BTMU LATIN AMERICA TOPICS

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MEXICO: SIGNS OF INCIPIENT RECOVERY

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Sluggish recovery pace moderates growth expectations in 2014

Mexico's economic recovery has been sluggish so far in 2014, although there are indications that the pace of economic activity is gradually accelerating upon improving external demand and higher public spending. Expansionary monetary policy and the advancement of reforms should also remain supportive. The index of economic activity (IGAE)—a monthly GDP proxy—rose 0.5% month-on-month in seasonally-adjusted terms (mom/sa) in February after growing 0.2% mom/sa in January. It increased 1.7% year-on-year (yoy) in February, the highest annual result since July 2013. (Figure 1.)

The recovery is not yet broad-based, however, and this is a key factor that is serving to moderate growth expectations for this year. The pick-up of economic activity is being driven by the external sector and public spending, but private consumption and investment indicators continue to show weakness. And, while the advancement of the important reforms that were passed last year maintains expectations for higher potential growth in the coming years, the approval of secondary legislation is moving somewhat slower than initially expected. In this context, consensus forecasts for real GDP growth in 2014 have been revised downwards closer to 3% from 3.5% a few months ago, although they still point to an adequate recovery from growth of 1.1% in 2013.

Export-oriented manufacturing is picking up

This year's figures suggest that Mexican industry is gradually beginning to bounce back after having de-coupled from US IP growth since mid-2012. (Figure 2.) The export-oriented industrial production sector showed signs of recovery during the first two months of the year when it returned to positive growth in annual and sequential terms, however, March's results indicate that a robust recovery is not yet certain.

Industrial production contracted 0.1% mom/sa in March upon an unexpected 0.34% mom/sa decline in manufacturing—which is closely tied to US IP—and the flat performance of the construction sector (0.05% mom/sa). IP results for the first quarter show a decelerating growth trend on the margin: +0.5% mom/sa in January, +0.3% mom/sa in February, and -0.1% mom/sa in March. Although IP rose 3.4% yoy in March, the annual result was distorted by the higher number of working days versus last March; in seasonally-adjusted terms, IP dropped 0.2% yoy.

The recovery in the US should support Mexico's IP from 2Q. Despite March's mixed results for IP, US industrial production and Mexico's domestic manufacturing activity are the main drivers behind the sector's developing recovery. Mexico's non-oil exports increased 6.9% yoy in March, and manufactured exports grew 6.7% yoy. (Figure 2.) In 1Q14, auto exports increased 14% yoy. Manufacturers have been responding to this overall increase in demand by taking on new hires. In February, the number of people employed in the manufacturing sector grew 1.9% yoy, with transportation equipment payrolls leading the growth. Construction activity is still weak, but has stabilized from last year's decline and should benefit from the government's sizeable increase in infrastructure spending in 2014.

Domestic demand remains weak, and public spending boost is underway

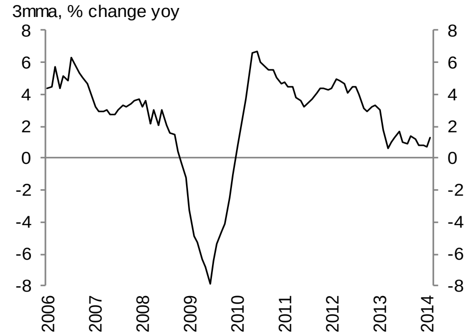
The gradual recovery of the export-oriented industrial sector is not yet reflected in domestic demand. (Figure 3.) Consumption and investment have been hit by last year's weak growth, tax increases that took effect in January under the fiscal reform, and the weather conditions in the US. Retail sales fell for the third consecutive month in February, surprising with 1.4% yoy drop. Fixed investment is weak, but slowly recovering as it rose 1.4% mom/sa in February. Total fixed investment fell 0.5% yoy, but machinery and equipment investment grew 3.3% yoy upon a 5.1% yoy rise in imported capital goods.

Domestic demand should eventually start improving, although the timing remains in question. It will be important to watch that confidence indicators maintain upward momentum. Among the factors that should support domestic demand this year are the increase in remittances (+16% yoy in March), formal employment growth, and the impact of the large public spending boost. The government's expansionary fiscal spending program is a central component of the expected economic recovery in 2014. In January-March, public sector spending increased 18.5% yoy and capital spending increased 40% yoy in real terms. The fiscal deficit is set to widen to 1.5% of GDP this year from 0.4% of GDP in 2013.

Central Bank on hold

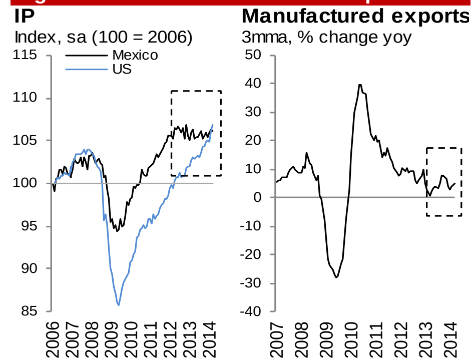
Banxico is expected to maintain the policy rate at 3.5% p.a. for the rest of 2014. With above-target inflation and expansionary fiscal policy, Banxico does not have much room to cut. The real overnight rate, which is already negative, should remain supportive of growth and deter further cuts. (Figure 4.) In the baseline scenario, we are of the view that Banxico's next move will be to start a hiking cycle in 2015. It will likely attempt to wait for the US Fed to raise the federal funds rate, but a weaker MXN could prompt an earlier rate hike just as a stronger MXN could give policy room for a cut if growth disappoints.

Figure 1: Economic activity index (IGAE)



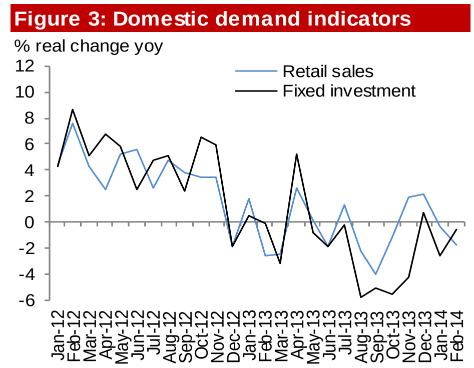
Source: INEGI; BTMU Economic Research.

Figure 2: IP and manufactured exports



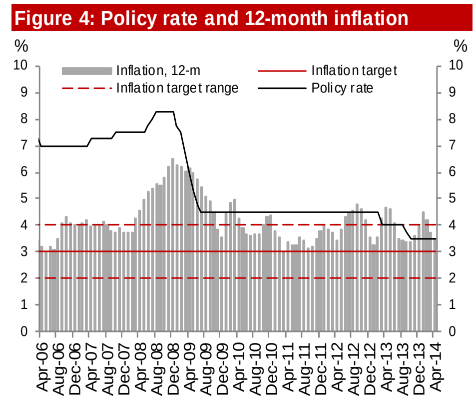
Source: INEGI; US Federal Reserve; BTMU Economic Research.

Figure 3: Domestic demand indicators



Source: INEGI; BTMU Economic Research.

Figure 4: Policy rate and 12-month inflation



Source: Central Bank; BTMU Economic Research.

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