

Regional Economic Report

October – December 2016

Summary

In the fourth quarter of 2016, economic activity in Mexico kept expanding, although at a more moderate pace than in the previous quarter. This evolution is mainly attributed to the dynamism of the services' sector, while the industrial production, as a whole, kept exhibiting stagnation it had presented since mid-2014. Indeed, while the expansion in the tertiary activities has been practically widespread across all sectors comprising it, within the industrial activity the mining kept contracting, whereas the manufacturing production presented a favorable trend, reflecting both the recovery of external demand and the dynamism of the domestic market. In turn, there was a rise in the levels of construction activity, with respect to the previous quarter.

The dynamism of the Mexican economic activity in the reference quarter was manifested across most regions of the country. Indeed, even though the growth rate in the Northern region is estimated to have somewhat moderated, in the Central regions a greater dynamism is foreseen as compared to the previous quarter. On the other hand, it is estimated that in the South the level of economic activity slightly contracted. The expansion in the Northern and Central regions is principally attributed to the relatively more favorable performance of manufactures, both destined to the domestic market and for exports, of construction and of tertiary activities, particularly retail trade. In the same vein, non-oil mining recovered incipiently in the North-Central region, and tourism and agricultural production expanded in the Central regions. Meanwhile, the economic activity in the Southern region contracted, consequent on a drop in oil mining, construction and retail trade, which was partially counteracted by the expansion in tourism and the agricultural sector in this region. To complement the analysis of the regional economic activity presented in this Report, Box 1 analyzes the determinants of labor productivity in the manufacturing sector during the period of 2007 – 2015.

During the reported quarter, annual headline inflation maintained an upward trend, which had been perceived since mid-2016. This performance was fundamentally accounted for by the additional depreciation of the national currency, as a reflection of the complex external environment faced by Mexico, especially in the wake of the elections in the U.S. and their outcome. In turn, the exchange rate evolution caused an increase in core inflation, mainly in its merchandise subindex. Additionally, during the fourth quarter of 2016, the annual growth rate of its non-core component also accelerated, as a consequence of increments in some agricultural products' prices and in gasoline prices in cities along the Northern border. As a result, annual headline inflation slightly exceeded

the 3 percent target as of October 2016, after a period of seventeen months below this level, and closed 2016 at 3.36 percent. As of January 2017, derived from the process tending to the liberalization of some energy prices, in particular gasoline and L.P. gas, the prices of these fuels spiked, reason why the upward trend, which had been exhibited by headline inflation, exacerbated. Therefore, annual headline inflation at the national level increased to 4.72 percent in January and to 4.86 percent in February. The evolution of inflation at the regional level has been generally congruent with this performance. In particular, across all regions inflation persisted slightly above 3 percent in the reference quarter. Likewise, the increment of inflation observed as of January 2017 was also perceived in all regional economies considered in this Report.

In general, business agents consulted for this Report anticipate demand for own goods and services to expand over the next twelve months, even though this signal somewhat weakened, as compared to the expectations in the previous quarter. Consistent with the above, business contacts estimate a moderate increment in the number of hired personnel and the physical capital stock in different regions of Mexico. Possibly, this in part reflects the prevailing uncertainty regarding a possible adjustment in the economic relation between Mexico and the U.S. in the future. In this respect, Box 2 presents the opinions of the consulted sources in the manufacturing sector regarding the expected change in the level of activity of their businesses, as a consequence of different elements of the economic policy that could be implemented by the incoming U.S. administration.

Business agents also detailed the main upward and downward risks to the regional economic growth. Among downward risks, the following were mentioned: i) that the new government of the U.S. implements policies that could lead to lower Mexican exports and lower foreign direct investment flows (FDI); ii) that the perception of public safety deteriorates; and iii) that new episodes of volatility in international financial markets are registered, leading to greater uncertainty over the exchange rate. In contrast, among upward risks, the next were listed: i) a higher-than-expected increment in the levels of private investment, especially in the automotive sector; and ii) that various public infrastructure projects that are being developed, in particular in transport, will become operational faster than previously estimated.

As regards the expected evolution of prices for the following twelve months, consulted business agents in most regions anticipate the annual changes in the sales' prices of own goods and services to be generally lower than last year, even

Summary

though this signal weakened with respect to the previous quarter. Furthermore, across all regional economies, consulted business contacts expect the annual growth rate of their input prices to be higher than last year, while in the Northern and Central regions an increment in the annual growth rate of wage costs is also anticipated for the next year.

In view of the uncertain and complex environment faced by the regional economies, in part, as a consequence of the economic agenda contemplated by the new U.S. government, it is necessary to encourage and adopt strategies that would boost productivity and competitiveness of the regional Mexican economies. In particular, the strengthening of the regulatory framework to facilitate businesses' management, higher efficiency of the justice system in all levels and the improved infrastructure, above all concerning transport and communications, among other factors, are fundamental to be able to fully exploit the comparative advantages of the regions. In turn, the implementation of the said strategies could be manifested in a greater flow of the FDI and an additional boost to exports in different regions of Mexico,

besides the strengthening of the domestic market, which is entailed by the above. The new international juncture makes it inevitable to seek greater diversification of the destination markets for Mexican exports, as well as sources of the Mexican imports and FDI flows. In this respect, Box 3 analyzes the degree of export diversification in terms of markets and products by state, and presents the strategies of export market diversification that are considered viable by business contacts of the manufacturing sector consulted by Banco de México, in light of a possible implementation of a protectionist trade policy in the U.S. In the same line, Box 4 analyzes the impact of the FDI on the performance of exports in the manufacturing sector across states, which demonstrates the need to keep improving conditions to attract and diversify the sources of the FDI. Finally, it should be noted that the commitment to adequately and promptly implement the structural reforms that have already been approved is a priority, as they will boost productivity of regional economies and will contribute to strengthening the domestic market.