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Economic Overview: November 2014

Summary

- The National Institute of Statistics and Geography (INEGI) published GDP figures for 3Q2014. The results were lower than expected, since the economy only grew 2.2% year on year in Q3. As a result, the Ministry of Finance downgraded its forecasts for 2014, from 2.7% to a range between 2.1% and 2.6%. Even when the recovery was weaker than expected, private consumption and government spending are already expanding and exports steadily increasing due to favourable conditions in the US. However, three main challenges remain: lower growth of gross fixed investment, low commodity prices (especially oil) and the security crisis caused by recent events in Guerrero.

- The most recent data from the National Institute of Statistics (INEGI) quantified the direct, measurable costs to businesses due to insecurity and crime. In 2012, the total direct cost of insecurity and crime for Mexico was £5.2bn, which represents roughly 0.75% of the GDP. Even when direct losses due to insecurity and crime do not represent a significant share of GDP (less than 1%), there are potentially substantial indirect costs that could have adverse effects on growth.

- As part of his National Security Plan, the President announced a new strategy for the South of the country. He proposed the establishment of three special economic zones, with the aim of reducing regional imbalances and addressing the historical problem of poverty and inequality. The zones will have a special regulatory framework aimed at attracting investment: modern infrastructure, improved public security, special credits from Development Banks, special conditions for international trade, and tax breaks for profits and social security payments.

Macroeconomic Overview: growth and oil prices

1. On 21 November, the National Institute of Statistics and Geography (INEGI) published the results of Mexico's GDP for 3Q2014. The results were lower than expected, since the economy only grew 2.2% year on year in Q3. Compared to the last quarter, the economy grew 0.5%, which was better than Q1 (0.36%) but lower than Q2 (0.89%). As a result, the Ministry of Finance downgraded its forecasts for 2014, from 2.7% to a range between 2.1% and 2.6% (with a middle point in 2.35%). This new forecast is consistent with the latest figures provided by the IMF. Private consumption and Government spending are already expanding and exports are expected to be boosted due to better conditions in the US economy driven by higher personal consumption by American households and lower unemployment rates. However, there are three factors ahead that could affect growth prospects in the last quarter of the year: lower than expected growth of gross fixed investment, a fall in commodity prices (especially oil) and political instability caused by recent events in Guerrero.

2. Gross fixed investment has shown weak signs of recovery. Investments in domestic and imported machinery had remained constant, while construction started to recover during the last quarter. A strong recovery in the latter could boost investment in the following months if the Government manages to implement a sound urban strategy to help the private housing sector to recover traction, since the real value of production plummeted during the second half of 2013, and there are still no signs of recovery in the short term.

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3. Low Commodity prices are taking their toll on the mining sector. The sector fell 2.13% year on year during Q3. The drop in oil prices could also impact oil exports, which are an important source of Government revenues. The Congress already made adjustments budget to prevent the public deficit from continuing to grow. The Ministry of Finance already hedged next year's revenues, buying coverage for prices of crude barrel below USD$75. However, if this negative trend is maintained in the medium term, the Government will have to make a decision to cut spending (and therefore withdraw the fiscal stimulus) or increase the public deficit (which is not a risk but it grew significantly during the last two years due to the changes made by the fiscal reform). A tax increase in the next three years is highly unlikely, since, as reported in previous economic reports, the Government make a political commitment with businessmen to not raise tax rates during Peña Nieto's term.

4. Finally, recent events in Guerrero could have an impact on investment as well as on tourism. The Minister of Finance, Luis Videgaray, acknowledged that the image of Mexico abroad has deteriorated as a result of insecurity and impunity. Mexican business chambers estimate that the direct economic loss of public demonstrations and social unrest caused by the kidnapping of 43 students in the cities of Iguala, Chilpancingo and Acapulco is almost £13.6m. In Acapulco, the hotel occupation rate this autum dropped from 80% to 40%. The next policy in focus will analyse in more depth the direct and indirect impacts of insecurity in Mexico. In order to promote a positive business environment for foreign investment in strategic sectors such as energy, telecoms and financial services, the Government needs to deliver a credible strategy to improve rule of law in regions plagued by corruption or controlled by organised crime.

Policy in Focus 1: Assessing the effects of insecurity in economic performance

5. The Mexican authorities are now becoming increasingly aware of the negative effects of insecurity on economic performance. The Governor of the Bank of Mexico, Agustin Carstens, independently acknowledged the increasing concerns among Mexican businessmen and economic analysts about recent events in Iguala. Post-Iguala protests and knock-on concerns about insecurity have so far had a direct impact on business and tourism rates in Acapulco, one of Mexico's most important tourist areas, as well as indirect impacts on other businesses in Mexico City and beyond, due to airport and highways blockades.

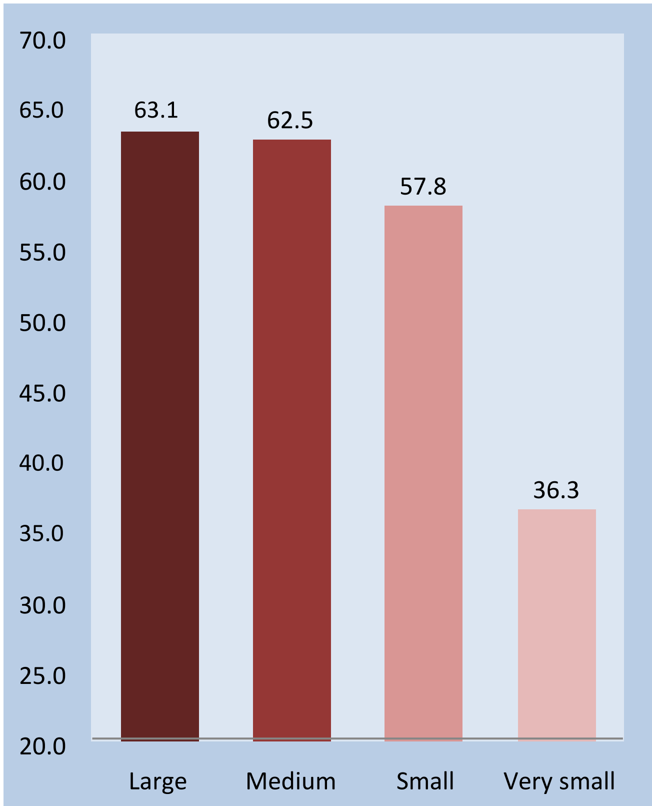
6. Structural reforms are closely linked with rule of law. The recently approved economic reforms provided Mexico with the potential to improve the domestic business environment by allowing for more competition and opening up strategic sectors (particularly telecoms and energy) to foreign investment. However, we and other

commentators have repeatedly emphasised the need for strong regulators in all sectors, backed by a robust legal and penal system, to secure domestic and foreign investor confidence.

7. According to the WEF Global Competitiveness Index 2014-2015, Mexico ranked (out of 144 countries): 99th in terms of irregular payments and bribes, 98th in judicial independence, 128th in reliability of police services, 135th in business costs of crime and violence, and 140th in organised crime. In Mexico, the most recent data from the National Institute of Statistics (INEGI) quantified the direct, measurable costs to businesses due to insecurity and crime. In 2012 the figures show that the total direct cost of insecurity and crime for Mexico was £5.2bn, which represents roughly 0.75% of GDP. The average estimated cost of insecurity for a business in Mexico was £2,580 per year. Also, preventative measures against crime represent an additional significant cost for the private sector, with firms spending £2.2bn in state of the art security systems, locks and safes, alarm systems, walls and fences, private security and insurances. The most common crimes against firms, in terms of their share in total crimes committed, are acts of corruption (24.7%), robbery of merchandise (22.6%), extortion (14.5%), petty theft (11.9%) and fraud (8.5%).

8. As Chart 1 shows, insecurity and crime have differentiated effects depending on the size of the firm and the state. As a result, at least in Mexico, another negative externality of insecurity on growth is that it discourages firms to go formal, grow and increase their scale. Whilst the probability of being victim of a crime for a very small business is 36%, the probability for a big firm is almost double that: 63.1%. There is no regional pattern to business victimisation. The states with highest victimisation rates (number of victims for every 10,000 firms) were Distrito Federal (the formal name for Mexico City) (4,152), Estado de Mexico (4,781), Nuevo Leon (4,870) and Guanajuato (4,640). It is worth noting that Guerrero, the state in which the 43 students were kidnapped, has one of the lowest victimisation rates in the country (2,995).

Chart 1: Percentage of firms victims of crime by size



Source: National Institute of Statistics and Geography. The classification of the size of businesses depends on the number of workers: very small (less than 10), small (from 11 to 30 for retail and 50 for industry and services), medium (31 to 100 for retail, 51 to 100 for services and 51 to 250 for industry) and large (more than 100 for retail and services and moree than 250 for industry)

9. According to the survey, it seems that part of the solution to the problem of insecurity lies in strengthening the rule of law at the local level. 70% of the firms think the municipal police are corrupt, whilst only 63.8% and 56.8% think the same about the state and federal police, respectively. The armed forces remain the most well perceived security institutions: only 23.1% think that the Army is corrupt and 15% think the same about the Navy.

10. Even when direct losses due to insecurity and crime do not represent a significant share of GDP (less than 1%), there are potentially substantial indirect costs that could have adverse effects on growth. In addition, the differentiated effects of insecurity on firm size mean that this issue further aggravates the complex problem of productivity and informality, since it reduces the incentives of small businesses to increase their size. Lastly, the endemic problem of corruption appears to be more important than robbery, extortion or fraud. This means that the roots of insecurity, at least from the perspective of businesses, are not in organised crime or gangs operating outside the State, but in the accountability mechanisms of the political system to ensure that public officers and politicians (especially at local level) comply with the law.

Policy in Focus 2: New development plan for the South

11. On 27 November, President Peña Nieto announced a 'Security Plan, a collection of measures aimed at tackling crime, reducing corruption and preventing infiltration of drug cartels in municipalities. In addition to the measures related with insecurity and corruption, the President announced a new strategy for the South of the country, consisting in three special economic zones, with the aim of reducing regional imbalances and addressing the historical problem of poverty and inequality.

12. The three economic zones will be: a corridor in the Isthmus of Tehuantepec (a land strip connecting the Pacific Ocean and the Gulf of Mexico), the Port of Chiapas, and a region of adjacent municipalities around the port of Lázaro Cárdenas. The zones will have a special regulatory framework to attract investments: modern infrastructure, improved public security, special credits from development banks, special conditions for international trade, and tax breaks for profits and social security payments.

13. There will be additional actions focused on Oaxaca, Guerrero and Chiapas. The President will publish in the following weeks a decree giving a special tax regime to agricultural producers in the mentioned states, in order to promote agro industry in the zone. Also, there will be special scholarships and more public investment for the rural teachers college (the 43 students of Ayotzinapa used to study in a rural school). Finally, the Government will invest an additional £181m in credits for agriculture and £68m on paving roads.

14. The proposed strategy follows the regional approach of previous attempts to address this issue. There have been several attempts to reduce poverty focusing resources on the poorest states in the country. During Felipe Calderon's administration, the Government created two policies (Micro-regions and the Strategy 100x100) to improve the wellbeing of people living in the poorest municipalities. Microregions invested in public infrastructure (housing, health, electricity and sewerage) in the zones with the highest levels of marginalisation, poverty head count ratio and social backwardness. Meanwhile, the Strategy 100x100 identified the 100 municipalities with the lowest Human Development Index to improve health and education conditions.

Table 1. Income, poverty and social deprivations for selected states, 2012

	National	Guerrero	Oaxaca	Chiapas
Poverty head count ratio	45.50%	69.70%	61.90%	74.70%
Deprived from health services	29.20%	25.40%	20.90%	24.90%
Deprived from social security	60.70%	78.50%	75.70%	83.30%
Educational non-completion rate	20.70%	26.80%	27.70%	33.50%
GDP per capita in current USD	$10,129	$4,892	$4,934	$4,259
Country with a similar level of GDP per capita	Venezuela	Timor-Leste	Jordan	Tunisia/Samoa

Source: National Council for the Evaluation of Social Policy and IMF stats

15. So far, these attempts have not delivered the expected results. As Table1 shows, there have not been significant improvements in poverty rates in Guerrero, Chiapas and Guerrero compared to the national figures. It is still too early to know the specific details of the proposal, but so far, the new industrial policy designed by the Government is different from past strategies in the sense that the main means of reducing poverty is economic growth, rather than social policy. The idea of the special zones is similar to the policies implemented by the Chinese government during the late seventies to develop their

main coastal cities. The Southern states could provide a good export platform for manufacturing basic consumption goods to the US and Asian markets, especially if one consider that real wages in China are starting to grow.

16. In order to transit from good intentions to delivering concrete results, the new strategy needs to overcome three obstacles faced by its predecessors. First, it needs to address the problem of geographical dispersion problem in rural areas of the South, which makes it very difficult to provide public services at a reasonable cost. Second, the tax breaks and special credits must compensate for the low transport costs and good infrastructure that the Northern states offer to investors interested in exporting to the US. Finally, in order to provide adequate security and infrastructure conditions, the state level authorities must undertake serious reforms in their states to improve the rule of law. The strategy will take some time to implement, since an improvement in rule of law at the local level is unlikely without a comprehensive reform to municipalities. Furthermore, in order to deliver the projects in the Tehuantepec Isthmus, the federal government is likely to find the strong opposition from indigenous people that traditionally oppose economic development projects of this kind, and who rule their own municipalities by constitutional mandate, by their customs and traditions.

Monthly Economic Monitor

17. Banxico's November survey downgraded its 2014 GDP growth expectations in 2.19%. The recent results of GDP for 2014Q3 were lower than expected. If the growth rate for 4Q2014 is similar to the 3Q, the Government may achieve an annual growth rate around 2.1%. Whilst the October survey had a 3.72% forecast for 2015, in November this forecast decreased to 3.51%. In this new context, the new forecast established by the Ministry of Finance (2.35%) seems difficult to achieve.

18. The end year general inflation forecast for 2014 and 2015 increased to 4.07% and 3.52%, respectively, slightly over Banxico's benchmark (3%+/-1). It is worth mentioning that there are no signs of inflationary pressures caused by underlying factors, but the Central Bank need to focus its attention on the exchange rate pass-through on domestic prices.

19. Forecasts for the Mexican peso (MXN) reflect the impact of financial volatility in international markets. Still, the depreciation rate of the MXN is less acute compared to Brazilian real or Russian rubble. A solid and stable currency backed by strong macro fundamentals will prevent exchange rate crisis. The USD/MXN year-end expected exchange rate for 2014 is 13.49.

Consensus Forecast (November 2014)	2014	Vs. October 2014	2015	Vs. October 2014
GDP (growth)	2.19%	⇩	3.51%	⇩
Inflation	4.07%	⇧	3.52%	⇧
Exchange Rate (year-end)	13.49	⇧	13.37	⇧
Source: Bank of Mexico survey on private sector expectations				