BRITISH EMBASSY
Mexico City

Economic Overview: June 2014

Summary

- The World Bank published its report on "Global Economic Prospects" for 2014, forecasting 2014-2016 growth rates for almost all Latin American countries. It downgraded its growth forecasts for Mexico from 3% to 2.3%. Despite regional and global risks, Mexican economy will grow above the Latin American average.
- On 26 May, Christine Lagarde, the Managing Director IMF, attend to an international forum on Financial Inclusion organised by the Ministry of Finance. She underscored the need of an inclusive financial system to reduce poverty, tackle social inequalities and promote growth. Further areas of cooperation between UK and Mexico could include policy advice in banking regulation.
- The secondary legislation on the energy reform (not approved yet) includes the creation of a Mexican SWF. The Fund would collect, administer and distribute a proportion of the income derived from contracts for oil exploration and extraction. There could be opportunities for HMG and the Fin Services industry to offer assistance and financial advice in terms of portfolio diversification, regulation and policy development, and schemes to maximise returns.

World Bank Global Economic Prospects 2014

1. On 10 June 2014, The World Bank published its report on "Global Economic Prospects" for 2014, forecasting 2014-2016 growth rates for almost all Latin American countries. Their short term prospects for emerging markets were not encouraging. Even if high income countries accelerate their growth during the year (high income countries' demand for imports is expected to grow 4.2% in 2014), most of the emerging markets are already working at full capacity, which means that further expansion could create inflation. Financial conditions for increasing growth will also be tighter as Federal Reserve's (FED) quantitative easing (QE) continues. In addition, the prices of commodities are expected to fall during 2013, bad news for commodity exporters.

2. The World Bank also downgraded its growth forecasts for Mexico from 3% to 2.3%, mirroring the action of the Mexican Finance Ministry (although their prognosis is more positive at 2.7%). These figures remain above the average for the region at 1.9%, which has been dragged down by the economies which are showing clear signs of stagnation in 2014 (Argentina (0%), Venezuela (0%) and Brazil (1.5%). The 2014-2016 forecasts suggest that, for the following couple of years, the Mexican economy will experience higher growth levels more than the Latin American average, but below the developing countries average.

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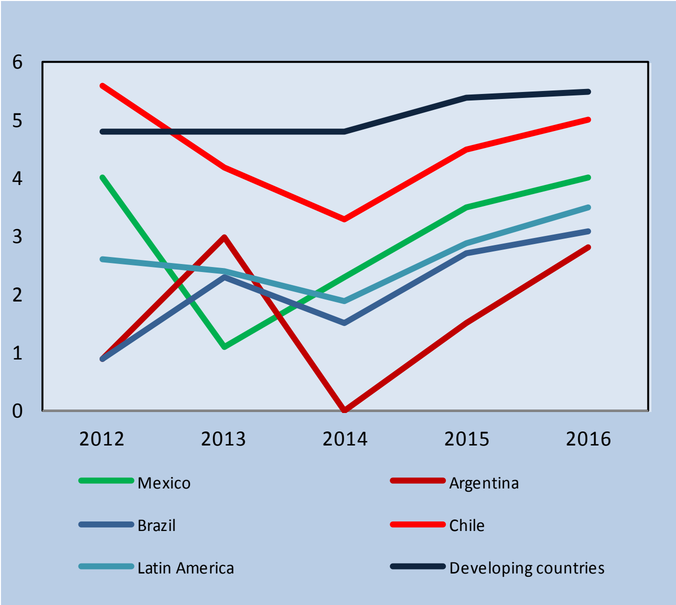
3. Latin America faces several downside risks, two of which are associated with a fundamental change in international conditions. First, Chinese growth is slowing down, which will have a negative impact on the demand for raw materials and commodities. Second, the FED tapering will reduce available, cheap credit in international financial markets. Taken together, these two factors will reduce the value of Latin American exports, domestic investment, and government revenues. Whilst Mexico has an advantageous geographical position and solid macro fundamentals, it is not fully exempt from these external shocks. Therefore, the Mexican Government will face difficult external constraints to deliver the promised recovery in the short and medium term.

Chart 1: GDP growth rates forecasts in Latin America, 2012-2016 (selected countries)



Source: The World Bank Global Economic Prospects 2014

4. Since the Mexican economy is resilient to financial volatility, the Central Bank was able to maintain low real interest rates during the 1Q2014. If it keeps the expansionary monetary policy throughout 2014 as expected, and the FED maintains QE, one should expect a short term depreciation of the real exchange rate, which could reinforce the boost of an increasing demand of imports. The US growth during the 2Q2014 will have a significant impact on the performance of the Mexican economy. In 1Q2014, the American economy registered the worst GDP quarterly contraction (year-on-year) since 1976 (-2.9%), due to one of the coldest winters ever registered in that country. However, the FED remains optimistic since they think this contraction is only transitory, and expects better figures for the second quarter.

5. In terms of trade, there are two opposite forces affecting export growth in the region. One is China's slowdown, and the other is the recovery of the US and Europe this year. Compared to other Latin American economies, the Chinese slowdown is not going to severely affect Mexico's performance, since they only account for 2% of its total exports, while US and the European Union account for 81% and 6%, respectively. Overall, we might expect the net effect on the Mexican exports should be positive.

6. Finally, the prices of non-energy commodities are likely to decrease in the medium term, as a result of the China's slowdown. Demand for metals and food will decrease, which will have differentiated effects in Latin America. Mexico's net exports should be less affected, considering that its industry is more focused on manufactured goods and has moved up in the added value chain. However, a possible fall in metal prices could affect the recovery of the mining sector, which already reported negative figures throughout 2013. It is worth to note that, in 2013, gold was the biggest Mexican export to the UK, which represented 20% of total exports. All things being equal, a fall in gold prices could improve Mexico-UK trade balance in favour of the latter.

Policy in Focus 1: IMF promotes financial inclusion in Mexico

7. On 26 May, the Ministry of Finance (Hacienda) organised an international forum on Financial Inclusion, with President Peña Nieto and Christine Lagarde, the Managing Director IMF making keynote speeches. Lagarde praised the political will of the Mexican Government's structural reform programme, and stressed that it will take time to see its impact. However, she underscored the need of an inclusive financial system to reduce poverty, tackle social inequalities and promote growth. In her view, the key to increase inclusion was in new technologies, which reduced the transaction costs and increased access to financial services.

8. Luis Videgaray, Minister of Finance, and Agustin Carstens, Governor of the Central Bank (Banxico), also attended to the forum. Both of them highlighted the close relationship between access to credit and poverty. Carstens explained the vicious cycle of financial exclusion: If low income households don't have access to credits, they will work and invest in low productivity, labour intensive activities. Therefore their wages will be low and would be reflected in their credit profile, and so on. Videgaray stressed that the social groups that were excluded from financial services were also the most vulnerable: women, low income households and indigenous groups.

9. Financial inclusion is a priority for the Hacienda. Over the past year, it has taken a number of actions to tackle this issue, including the financial reform, which aims to increase the level of credit penetration and lower the interest rates for the consumer. Further policy steps involve shifting from cash transfers and subsidies to electronic payments, promoting technologies to reduce transaction costs, increasing the resources of development banks to SMEs and the basic infrastructure in rural areas of the South.

10. However, the problem remains real. 50% of rural communities do not have financial infrastructure (i.e. ATMs and banks). The access in rural areas is worse in the Southeast of the country since, on average, there are only 3 ATMs for every 10,000 adults. In addition, 20% of adult population do not use any formal financial service whatsoever, whilst 60% uses informal financial services such as cooperative savings scheme and loan sharks, which charge annual interest rates up to 150%.

11. Financial Inclusion figures for Mexico are well below the Latin American average. Only 12% of low income households have access to formal financial services, compared to the Latin American average for the same group (25%). The financial penetration of Mexico is only 28% of GDP, again low compared to the 50% for the region and countries such as Chile which has 70%.

12. Inequality in terms of access to credit is also reflected in the allocation of the aforementioned 28%, as 26% goes to large firms and only 2% goes to small and medium enterprises (SMEs). This is one of the most important challenges for Mexico to overcome to achieve higher growth rates, since SMEs do not have full access to financial services. The Mexican financial system exists in a paradox, produced by market failures in the banking sector. Whilst it is a solvent and stable financial system, there is low penetration and a lack of available credit for productive activities. This translates into low capitalisation levels and low labour productivity. SMEs still do not have any instruments to acquire the necessary capital and most of the time they are forced to pay high interest rates in the informal sector or remain small and with low levels of capital. A sustainable strategy to reduce informality in Mexico needs to take into account access to credit, since this will provide positive incentives for small businesses to grow in scale.

13. One of the most important British companies in Mexico is HSBC, and financial services is a growing sector in which there are significant opportunities to grow. Financial inclusion could increase the size of the market by increasing the penetration, and therefore, with the right engagement, UK businesses could capitalise on that market share. In addition, the UK can be a helpful partner for Mexico sharing experience on financial regulation. There is an ongoing project with Banxico through the FCO's Prosperity Fund to preserve and improve financial stability. Further areas of cooperation could also include policy advice in banking regulation.

Policy in Focus 2: Mexican Sovereign Wealth Fund

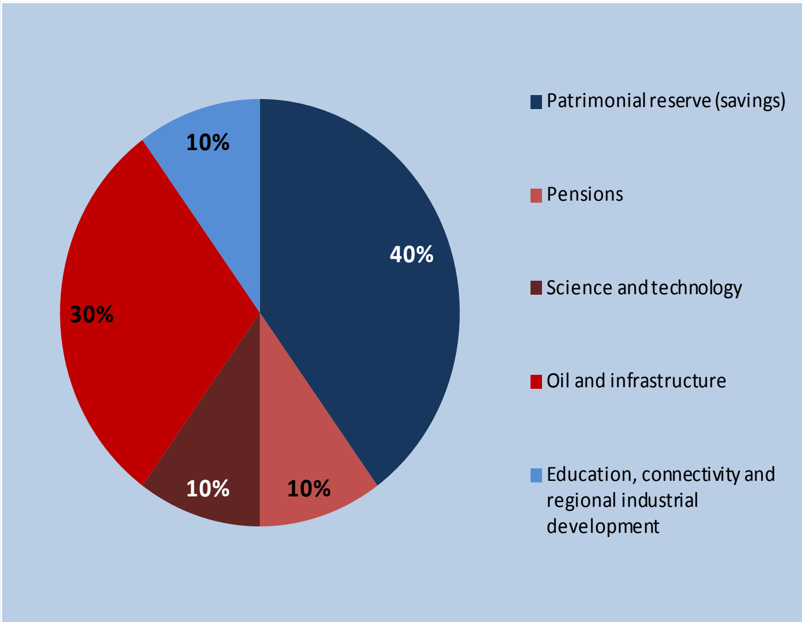
14. The proposals for the secondary legislation on the energy reform include the creation of a sovereign wealth fund, the 'Mexican Oil Fund for Stabilisation and Development'. The proposal is still being discussed in Congress, alongside other initiatives, but as currently drafted the Fund would collect, administer and distribute a proportion of the income derived from contracts for oil exploration and extraction (income derived from taxes collected by Hacienda from Pemex would not be paid into the Fund).

15.The Fund will be managed by an independent committee headed by Banxico and run by seven members: the Governor of Banxico, the Minister of Finance, the Minister of Energy and four independent members proposed by the President, and approved by the Senate. Government oil revenues will be allocated as follows: The first monies will be paid into Federal coffers in a sum equivalent to 4.7% of GDP (which has being set as a fixed amount). A sum equivalent to 3% of GDP will then be allocated to the Fund, which is expected to achieve savings between 3% up to 10% of GDP. If the annual revenues surpass 7.7% of GDP (i.e. the amount used by de budget plus mandatory savings), the remainder will be used for several investments and projects depicted in Graph 2. If the amount of savings over the years exceeds 10% of the GDP, then the resources are reallocated again to the budget.

16.The Mexican fund is less strict in the use of its savings compared to its Norwegian peer. Whilst both of them are designed to increase long run savings from non-renewable resources, there are several differences. The most important is that only one small share of the Norwegian fund (4.2%) is allocated to the budget; most of the savings are reserved to pay the pensions of the Norwegian population. In addition, all the investments undertaken by the Norwegian Government are made outside the country, to avoid inflationary pressures. In Mexico, part of the resources would be directly invested in developing the country and the rest will be allocated in several investment instruments, taking into consideration risk management.

17.Oil production needs to increase in the medium term in order to provide sufficient resources for long run savings. The Mexican Government is forecasting relatively high prices of oil, which will also affect the potential resource increase. In 2013, oil revenues represented 7.8% of GDP, providing just enough revenue to cover the payments to the budget and Fund. It therefore seems that, at least in the short run, there will not be enough revenue for the projects depicted in graph 2. This may not necessarily be a bad thing as two major risks arise if these funds are used to finance domestic projects: one is demand driven inflation, and the other is a possible Dutch disease that will reduce the competitiveness of other Mexican exports.

Chart 2: Resource allocation after the Fund accumulates 3%, of GDP



Source: Ministry of Energy

18.Despite this, due to political sensitivities, the Fund has been designed so that the majority of money will be channelled into domestic projects. However, there may still be opportunities for HMG and the Financial Services industry to offer assistance and financial advice in terms of portfolio diversification, regulation and policy development, and schemes to maximise returns.

Monthly Economic Monitor

19. Banxico's June survey registered a downgrade in GDP growth expectations, decreasing from 2.77% to 2.65%. It seems that there is a strong downward trend in the survey which will continue through the end of the year. Whilst the May survey had a 2.77% and 3.87% forecast for 2014 and 2015, in June the forecast for 2014 and 2015 fell to 2.65% and maintain 3.87%, respectively. The forecast took into account the downgrades made by the Ministry of Finance, the IMF and the World Bank, as well as the recent information about weaker than expected consumption increase in the US.

20. The yearly inflation forecast for 2014 slightly decreased to 3.79%, and the expected inflation for 2015 marginally decreased to 3.50%, within Banxico's benchmark. It is worth to mention that the decision of cut the interest rate half point did not have any impact on inflation expectations.

21. Forecasts for the Mexican peso (MXN) reflect a solid and stable currency and a more optimistic environment during the year for emerging markets. The USD/MXN year-end expected exchange rate for 2014 is 12.95.

Consensus Forecast (June 2014)	2014	Vs. May 2014	2015	Vs. May 2014
GDP (growth)	2.65%	⇩	3.87%	=
Inflation	3.79%	⇩	3.50%	⇩
Exchange Rate (year-end)	12.95	=	12.90	⇩
Source: Bank of Mexico survey on private sector expectations				