C K F

CENTER FOR ECONOMIC FORECASTING OF MEXICO

MEXICO ECONOMIC OUTLOOK

2015 – 2017

PREPARED FOR THE FALL MEETING OF PROJECT LINK, TO BE HOSTED BY THE UNITED NATIONS, DEPARTMENT OF ECONOMIC AND SOCIAL AFFAIRS, U.N. HEADQUARTERS, NEW YORK. OCTOBER 21-23, 2015

SEPTEMBER 2015

MEXICO ECONOMIC OUTLOOK (2015-2017)

By

Alfredo Coutiño

Center for Economic Forecasting of Mexico

Philadelphia, PA. U.S.A.

October 2015

ckf-forecasting.com

C K F

CENTER FOR
ECONOMIC FORECASTING
OF MEXICO

Prepared for the Fall Meeting of Project LINK-United Nations, to be hosted by the United Nations, Department of Economic and Social Affairs, U.N. Headquarters, New York. October 21-23, 2015. Project LINK Research Centre. Institute for Policy Analysis.

University of Toronto
Project LINK
United Nations, Department of Economic and Social Affairs
U.N. Headquarters, New York City
October 21-23, 2015

MEXICO */

1. Recent Trends

In 2015, the economy performs at rates similar to those in the previous year, but below potential, with no major improvement. The economy started the year with moderation, affected by the slowness in the U.S. and the budget cut implemented by the Mexican government as a result of the shortfall in oil revenues. Inflation has adjusted down significantly given the absence of new taxes and the positive arithmetic effect of the comparison base. Monetary conditions remain expansionary, keeping the external imbalance under pressure.

The economy moderated in the second quarter, despite further advance in the U.S. recovery. Domestic activity is still restrained by the limited production capacity. The national industry continues to underperform as a result of the inefficiencies generated by the prolonged absence of reforms in the past fifteen years. The fiscal adjustment implemented by the government since the beginning of year has affected public spending but also slowed private activities highly dependent on the federal budget. Hence, GDP reported annual growth of 2.2% in the second quarter, after increase of 2.6% in the previous quarter and 1.8% a year earlier.

Three main factors affected the economy's performance at the beginning of the year. First, the U.S. economy reported a significant moderation with almost no annual growth in the first quarter, which imposed restrictions to Mexican exports –particularly manufacturing products. Second, oil production continued to fall as a result of structural bottlenecks and lack of investment in the sector. Third, the government cut the federal budget for about 0.7% of GDP for the year, mainly forced by the fall in oil revenues generated by the combination of lower prices and production.

After ending at 4.1% in 2014 –a rate just above the 4% target's upper limit, inflation has adjusted down significantly since the beginning of 2015. In fact, since February –for the first time in the past nine years– inflation hit its central target of 3% and continued to decline toward 2.5% by September. The surprise came because the target was reached even in an environment of expansionary fiscal and monetary policies. Obviously, something else was explaining the apparent inflation success. On the one hand, the inflation decline has to do with the positive arithmetic effect generated by last year's high comparison base. On the other hand, consumer prices are moderating this year, mainly as a result of more consistent increases in public prices and tariffs. Also, the economy's underperformance has kept consumer prices under control, consequently keeping inflation subdued.

Monetary conditions, on the contrary, have remained in the expansionary zone since last year when the interest rate was cut to 3%. The nominal and real interest rates have stayed below the neutrality level most of the time, thus making monetary conditions stimulative for domestic demand. However, since the end of 2014 with the rising probability of the monetary reversal in the U.S., the peso has been under significant depreciation pressures. This year, with the proximity of the beginning of the Fed’s rate hikes, Mexico’s interest rates will need to increase even though the inflation rate is below target. In fact, domestic rates will have to react to the loss of competitiveness in bonds that will come with rate hikes in the U.S. Otherwise, prolonged unchanged rates will take a heavier toll on the peso and, consequently, on future inflation.

The labor market has advanced slowly as a result of the economy’s underperformance. Some temporary jobs have been created by public spending, although private firms are still cautious in hiring since they are still facing the burden of new taxes introduced in 2014. Employment will improve as the economy strengthens, but the creation of jobs will be limited since the increase in productivity generated by reforms will displace low-skilled workers.

The country has approved 11 structural reforms and most of them are already in place. However, the economy continues to advance slowly and still shows structural weakness. New reforms will benefit the economy’s potential capacity in the medium term. However, the size of the economic impact will depend on the magnitude of the structural changes produced by the main reforms. The key is not the quantity but rather the quality of reforms. Mexico is moving in the right direction of strengthening the fundamental sources of permanent growth, but it will take time for the economy to increase its production capacity.

2. National Policy Assumptions and International Environment

Our Baseline Scenario for the Mexican economy is based on three main assumptions: economic policy, structural changes, and international conditions.

The first assumption establishes the country’s return to macroeconomic discipline as a necessary condition for preserving stability and keeping the economy near the equilibrium. Economic policy, in general terms, will be mainly focused on stability in order to create favorable conditions for growth and employment. However, in order to generate growth and employment, stability will not be sufficient. Therefore, economic policy must have to be accompanied by public policies to directly promote social progress and reinforce the fundamental sources of permanent growth (saving-investment, productivity, and technological change), which in turn will increase the country’s potential to grow. However, in the short run economic policy will be focused on strengthening the domestic absorption in order to compensate for the prolonged external weakness, which also implies a wider fiscal imbalance.

The second assumption considers the effective implementation of the already-approved structural reforms, particularly in the second half of the ongoing administration (2016-2018). The fiscal reform will continue to improve the efficiency of the tax system, while the energy reform will increase the production capacity in the oil industry. The government will also implement changes that do not require Congress approval, particularly those reinforcing institutions and the application of the law. In the medium and long term, there is a possibility of deepening the reform process, which will increase the country's production capacity throughout the next decade.

The third assumption includes the improvement of the global economy. The U.S. economy will continue to strengthen in the coming years. Growth this year will be around 2.5%, and will stay around 3% in the next two years. In the medium term, with most of fiscal problems resolved, the U.S. economy is expected to advance at rates consistent with its potential growth. We expect the Fed to start normalizing the policy interest rate between the end of this year and the beginning of next, moving the rate at a very gradual pace toward neutrality to let the economy advance in an environment of price stability.

Domestically, monetary policy will have to return to a management consistent with the "inflation targeting" approach in order to keep inflation under control and preserve the currency stability. In the short term monetary policy will remain loose, even with the first rate hike by the end of the year. It will move to neutrality next year, with the possibility of turning restrictive in case of a significant inflation rebound generated by the steady peso depreciation. The central bank will return to the use of the dual mechanism of external-shock absorption through the flexibility of the exchange rate and interest rate. In case of unexpected volatility, this automatic mechanism could be accompanied by discretionary monetary interventions to restore market stability. In the following three years fiscal policy will still remain in deficit, although decreasing. At some in the medium term, fiscal policy is expected to be managed by the effective application of the structural rule in order to better contribute to macroeconomic stability.

The international market of oil will remain affected by geopolitical events in the short term. In the longer term prices will start to adjust down as production capacity and supply will increase. The price for the light crude in New York (WTI) will average around $50 dollar per barrel (dpb) this year, around $45 next year, and will recover a little in 2017. The price for the Mexican crude will average around $47.50 dpb this year, just below $45 next year, and it will move toward $50 in the medium term.

3. Forecast Summary

Our Baseline scenario foresees an economy with no much improvement this year, advancing at still-limited rates since the impact of reforms will only be felt in the medium term. The medium-term recovery will be the result of some positive factors: a domestic market gaining some steam by the improvement in purchasing power, some strengthening of the external demand, and positive effects generated by new reforms. Even though growth will still remain restricted by the limited potential capacity, the economy will advance at a rate of 2% this year, after 2.1% in 2014. In the medium term, the economy will advance at rates determined by the increased production capacity.

Inflation will end this year just around the 3% central target, pushed by the significant currency depreciation and the still expansionary monetary policy. For next year, inflation will be higher given the economic recovery and the realignment of prices generated by the peso depreciation. Under these circumstances, policymakers will keep normalizing monetary conditions to put the interest rate at its neutral level at least. Rates could also enter restrictive territory if volatility worsens as a result of a market overreaction to the Fed's monetary normalization.

New reforms will certainly benefit the economy's potential capacity. However, the size of the economic impact will depend on the magnitude of the structural changes produced by main reforms. The greater the economic opening the bigger the impact on potential growth. Mexico is certainly moving in the right direction of strengthening the accumulation of capital, which in the end will increase productivity and promote technological progress.

The flexible exchange rate mechanism will be preserved, with the hope that the foreign exchange market will adjust the Mexican peso at a speed equivalent to at least the differential of inflations between Mexico and the U.S. However, in the medium term there exists the possibility of a significant arrival of foreign direct investment attracted by new reforms. Therefore, the current account deficit will increase –in absolute and relative terms– as a result of the economy's dynamics and also as a consequence of some currency misalignment.

The new production capacity generated by reforms, together with the positive effects from the U.S. recovery, will determine growth in the future. However, in order to promote a growth path free of imbalances, in the long run the economy should be functioning around its new steady state rate (3.5%-4%).

4. Uncertainties

Some downside risks remain in the horizon, which could generate a pessimistic scenario in the near future. On the domestic side, there is an important downside risk that has to do with a potential increase in the country's vulnerability to financial shocks. Persistent fiscal and external imbalances and the associated potential loss of policy credibility could make the country more vulnerable to speculation and financial crises. As a result, the economy's capacity could be hurt significantly, with significant consequences for social well being.

On the external side, we identify three main risks. First, since the Mexican economy is highly dependent on the U.S. performance, the main risk comes from a potential weakening of the northern neighbor. Under that scenario, the U.S. weakness will have significant impact on the Mexican economy. Second, a scenario of a return to recession in Europe and more severe fall in oil prices would impose severe constraints to Mexico's performance in coming years. Third, the potential collapse of the Chinese housing market with severe consequences on the economy and the global financial system, thus affecting the U.S. economy and consequently Mexico.

TABLE 1.- MACROECONOMIC INDICATORS

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Gross Domestic Product															
Real GDP (bill. 1993 pesos)	1637.4	1707.7	1759.5	1847.5	1905.7	1932.4	1841.5	1935.7	2013.9	2094.9	2123.9	2169.4	2213.4	2276.3	2351.9
Change (%)	1.4	4.3	3.0	5.0	3.1	1.4	-4.7	5.1	4.0	4.0	1.4	2.1	2.0	2.8	3.3
Nominal GDP (bill. pesos)	6895.4	7789.2	8459.5	9442.3	10217.4	10982.3	10836.3	11900.9	13037.0	14001.9	14440.5	15376.8	16411.8	17583.4	18904.7
Change (%)	10.0	13.0	8.6	11.6	8.2	7.5	-1.3	9.8	9.5	7.4	3.1	6.5	6.7	7.1	7.5
GDP in Dollars (bill. dls.)	639.1	690.2	776.2	869.1	935.0	986.8	801.9	942.4	1048.8	1063.2	1125.7	1155.9	1041.4	1048.1	1139.8
Change (%)		8.0	12.5	12.0	7.6	5.5	-18.7	17.5	11.3	1.4	5.9	2.7	-9.9	0.6	8.8
National Income and Savings															
Personal Disp. Income (real %)	2.1	3.5	2.5	4.2	2.2	0.8	-5.1	4.5	3.4	3.4	-0.3	1.4	2.4	2.7	2.9
Gross Savings (% of GDP)	21.2	20.8	20.3	21.0	21.0	21.7	20.1	20.4	20.4	21.3	21.7	21.8	21.8	21.9	21.9
Prices (1993=1.0)															
GDP Deflactor (%)	8.60	8.31	5.41	6.30	4.91	6.00	3.54	4.49	5.29	3.25	2.25	4.44	3.88	4.18	4.06
Consumer (% average)	4.50	4.69	3.99	3.63	3.97	5.12	5.30	4.16	3.41	4.11	3.84	4.29	3.04	3.98	4.18
Consumer (% end of period)	4.00	5.19	3.33	4.05	3.76	6.53	3.57	4.40	3.82	3.57	4.05	4.38	3.18	4.22	4.04
Foreign Exchange Market (ps/dls)															
Interbank (average)	10.802	11.289	10.895	10.846	10.930	11.155	13.512	12.629	12.429	13.168	12.832	13.305	15.766	16.791	16.607
Change (%)	11.7	4.5	-3.5	-0.4	0.8	2.1	21.1	-6.5	-1.6	5.9	-2.5	3.7	18.5	6.5	-1.1
Interbank (end of period)	11.236	11.265	10.778	10.881	10.866	13.538	13.058	12.365	13.973	12.870	13.410	14.740	16.995	16.689	16.506
Change (%)	8.1	0.3	-4.3	1.0	-0.1	24.6	-3.5	-5.3	13.0	-7.9	4.2	9.9	15.3	-1.8	-1.1
Conversion (average)	10.789	11.286	10.898	10.865	10.928	11.130	13.514	12.629	12.430	13.169	12.828	13.303	15.759	16.777	16.586
Change (%)	11.7	4.6	-3.4	-0.3	0.6	1.8	21.4	-6.5	-1.6	5.9	-2.6	3.7	18.5	6.5	-1.1
Conversion (end of period)	11.232	11.151	10.627	10.809	10.920	13.815	13.082	12.350	13.948	12.966	13.512	14.748	17.007	16.704	16.524
Change (%)	9.0	-0.7	-4.7	1.7	1.0	26.5	-5.3	-5.6	12.9	-7.0	4.2	9.1	15.3	-1.8	-1.1
External Sector (bill. dls.)															
Current Account Balance	-8.338	-7.007	-8.956	-7.795	-14.658	-20.194	-8.287	-4.993	-13.229	-16.364	-30.469	-24.983	-30.060	-28.327	-30.146
Trade Balance	-5.792	-8.843	-7.663	-6.312	-10.311	-17.615	-4.926	-3.009	-1.409	0.018	-1.195	-2.849	-8.102	-5.910	-5.465
Oil Price (dls/barrel)	24.78	31.05	42.71	53.04	61.64	84.38	57.40	72.46	101.13	101.96	98.44	86.00	47.50	45.50	48.50
Total External Debt	132.524	130.925	128.248	116.668	124.433	125.233	163.345	189.175	191.874	194.857	195.647	198.830	204.057	212.296	220.535
Financial Sector															
Monetary Base (mill. ps)	303614	340178	380034	449821	494743	577543	632032	693423	787737	884546	950961	1058057	1180144	1321706	1485817
Change (%)	15.0	12.0	11.7	18.4	10.0	16.7	9.4	9.7	13.6	12.3	7.5	11.3	11.5	12.0	12.4
Money Supply: M1 (mill. ps)	856216	944790	1066138	1215636	1346715	1479691	11248158	1825607	2087566	2353517	2534884	2830716	3169529	3564361	4024448
Change (%)		10.3	12.8	14.0	10.8	9.9	660.2	-83.8	14.3	12.7	7.7	11.7	12.0	12.5	12.9
Interest Rate (Cetes 28) (%)	6.23	6.82	9.20	7.19	7.19	7.68	5.43	4.40	4.24	4.24	3.75	3.00	3.15	4.50	5.50
Public Sector (% of PIB)															
Economic Balance	-0.62	-0.25	-0.12	0.11	0.05	-0.07	-2.52	-3.11	-2.85	-2.53	-3.77	-3.92	-4.17	-3.81	-3.63
Primary Balance	2.16	2.24	2.49	2.96	2.60	2.00	-0.10	-0.96	-0.97	-0.83	-2.05	-2.08	-2.35	-2.01	-1.85
Labor and Employment															
Minimum Wage															
Nominal (%)	4.5	4.5	4.5	4.0	3.8	4.0	4.6	4.8	4.2	4.0	3.8	4.0	4.0	4.2	4.2
Real (93=1) (%)	0.0	-0.3	0.5	0.4	-0.2	-1.1	-0.7	0.6	0.8	-0.1	0.0	-0.3	0.9	0.2	0.0
Manufacturing Wages															
Nominal (%)	5.5	5.3	5.0	4.4	4.0	4.5	5.3	5.4	4.6	4.4	4.2	4.4	4.4	4.6	4.6
Real (93=1) (%)	0.9	0.7	0.8	0.7	0.0	-0.6	0.0	1.2	1.2	0.3	0.3	0.1	1.3	0.6	0.4
Employment (million people)	31.790	32.240	32.580	33.395	33.912	34.217	34.185	34.769	35.397	35.970	36.324	36.695	37.081	37.614	38.261
Change (%)	0.1	1.4	1.1	2.5	1.5	0.9	-0.1	1.7	1.8	1.6	1.0	1.0	1.1	1.4	1.7
Open Unemployment Rate (%)	3.25	3.92	3.58	3.59	3.72	3.97	5.47	5.37	5.23	4.95	5.00	4.84	4.52	4.21	3.78
U.S. Economy															
GDP (%)	2.81	3.79	3.35	2.67	1.78	-0.29	-2.78	2.53	1.60	2.22	1.49	2.43	2.50	3.20	3.00
Consumer Inflation (%)	2.30	2.67	3.37	3.22	2.87	3.81	-0.32	1.64	3.14	2.08	1.46	1.61	1.42	2.02	2.83

Note.- Forecasts start in 2015.

*/ Mexican Economic Outlook. Center for Economic Forecasting of Mexico (CKF). October 2015.
acoutino@ckf-forecasting.com; www.ckf-forecasting.com.

C K F

Center for Economic Forecasting of Mexico

P. O. Box 38521

Philadelphia,
Pennsylvania 19104

Email:
acoutino@ckf-forecasting.com

http://www.ckf-forecasting.com