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Economics Group

Special Commentary

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Mexican Economy: The Boom That Never Was?

Executive Summary

Mexican politicians as well as most analysts that follow the Mexican economy closely have been expecting a revival in economic growth in Mexico for some years. However, the economy has been disappointing them year-in, year-out. Reform measures that should have given rise to a revolution in the energy sector are looking more like another failed attempt to convince foreign investors of the seriousness of the Mexican reform process. It is true that perhaps most of the responsibility today falls on the collapse in oil prices during the past year and a half, but it also has to do with the halfhearted reform process which, although historic by Mexican reform standards, is likely viewed as mild by many outside observers.

Many observers have been expecting a revival in Mexican economic growth for some years.

Thus, absent a large effect on the economy by the energy reform, we look at what other sectors could drive economic growth in Mexico going forward. We conclude that the construction sector is one of the few sectors that has the potential to drive economic growth in the next several decades. The export sector will continue to generate and help growth in the future, but we believe that the construction sector has the potential to generate a higher rate of investment and personal income generation for the Mexican economy. This should help drive personal consumption expenditures (PCE) growth, which has remained constrained in recent years.

Disappointing Energy Reform Response, For Now

After missing the boat on the petroleum boom for more than a decade, the Mexican government woke up roughly three years ago and started a necessary, but perhaps insufficient and poorly timed, reform aimed at turning the energy sector and the economy around. So far, however, the Mexican economy has little to show for the projected energy boom. Although some of the poor results may be related to the incomplete semi-privatization of the country's petroleum industry, perhaps the most important determinant of the inability to turn the energy sector around was the collapse in the price of petroleum that started last summer. The collapse in oil prices could not have happened at a more inopportune time, just as the Mexican petroleum sector was preparing to open to more competition through some limited private and foreign investment alternatives.

The Mexican government claimed energy reform would add 1 percentage point to growth by 2018 and 2 percentage points by 2025.

One of the most significant sources of disappointment regarding the positive effects of the energy reform was, as we have argued many times, the overinflated expectations of an effect that has continued to miss the mark. According to the Mexican government, the energy reform was going to add 1 percentage point to Mexican economic growth by 2018 and 2 percentage points by 2025. However, these projected results have yet to be seen and the soft demand at the first auction of exploration sites earlier this year make the prospects for this forecast dubious at best. Had markets and market analysts been more realistic about the potential effects of the reform, the disappointment probably would not have been so significant.

Figure 1

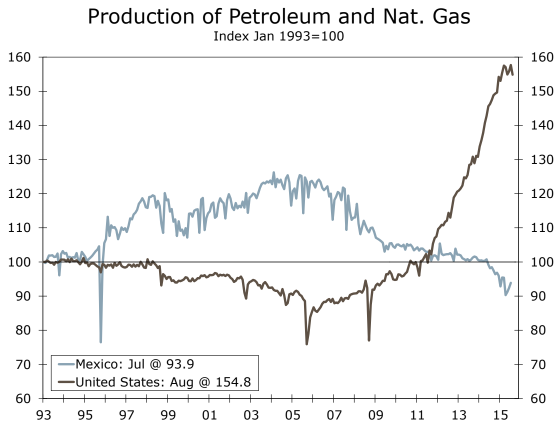
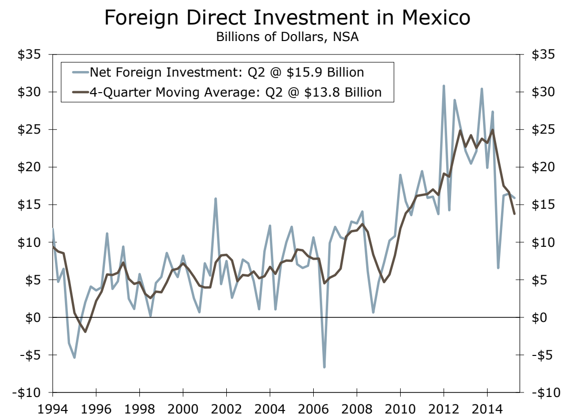


Figure 2



Source: Federal Reserve Board, IHS Global Insight and Wells Fargo Securities, LLC

As we said before, the poor results on the auctions are probably related to the low price of petroleum and the prospects would probably improve if the price of petroleum increases in the future. However, it is difficult to know how long the country will need to wait to see higher petroleum prices. At the same time, the fact that the energy reform was not a full privatization of the energy sector might mean it does not go far enough to encourage foreign investment, even if the price of petroleum remains at current levels. Furthermore, there is a risk that a different political party would try to backtrack and reverse the reform efforts that previous parties have worked so hard to achieve. This alternative is probably highly unlikely today, but since these petroleum projects are such long-term endeavors, the long-term uncertainty will remain, especially if the current energy reform does not produce the expected results.

In the United States, the mere thought of nationalizing (i.e., ceding ownership to the federal government) the petroleum or energy sector is probably unthinkable. However, returning full control of the petroleum/energy sector in Mexico to the government is, for some in the Mexican political opposition, a matter of time. We are not saying that this will necessarily happen any time soon, but it happened in Mexico several decades ago and more recently in Argentina, so it is not a far-fetched idea, especially if the current reform efforts do not pan out.[1]

So now that the contribution from the energy reform expected by the Mexican government may not come to fruition during the next several years, what can be done to improve economic growth prospects from the 2.5 percent rate that we have seen in the last several years?

Investment and Consumption Are the Keys to Growth

Weakness in overall growth has been the result, at least in part, of weak investment growth.

While the lackluster performance of the Mexican petroleum sector has led to disappointment, overall Mexican economic growth has fallen short of expectations even after accounting for this weakness in energy. Part of this weak performance can be explained by the softness in investment spending since about mid-2010. Despite a partial recovery in 2010 when it grew 5.3 percent, real gross investment has been decidedly weak, posting a 2.5 percent growth rate in 2011, 1.1 percent in 2012, -0.9 percent in 2013 and 0.1 percent in 2014. Furthermore, we are expecting gross investment to drop once again in 2015, underscoring the continuous weakness in the sector. The consequences of the weakness in investment are not confined to this sector's inability to help the Mexican economy grow. Soft investment growth also keeps a lid on productivity growth and subsequently restrains the overall potential growth rate of the broader economy.

[1] The Argentinian government took over YPF from Repsol in 2012, reversing the privatization of the company that occurred during the 1990s.

Figure 3

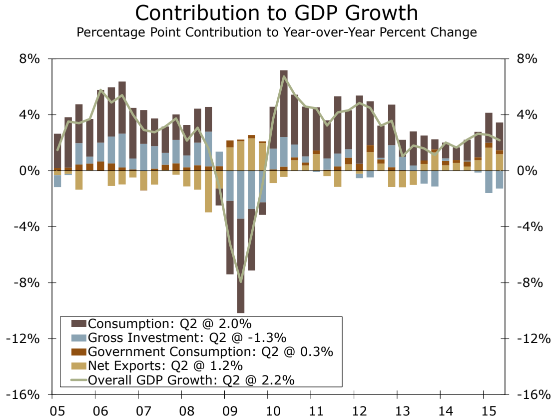
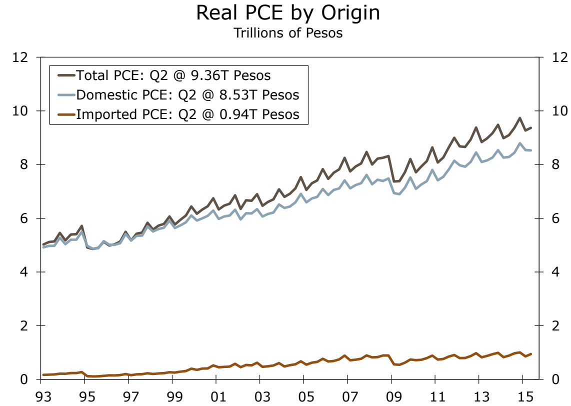


Figure 4



Source: IHS Global Insight and Wells Fargo Securities, LLC

Meanwhile, the Mexican economy continues to rely heavily on the consumer for economic growth. While Mexican consumption has been growing faster than investment recently, it has weakened considerably during the past two years and represents a much larger share of the overall economy. Furthermore, the expectation is for domestic consumption growth to remain limited due to overall weakness in the broader economy.

The depreciation of the Mexican peso, down almost 30 percent since May 2011, has not necessarily translated into a run up in inflation.

Notably, the current depreciation of the Mexican peso, which has fallen almost 30 percent versus the U.S. dollar since May 2011, has not had the usual impact on Mexican consumer prices. This is a further demonstration that consumer demand has weakened considerably, to the point where it is limiting the effects of the depreciation of the peso on inflation.

This also suggests that Mexican inflationary expectations have been successfully anchored, perhaps for the first time in history after a large depreciation of the currency. However, this is not a guarantee going forward so the Mexican central bank will need to be very careful and will need to monitor expectations very closely. For now, the central bank has a weak economy which has helped keep expectations contained. However, this could change any time and this will keep them busy during the next several quarters.

Figure 5

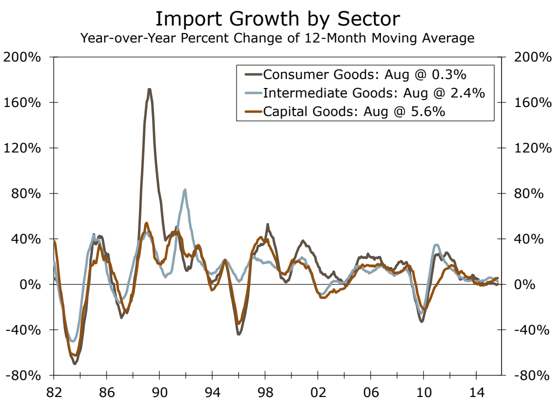
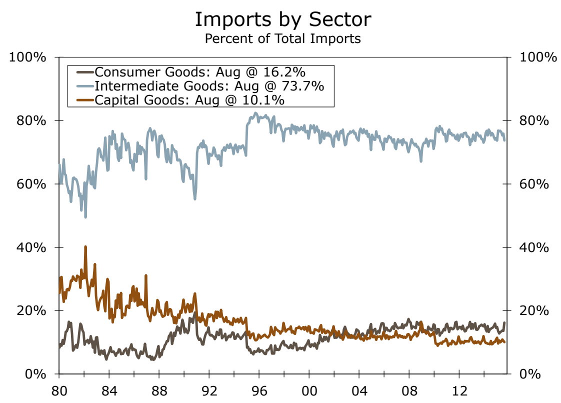


Figure 6



Source: IHS Global Insight and Wells Fargo Securities, LLC

Figure 5 shows how weak production and consumption have been in Mexico, shown by the weak growth of imports of every type of goods, consumer goods, capital goods and intermediate goods for production. Although capital goods imports have moved higher during the last several months they are still decidedly weak. Meanwhile, Figure 6 shows the share, in percentages of total imports, for consumer goods (about 15 percent), capital goods (about 10 percent) and intermediate goods (about 75 percent). The fact that intermediate goods imports represent such a large share of imports and we have not seen any reaction of prices underscores weakness in economic activity and, by extension, inflation.

For now, it is difficult to see where Mexican investment growth will come from in the coming quarters. The energy reform was a compelling alternative until the price of petroleum plunged. Meanwhile, the investment in the Mexican auto industry that was such a boon for economic growth in the initial years after the recession seems to have slowed, and we expect this slowing will continue as U.S. auto demand growth begins to level off. Our guess is that the construction industry may be one of the few industries whose investment potential is probably high, as Mexican population growth is set to continue and the need for housing and infrastructure should increase.

Before 2011, the construction industry was one of the drivers of stronger growth, both on the investment side as well as through the income it provided to Mexican workers.

Before 2011, the construction industry was one of the drivers of stronger growth, both on the investment side as well as through the income it provided to Mexican workers. However, as we have written previously, policy decisions in the early years of the Peña Nieto administration wreaked havoc on the construction industry, which tanked between 2011 and 2013. However, construction has started to finally put up some encouraging numbers since mid-2014 and early 2015. We estimate that this industry will be one of the most important drivers of growth both for investment as well as for income going forward.

Contributing to this growth will be the building of the new airport in Mexico City which will ultimately replace the current Benito Juárez airport, originally constructed in 1929. The airport construction has already started, with the first phase expected to be finished by 2020. At that time, the new airport is expected to have three functioning runways and handle 52 million customers per year. By 2050, three more runways are expected to be added and the airport is estimated to be able to move 120 million travelers per year. Today's estimated cost of the project is about $10 billion.[2]

However, infrastructure projects like the Mexico City airport will not be the only drivers of growth in the Mexican construction sector. Housing construction will also need to step up to the plate as population growth continues. Thus, for the short to medium term, we expect the construction sector will be the key driver of higher investment in the Mexican economy over the next several years.

Mexican PCE growth, on the other hand, will likely remain range-bound as Mexicans adapt to the recent depreciation of the currency. Although our currency strategists estimate that the Mexican peso will appreciate in the medium term, the short term prospects of the currency will remain under pressure, especially if the economy remains weak. However, the effect of the depreciation of the currency on Mexican consumer goods spending does not come in directly from the import of goods and services, as goods and services imports remain a very small percentage of PCE. Rather, the effects come from the import of intermediate goods for production (see Figure 6 above). Mexican firms import a large percentage of intermediate goods for production, i.e., inputs used in the production of goods and services.

Thus, if we see a larger effect of the depreciation on prices this effect should come from cost pressures on local producers/manufacturers rather than from the increased costs of imports of consumer goods. For the last several years, these cost pressures have remained muted. However, this lack of reaction on Mexican cost pressures has not been common. This is the reason why we believe the Mexican central bank will tread carefully as the Federal Reserve starts its campaign to raise interest rates. Perhaps historically low interest rates, which depress interest expense, have kept overall cost pressures from firming up due to the significant depreciation of the currency. However, this low interest rate environment is about to change as the Federal Reserve starts its campaign towards normalization.

[2] **"Airport Project Development—Mexico City Airport." (March 2015). Price Waterhouse Coopers. https://www.pwc.com/mx/es/knowledge-center/archivo/2015-03-kc-airport-project-development-mexico-city-airport.pdf**

Conclusion

Absent a strong effect from the Mexican energy reform we believe that investment in the construction industry will become the main driver of economic growth in the country during the next several years. Although the export sector will remain an important contributor to economic growth in the future as it has been the case in the past, the potential for the construction sector remains intact despite several policy mishaps at the beginning of the Peña Nieto administration. Furthermore, stronger investment in the construction industry will generate stronger personal income growth and this personal income growth will help bring some impetus to Mexican PCE, which has also remained weak during the last several years.

We believe that investment in the construction industry will become the main driver of economic growth in the country during the next several years.

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