Of Cars and Capital Flows: Mexican Central Bank Leader Discusses Auto Production, Global Challenges

December 17, 2015

Dennis Lockhart and Agustín Carstens had discussed global economics before, first when they ran into one another in a European airport. But in early December, Carstens, the governor of Mexico's central bank, Banco de Mexico, and Atlanta Fed President Lockhart had a more substantive conversation when they reunited for a discussion before the World Affairs Council of Atlanta in early December.

At the Atlanta Fed's headquarters, the University of Chicago-educated Carstens discussed challenges facing emerging markets, his country's burgeoning automotive manufacturing industry, and what lies ahead for Mexico. These matters also interest the Atlanta Fed. The Reserve Bank's Americas Center studies economic, financial, and regulatory issues throughout Latin America, and its Miami Branch houses a team that examines domestic operations of Latin American financial institutions.

What's more, our nations are tightly linked not just geographically but also economically. Mexico is America's third-biggest trading partner in dollar terms. Mexico's 2014 gross domestic product (GDP) of $1.3 trillion ranks second in Latin America behind Brazil and 15th globally, according to the World Bank.

Manufacturing, energy reforms leading Mexican economy

Mexico's GDP will grow about 2.5 percent this year, Carstens predicted, and gain speed in the next couple of years. Key engines include an expanding manufacturing base and the privatization of Mexico's energy industry, which Carstens said has lagged in investment under government ownership as energy revenues were diverted into other federal programs. Energy sector reforms were officially launched in December 2013, ending 75 years of state monopoly in the oil and gas business.

Those reforms coincided with falling energy prices, which have proven a mixed blessing for Mexico, Carstens explained. Although lower fuel prices have dampened private investor interest in the newly opened energy sector, cheap natural gas has sharpened the global competitiveness of Mexican factories. For example, electricity prices in the country fell 30 percent last year because of inexpensive natural gas, the main fuel for the country's power plants and many factories.

Auto assembly sector growing quickly in Mexico

Auto manufacturing in particular is blossoming. "The auto sector is probably the key sector right now," Carstens said.

Production will total 3.5 million vehicles in 2015 and should reach 5 million by 2019, according to the Banco de Mexico governor. The 2019 figure would make Mexico the world's third-largest car producer after the United States and China.

Carstens cited three main reasons why Mexico's auto industry is flourishing: the arrival of three Korean assembly plants whose owners sought production sites where they could better compete with Japanese exporters benefiting from a falling yen; universities and the government have invested in training auto workers; and, again, lower natural gas prices.

As Mexican manufacturing has expanded, the country has become less dependent on its energy sector, though it is still critical, Carstens explained. Thirty years ago, oil and gas supplied 80 percent of Mexico's foreign exchange revenue. Today, Carstens said, that share has fallen to 10 percent. However, 30 percent of government revenue is still tied to oil and gas, he noted.

Challenges facing emerging economies

Mexico's economic outlook is generally bright, in Carstens's view, yet difficulties loom. The most fundamental concern for any economy today, he said, is to simultaneously sustain economic growth and financial stability. For developing economies in particular, like Mexico's, Carstens outlined three primary challenges:

- *Sluggish global economic growth*. Carstens explained that although emerging markets have recovered from the global recession faster than advanced economies, emerging-market growth is slowing. And advanced economies generally continue to expand gradually, a troublesome trend for emerging markets because they benefit from strength in the developed world. Closest to home, Carstens emphasized that a strong U.S. economy boosts Mexico. One reason: Mexican goods exports to the United States totaled $318.7 billion in 2014, nearly 30 times the value exported to second-place Canada, according to United Nations data.
- *Slowing export revenues, especially resulting from falling commodity prices.* Exports tend to be vital to developing economies because, for one, they lack robust consumer markets at home. Exports of goods and services equaled about a third of Mexico's GDP in 2014, compared with 14 percent for the United States. Carstens stressed that Mexico's economy is not commodity based, like many emerging markets, but rather is based on manufacturing. Indeed, although crude petroleum is Mexico's leading export product, the other leading exports are not commodities but cars, vehicle parts, delivery trucks, and computers.
- *Volatile capital flows*. This year has been the worst ever for emerging markets in terms of capital inflows, Carstens said. Low interest rates in advanced countries like the United States for a while sent capital flowing into emerging markets in search of higher returns. Now, the flow of money has slowed thanks to a stronger U.S. economy and slowing emerging economies, Carstens said. Some investors move lots of capital quickly from one nation to another, and this volatility can push down the value of local currencies.

Charles Davidson
Staff writer for *Economy Matters*