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Center for
Economic Forecasting
of Mexico

MEXICO ECONOMIC OUTLOOK

2016 – 2018

Prepared for the Fall Meeting of Project LINK, to be hosted by Project LINK Research Center. Institute for Policy Analysis, University of Toronto. Toronto, Canada. October 19-21, 2016

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MEXICO ECONOMIC OUTLOOK (2016-2018)

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MEXICO */

1. Recent Trends

The economy performed at its limited potential capacity in the half of 2016, but started to show signs of deceleration. The ongoing fiscal adjustment and monetary normalization are withdrawing the stimulus to domestic market. Inflation remains below the 3% target but shows an upward trend, which will be fueled by the persistent currency depreciation. Growth will decelerate to below potential rates this year. Prospects for the medium term are subject to the size of structural changes to be produced by reforms in place.

In the first semester, the economy advanced at a rate just around potential growth. Since the economy has been running at a steady speed consistent with its production capacity, the output gap has closed. The output gap's closure indicates that the economy was functioning at capacity or full employment of resources. Therefore, the fiscal and monetary stimulus measures are no longer needed and prolonging them could fuel inflation to rates above the 3% target. Pushing the economy beyond its steady state will only develop macroeconomic imbalances.

Growth was reported at 2.5% in the second quarter and 2.4% in the first quarter. Growth has averaged 2.6% in the past eight quarters, indicating that the economy has reached its steady state. Even though the external environment has not improved significantly, the economy has stayed around its potential growth (2.6%). The national industry advanced further, benefiting from a domestic market propelled by monetary expansion.

Inflation is showing an increasing trend as the positive factors have vanished this year. Consumer prices are now moving more consistently with the structure of price formation. Certainly, inflation still stays below the 3% target, but has increased from 2.1% last December to 2.9% in September. Core inflation is reflecting the pass-through effect from the currency depreciation to prices of imported merchandise, thus increasing from 2.4% in December to 3.1% in September. Inflation will continue to trend up as the currency pass-though will affect consumer prices. In fact, the prolonged money expansion and the depreciation of the peso will prevent inflation from remaining below target.

Monetary conditions moved into neutral territory in June of 2016, after staying stimulative for domestic absorption with most of the stimulus still accommodating in imports and some inflation. The policy rate has been hiked by 125 basis points from its expansive level of 3% in the previous two years. The peso remains depreciated, but the interest rate is now used as a second buffer since February when the central bank was forced to implement a surprising and significant rate hike. In June, the policy rate was increased by another 50 basis points to 4.25%, and will probably report at least one more hike before the end of the year.

The labor market has advanced slowly because of the economy's below-potential performance. Some temporary jobs have been created, although private firms remain cautious in hiring since they are affected by domestic uncertainty and global volatility. 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 Mexican peso has weakened significantly since the end of 2015 and remains depreciating since the currency adjustment is mostly a correction. Domestic monetary policy has tightened in 2016, mainly to reduce capital outflows generated by the monetary reversal in the U.S. The loss of competitiveness in the bond market is forcing policymakers to act ahead of the Federal Reserve's rate hike cycle. Further monetary tightening could be necessary in the event of the ongoing currency depreciation. This way, Mexico will deal with the financial volatility—generated by the global monetary tightening—by using the more effective dual system of shock absorbers: the exchange rate and the interest rate

Mexico's 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. The country is moving in the right direction by 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 has focused on strengthening the domestic absorption in order to compensate for the prolonged external weakness, which has so implied wider fiscal and external imbalances.

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 could 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 1.5%, and will stay between 2% and 2.5% in the following 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 continue normalizing the policy interest rate between the end of this year and along 2017, moving the rate at a very gradual pace toward neutrality to let the economy advance in an environment of price stability.

Domestically, monetary policy is expected 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 move into restrictive territory to avoid the inflation acceleration. It will stay a little restrictive next year, with the possibility of tightening even more in case of a significant inflation rebound generated by the steady peso depreciation. The central bank will effectively apply 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 point 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 up as demand and supply return to more normal conditions. The price for the light crude in New York (WTI) will average around $38 dollar per barrel (dpb) this year, around $40 next year, and will recover a little more in 2018. The price for the Mexican crude will average around $35.50 dpb this year, $37.50 next year, and around $40 in 2018.

3. Forecast Summary

Our Baseline scenario foresees an economy with no 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 2.2% this year, after 2.5% in 2015, and will grow 2.4 in 2017. In the medium term, the economy will advance at rates determined by the increased production capacity, between 3% and 3.5%.

Inflation will end this year above the 3% central target, pushed by the significant currency depreciation and the still remaining excess liquidity. Next year, inflation will be higher since it will return to its structural rate around 4%. Under these circumstances, policymakers will keep monetary conditions mildly restrictive until the fiscal policy corrects the imbalance and opens space for monetary policy to return to neutrality. Rates could turn even more restrictive 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 (3.0%-3.5%).

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	2018
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	2123.4	2171.0	2224.6	2273.0	2328.5	2405.8
Change (%)	1.4	4.3	3.0	5.0	3.1	1.4	-4.7	5.1	4.0	4.0	1.4	2.2	2.5	2.2	2.4	3.3
Nominal GDP (bill. pesos)	6895.4	7786.8	8454.7	9436.3	10209.5	10976.9	10831.6	11898.3	13032.5	14000.2	14438.8	15458.3	16240.2	17161.8	18304.9	19752.3
Change (%)	7.5	12.9	8.6	11.6	8.2	7.5	-1.3	9.8	9.5	7.4	3.1	7.1	5.1	5.7	6.7	7.9
GDP in Dollars (bill. dls.)	639.1	690.0	775.8	868.5	934.2	986.3	801.5	942.2	1048.5	1063.1	1125.6	1162.0	1024.4	929.5	973.3	1041.3
Change (%)		8.0	12.4	11.9	7.6	5.6	-18.7	17.5	11.3	1.4	5.9	3.2	-11.8	-9.3	4.7	7.0
National Income and Savings																
Personal Disp. Income (real %)	2.1	3.5	2.5	4.1	2.2	0.8	-5.1	4.5	3.4	3.4	0.8	1.6	2.0	1.6	1.7	2.6
Gross Savings (% of GDP)	21.2	20.8	20.3	21.0	21.0	21.7	20.1	20.4	20.4	21.3	21.6	21.9	23.0	22.9	23.0	22.9
Prices (1993=1.0)																
GDP Deflactor (%)	8.60	8.28	5.38	6.29	4.89	6.03	3.54	4.51	5.27	3.28	1.75	4.71	2.53	3.42	4.12	4.44
Consumer (% average)	4.55	4.69	3.99	3.63	3.97	5.13	5.30	4.15	3.37	4.14	3.81	4.00	2.73	3.33	3.88	4.22
Consumer (% end of period)	4.00	5.19	3.33	4.05	3.76	6.53	3.57	4.40	3.82	3.57	3.97	4.08	2.13	3.52	4.04	4.22
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	15.884	18.505	18.856	19.026
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	19.4	16.5	1.9	0.9
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	17.209	18.964	19.134	19.268
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	16.7	10.2	0.9	0.7
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	15.854	18.464	18.807	18.969
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	19.2	16.5	1.9	0.9
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	17.207	18.965	19.139	19.277
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	16.7	10.2	0.9	0.7
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	-30.978	-26.249	-32.707	-33.393	-32.435	-35.338
Trade Balance	-5.779	-8.811	-7.587	-6.133	-10.074	-17.261	-4.681	-3.009	-1.409	0.018	-1.195	-3.066	-14.609	-15.576	-14.529	-16.825
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	85.48	43.29	35.50	37.50	40.00
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	214.296	222.535	223.333
Financial Sector																
Monetary Base (mill. ps)	303614	340178	380034	449821	494743	577543	632032	693423	787609	884615	951039	1064286	1167156	1288021	1435626	1620194
Change (%)	15.0	12.0	11.7	18.4	10.0	16.7	9.4	9.7	13.6	12.3	7.5	11.9	9.7	10.4	11.5	12.9
Money Supply: M1 (mill. ps)	856216	944790	1066138	1215636	1346715	1479691	11248158	1825607	2087205	2353704	2535097	2848199	3132906	3469081	3881923	4401248
Change (%)		10.3	12.8	14.0	10.8	9.9	660.2	-83.8	14.3	12.8	7.7	12.4	10.0	10.7	11.9	13.4
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	2.98	4.50	5.00	5.00
Public Sector (% of PIB)																
Economic Balance	-0.62	-0.25	-0.12	0.11	0.05	-0.07	-2.52	-3.11	-2.53	-2.59	-2.42	-3.23	-3.50	-3.30	-3.01	-3.07
Primary Balance	2.16	2.24	2.49	2.96	2.61	2.00	-0.10	-0.97	-0.90	-1.10	-1.09	-1.82	-2.09	-1.87	-1.56	-1.59
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	3.8	3.8	4.0
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	0.0	1.2	0.5	-0.1	-0.2
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	4.2	4.2	4.4
Real (93=1) (%)	0.9	0.7	0.8	0.7	0.0	-0.6	0.0	1.2	1.2	0.2	0.4	0.4	1.6	0.8	0.3	0.2
Employment (million people)	31.790	32.240	32.580	33.395	33.912	34.217	34.185	34.769	35.397	35.970	36.315	36.724	37.269	37.746	38.138	38.794
Change (%)	0.1	1.4	1.1	2.5	1.5	0.9	-0.1	1.7	1.8	1.6	1.0	1.1	1.5	1.3	1.0	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	4.92	4.82	4.36	4.08	4.55	4.03
U.S. Economy																
GDP (%)	2.8	3.8	3.3	2.7	1.8	-0.3	-2.8	2.5	1.6	2.2	1.7	2.4	2.6	1.5	2.2	2.5
Consumer Inflation (%)	2.30	2.67	3.37	3.22	2.87	3.81	-0.32	1.64	3.14	2.08	1.47	1.61	0.12	0.32	1.43	1.78

Note.- Forecasts start in 2016

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