro Social.
Peso Appreciates into 2014

Peso/dollar average

SOURCE: Banco de México.
Inflation Falls in March

SOURCE: Instituto Nacional de Estadística y Geografía.
Retail Sales Take a Dip

Index, January 2000 = 100*

*Seasonally adjusted, three-month moving average; real pesos.
SOURCE: Instituto Nacional de Estadística y Geografía.
Texas Exports to the World

Index '00Q1=100
Real $, SA

*Asia excludes China
**Latin America excludes Mexico
Source: Census Bureau; WiserTrade.

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Non-Maquiladora-Related Products Represent 35% of Total Texas Exports to Mexico

Note: Categories shaded in blue are non-maquiladora related.
Sources: U.S. Census Bureau; Wisertrade.
### US-Mexico trade by top 10 land ports
#### 2013 (billions of U.S. $)

<table>
<thead>
<tr>
<th>Rank</th>
<th>City</th>
<th>Total Trade</th>
<th>Share of Total (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Laredo, TX</td>
<td>168.79</td>
<td>43.06</td>
</tr>
<tr>
<td>2</td>
<td>El Paso, TX</td>
<td>66.85</td>
<td>17.06</td>
</tr>
<tr>
<td>3</td>
<td>Otay Mesa – San Ysidro, CA</td>
<td>34.75</td>
<td>8.87</td>
</tr>
<tr>
<td>4</td>
<td>Hidalgo, TX</td>
<td>26.84</td>
<td>6.85</td>
</tr>
<tr>
<td>5</td>
<td>Nogales, AZ</td>
<td>23.52</td>
<td>6.00</td>
</tr>
<tr>
<td>6</td>
<td>Eagle Pass, TX</td>
<td>21.65</td>
<td>5.52</td>
</tr>
<tr>
<td>7</td>
<td>Santa Teresa, NM</td>
<td>19.89</td>
<td>5.07</td>
</tr>
<tr>
<td>8</td>
<td>Brownsville – Cameron, TX</td>
<td>15.39</td>
<td>4.00</td>
</tr>
<tr>
<td>9</td>
<td>Calexico, CA</td>
<td>7.28</td>
<td>1.86</td>
</tr>
<tr>
<td>10</td>
<td>Del Rio, TX</td>
<td>4.11</td>
<td>1.05</td>
</tr>
<tr>
<td>11</td>
<td>Other</td>
<td>2.87</td>
<td>0.73</td>
</tr>
</tbody>
</table>

Source: Texas Center for Border Economic and Enterprise Development, Texas A&M International University
... and it has been the top exporter of auto parts since 2001
(Share of U.S. auto parts imports)

Mexico Tops Japan as the No. 2 Supplier of Motor Vehicles to the US
(Share of U.S. motor vehicle imports)

Maquiladoras impact by border city

• 10 percent increase in maquiladora output leads to an increase in the adjacent U.S. city as follows:
  – 3 percent increase in total employment in El Paso
  – 3.6 percent increase in total employment in Laredo
  – 1.9 percent increase in total employment in Brownsville
  – 5.9 percent increase in total employment in McAllen
Reforms will help, but in the medium to long term

• **Energy**
  – Open whole production chain to private investment

• **Financial**
  – Boost access to credit

• **Telecom and Competition**
  – Boost market competition and break dominant firms

• **Labor**
  – Enhance flexibility in the labor market

• **Education**
  – Seeks to improve education quality

• **Fiscal**
  – Increase tax revenue by increasing VAT and close loopholes
Growing pains from the reforms in the short run

**Consumer confidence**
(Quarterly observations, s.a.)

**Consumer price index**
(Year-over-Year growth, s.a.)

Index, Jan. 2003=100

SOURCE: Instituto Nacional de Estadística y Geografía.
Pemex Investment Doesn't Reverse Mexican Crude Production Decline

Million barrels per day

Billion pesos

Production

Pemex investment on production and exploration for oil


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Pemex Loses Money Due to Heavy Tax Burden

Billion dollars

2007 2008 2009 2010 2011 2012

Operating income
Taxes
Profit

SOURCES: Bloomberg; IMF.
Mexico's Government Deficit More Than Three Times Higher Without Pemex

Gov. deficit as % GDP
Gov. deficit as % GDP w/out Pemex revenue

SOURCES: Secretary of Housing and Public Credit (SHCP) and author's calculations.
Reforma Energética

• Profit-sharing envisions government payment to oil companies based on a % of the revenue generated after exploration and production costs are recovered. The outside firms would not own a share of production.

• Production sharing will provide for participating companies to be compensated based on a % of production, after cost recovery.

• Licensing will allow companies to acquire possession of hydrocarbons at the wellhead, upon the payment of taxes, if commercial production occurs.

• Service contracts call for cash payment to companies that undertake exploration and production activities. The firms will be paid even if production never occurs.
The Potential...
## Oil and gas production

<table>
<thead>
<tr>
<th>Crude Oil (mb/d)</th>
<th>Natural Gas (tcf)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>World</strong></td>
<td><strong>World</strong></td>
</tr>
<tr>
<td>75.6</td>
<td>122.8</td>
</tr>
<tr>
<td><strong>Russia</strong></td>
<td><strong>U.S.</strong></td>
</tr>
<tr>
<td>9.9</td>
<td>25.3</td>
</tr>
<tr>
<td><strong>Saudi Arabia</strong></td>
<td><strong>Russia</strong></td>
</tr>
<tr>
<td>9.8</td>
<td>23.8</td>
</tr>
<tr>
<td><strong>U.S.</strong></td>
<td><strong>Texas</strong></td>
</tr>
<tr>
<td>8.1 (Jan 2014)</td>
<td>7.5</td>
</tr>
<tr>
<td><strong>Canada</strong></td>
<td><strong>Iran</strong></td>
</tr>
<tr>
<td>3.1</td>
<td>6.1</td>
</tr>
<tr>
<td><strong>Texas</strong></td>
<td><strong>Canada</strong></td>
</tr>
<tr>
<td>2.8 (Nov 2013)</td>
<td>5.7</td>
</tr>
<tr>
<td><strong>Mexico</strong></td>
<td><strong>Qatar</strong></td>
</tr>
<tr>
<td>2.6</td>
<td>4.9</td>
</tr>
<tr>
<td><strong>Venezuela</strong></td>
<td><strong>Norway</strong></td>
</tr>
<tr>
<td>2.2</td>
<td>3.7</td>
</tr>
<tr>
<td><strong>Norway</strong></td>
<td><strong>Saudi Arabia</strong></td>
</tr>
<tr>
<td>1.6</td>
<td>3.6</td>
</tr>
<tr>
<td><strong>Libya</strong></td>
<td><strong>Algeria</strong></td>
</tr>
<tr>
<td>1.4</td>
<td>3.5</td>
</tr>
<tr>
<td><strong>Qatar</strong></td>
<td><strong>Mexico</strong></td>
</tr>
<tr>
<td>1.3</td>
<td>1.8</td>
</tr>
</tbody>
</table>
Outlook: 5 percent growth by the end of sexenio

Effects of the structural reforms on annual potential GDP growth rates
Percentage points

<table>
<thead>
<tr>
<th></th>
<th>Average in the next 5 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Energy Reform</td>
<td>0.70</td>
</tr>
<tr>
<td>Financial Reform</td>
<td>0.36</td>
</tr>
<tr>
<td>Telecommunications Reform</td>
<td>0.24</td>
</tr>
<tr>
<td>Fiscal Reform</td>
<td>0.18</td>
</tr>
<tr>
<td><strong>Total Effect</strong></td>
<td><strong>1.48</strong></td>
</tr>
</tbody>
</table>

Source: SHCP Criterios Generales de Política Económica 2014
Conclusion

• Mexico strong fundamentals
  – Past reforms paying off so handle tapering well

• New reforms hurt in short term
  – Promise to pay off in the medium to long run
    – *If carefully and deliberately implemented*
Maquiladoras drive employment growth in Texas border cities

<table>
<thead>
<tr>
<th>Estimation method: IV</th>
<th>El Paso</th>
<th>Laredo</th>
<th>McAllen</th>
<th>Brownsville</th>
</tr>
</thead>
<tbody>
<tr>
<td>City Level</td>
<td>2.77*</td>
<td>4.62</td>
<td>6.58*</td>
<td>2.21</td>
</tr>
<tr>
<td>Construction</td>
<td>0.20</td>
<td>3.19</td>
<td>4.04*</td>
<td>1.29*</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>-1.28</td>
<td>1.02</td>
<td>1.64</td>
<td>0.66</td>
</tr>
<tr>
<td>Transportation</td>
<td>5.30*</td>
<td>7.21*</td>
<td>6.63*</td>
<td>4.6*</td>
</tr>
<tr>
<td>Wholesale</td>
<td>0.43</td>
<td>1.96</td>
<td>4.01*</td>
<td>0.84</td>
</tr>
<tr>
<td>Retail</td>
<td>1.31</td>
<td>0.66</td>
<td>3.21*</td>
<td>1.34*</td>
</tr>
<tr>
<td>FIRE</td>
<td>2.12*</td>
<td>8.23*</td>
<td>4.63*</td>
<td>0.64</td>
</tr>
<tr>
<td>Services</td>
<td>1.84*</td>
<td>5.93*</td>
<td>7.38*</td>
<td>3.89*</td>
</tr>
</tbody>
</table>

Notes: This table shows elasticity estimates. That is the table shows the percentage increase in local employment from a 10 percent increase in maquiladora production for each Texas Border Cities. * indicates significant at the 10% level.

Maquiladoras impact changed over time...

- The impact has switched from manufacturing to services
- Texas border cities supply maquiladoras business services such as accounting and legal, transportation and warehousing
- Good news since these type of jobs pay higher wages
Per capita income in Texas border cities,
(As a share of the US level)

Source: Bureau of Economic Analysis, Haver Analytics
Chart 15
Mexican Inflation In a Downward Trend As the Peso Gains Some Ground

Year/Year Percent Change, SA

Sources: Banco de Mexico; INEGI.

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