C K F

Center for
Economic Forecasting
of Mexico

MEXICO ECONOMIC OUTLOOK

2017 – 2019

Prepared for the Fall Meeting of Project LINK, to be hosted by UNCTAD, Palais des Nations. Geneva, Switzerland. October 3-5, 2017

September 2017

MEXICO ECONOMIC OUTLOOK (2017-2019)

By

Alfredo Coutiño

Center for Economic Forecasting of Mexico

Philadelphia, PA. U.S.A.

October 2017

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 UNCTAD, Palais des Nations, Geneva, Switzerland on October 3-5, 2017. Project LINK Research Centre. Institute for Policy Analysis.

University of Toronto
Project LINK
UNCTAD, Palais des Nations
Geneva, Switzerland
October 3-5, 2017

MEXICO */

1. Recent Trends

Mexico's economy continued to advance in the first half of 2017, although at rates consistent with its limited potential capacity given the still-anemic investment. Production remains restrained by structural obstacles from the past. In 2017, the economy is functioning under fiscal and monetary adjustment, which, together with an unfavorable external environment, is limiting its performance. Inflation is showing an upward trend during the year, coming from below to above-target rates, with prices still realigning. The currency remains depreciated, and even though has gained some ground, it stays under pressure.

During the first half of the year, the economy advanced further despite the financial turbulence and uncertainty regarding the future of the trade relations with the U.S. GDP reported annual growth of 1.8% in the second quarter, after increase of 2.8% in the previous quarter and 2.6% a year earlier. The economy advanced at a rate of 2.3% in the first half of the year, just a little lower than the 2.4% reported in the same period a year before. However, the economy continues to face a limited production capacity given the insufficient investment. Despite the ongoing reforms, investment as a ratio of GDP has not increased significantly, thus limiting production capacity and restraining potential growth.

Inflation has increased rapidly during the year to rates far above the 3% target as prices continue to realign. After staying below target for almost one year and a half, inflation started to trend up since the second half of 2016. After accumulating long lags, consumer prices started to unleash as the currency depreciation showed to be a more permanent correction. The prolonged monetary expansion and the fiscal indiscipline are the real roots of the inflation phenomenon. Hence, inflation has reached an annual rate of 6.7% at the end of the third quarter, twice higher than that reached at the end of 2016 and more than double the 3% target. The accumulated currency depreciation has also generated a pass-through into inflation, which continues to extend along 2017.

Despite the peso's depreciation, the liberalization of fuel prices, and the adjustment in the minimum wage, Mexico's inflation is mostly the result of a prolonged expansionary monetary policy that accommodated an increasing fiscal imbalance in the first four years of the administration. The inflation root was certainly planted by the central bank, when in 2013 monetary policy started to turn expansionary to support the fiscal effort that pretended to help an economy in frank deceleration. As a result of the money expansion, the quantity of money per unit of output accelerated since 2013, creating a situation of an increasing amount of money before a limited supply of goods.

In 2017, despite some gain, the Mexican peso remains depreciated since the currency adjustment is mostly a correction. Domestic monetary policy only reacted effectively after inflation proved to be a more persistent event, and has tightened further in 2017. In order to reduce the risk of capital outflows—generated by the threats of the U.S. new government and the Fed's monetary reversal, to fight the galloping inflation, and to recover some competitiveness in the bond market, Mexico's policymakers started to act ahead of the Federal Reserve's rate hike cycle. Thus, the policy interest rate increased by 400 basis points since the end of 2015 to stays at 7.0% at present.

This year, fiscal policy tightened by implementing a budget cut, mainly forced by the acceleration of the government debt. The economy was running with increasing fiscal imbalance during the first four years of the administration, which imposed pressures on the external imbalance. The persistent fiscal deficit produced an acceleration of the government debt, increasing by more than 12 percentage points of GDP in the first four years of the government. The deficit is expected to decline to around 2.5% of GDP in 2017, after reaching a peak of 3.5% in 2015, thanks to the combination of the budget cut and the currency gain generated by the peso's depreciation.

New reforms will benefit Mexico'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 those 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. U.S. policies affecting trade and investment with Mexico will affect the country's potential capacity to grow.

2. National Policy Assumptions and International Environment

Mexico's Baseline Economic Scenario is based on three main assumptions: economic policy, structural changes, and international conditions.

The first assumption establishes further advance in 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. In the past few years, economic policy has focused on strengthening the domestic absorption in order to compensate for the prolonged external weakness; the policy expansion, however, has implied wider fiscal and external imbalances. The assumption establishes that these major imbalances are reduced to levels that do not represent a risk for macroeconomic stability.

The second assumption considers the continuous implementation of the already-approved reforms, and further deepening of structural changes. 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 country 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 another round of reforms, 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. U.S. growth this year will be around 2%, and will stay between 2% and 2.5% in the following two years. In the medium term, 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 at a gradual pace in coming years, moving the rate toward neutrality to let the economy advance in an environment of price stability. We also assume that NAFTA will be renegotiated positively and will end with benefits for all the three countries involved. Europe and Asia will continue to advance.

Domestically, monetary policy is expected to stay on hold for the remainder of the year, and for most of next year as inflation will still stay above the 3% target. Policy will be managed according to the "inflation targeting" approach in order to keep inflation under control and preserve the currency stability. The central bank will effectively apply 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. In the longer term, fiscal policy is expected to be managed by the effective application of the structural rule in order to effectively contribute to macroeconomic stability.

The international market of oil will remain subject to 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 $49.50 dollar per barrel (dpb) this year, around $50.50 next year, and will stay around $51 in 2019. The price for the Mexican crude will average around $43.50 dpb this year, $44.50 next year, and around $45 in 2019.

3. Forecast Summary

Our Baseline scenario outlines an economy with no major improvement this year, advancing at still-limited rates since the impact of reforms will be felt only in the medium term. The recovery in the medium-term will be the result of some positive factors: a domestic market gaining some steam by the improvement in purchasing power, the strengthening of the external demand—particularly under a new NAFTA agreement, and positive effects generated by new reforms. Growth will still remain restricted by the limited potential capacity, with the economy advancing at a rate of 2% this year (after 2.3% in 2016), accelerating to 2.5% in 2018 benefited by the positive effects of the election year, and decelerating to 1.5% in 2019 as a result of the negative effect of the political business cycle during the first year of the new administration. In the medium term, the economy will advance at rates determined by the increase in production capacity, between 3% and 3.5%.

Inflation will end this year well-above the central target, even surpassing 6% given the more general price realignment in process. The currency pass-through will stay affecting inflation this year. Next year, inflation will show some decline but will remain above the 3% target, since it will just converge to its genuine structural rate around 4%. In 2019, with the traditional deceleration at the beginning of the new government, and the surrounding uncertainty affecting the MXN peso, inflation will rebound again. Under these circumstances, policymakers will keep monetary conditions mildly restrictive until fiscal policy 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, or in the event of a new government with anti-market approach.

New rounds of reforms will certainly strengthen the economy's potential capacity, particularly if they deepen structural changes. 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. A new fiscal reform will soon be needed, since the country remains as one with the lowest tax revenues as a ratio of GDP in Latin America, and even with a ratio below the region's average.

The flexible exchange rate mechanism will be preserved, with the hope that the foreign exchange market will adjust the 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 a transitory 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

A downside scenario cannot be ruled out in the medium term, mainly associated with the potential arrival of a market-unfriendly government in 2019. Radical or even populist policies would have the potential to increase 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 important consequences for social well being.

On the external side, we continue to identify three main risks. First, since Mexico's economy is highly dependent on the U.S. performance, the main risk comes from a potential economic 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 global deceleration mainly triggered by China, with consequences for oil prices, would impose constraints to Mexico's performance in coming years. Third, there exists the possibility of a NAFTA breakup or even a trade war in the area, which could generate a severe and prolonged downturn for Mexico.

TABLE 1.- MACROECONOMIC INDICATORS

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
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	2171.6	2229.1	2280.1	2326.1	2385.0	2420.3
Change (%)	1.4	4.3	3.0	5.0	3.1	1.4	-4.7	5.1	4.0	4.0	1.4	2.3	2.6	2.3	2.0	2.5	1.5
Nominal GDP (bill. pesos)	6895.4	7789.2	8459.5	9442.3	10217.4	10982.3	10836.3	11900.9	13037.0	14001.9	14441.9	15465.0	16362.4	17507.9	19079.8	20431.0	21747.3
Change (%)	5.9	13.0	8.6	11.6	8.2	7.5	-1.3	9.8	9.5	7.4	3.1	7.1	5.8	7.0	9.0	7.1	6.4
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	1125.8	1162.5	1030.1	936.9	1002.4	1064.2	1121.4
Change (%)		8.0	12.5	12.0	7.6	5.5	-18.7	17.5	11.3	1.4	5.9	3.3	-11.4	-9.1	7.0	6.2	5.4
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	0.8	1.6	2.0	1.8	1.5	2.0	1.1
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	23.1	23.2	23.0	22.2	21.8
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	1.76	4.71	3.07	4.61	6.82	4.44	4.89
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	2.72	2.82	6.02	4.28	4.56
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	3.36	6.38	4.22	4.78
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	15.881	18.689	19.044	19.215	19.417
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	17.7	1.9	0.9	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	17.249	20.619	18.557	19.012	19.520
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	17.0	19.5	-10.0	2.5	2.7
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	15.884	18.687	19.035	19.199	19.393
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	19.4	17.7	1.9	0.9	1.0
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	17.209	20.636	18.577	19.035	19.547
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	19.9	-10.0	2.5	2.7
External Sector (bill. dls.)																	
Current Account Balance	-5.575	-5.591	-7.698	-3.239	-9.711	-16.834	-8.625	-5.611	-12.855	-15.463	-30.517	-22.451	-28.201	-22.420	-26.737	-31.818	-30.397
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	-14.683	-13.125	-9.452	-12.753	-8.679
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	43.12	35.63	43.50	44.50	45.00
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	229.333	237.415
Financial Sector																	
Monetary Base (mill. ps)	303614	340178	380034	449821	494743	577543	632032	693423	787737	884546	951063	1064562	1176336	1315625	1500538	1679585	1867958
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	10.5	11.8	14.1	11.9	11.2
Money Supply: M1 (mill. ps)	856216	944790	1066138	1215636	1346715	1479691	11248158	1825607	2087566	2353517	2535170	2848982	3158792	3547148	4066222	4570641	5103461
Change (%)		10.3	12.8	14.0	10.8	9.9	660.2	-83.8	14.3	12.7	7.7	12.4	10.9	12.3	14.6	12.4	11.7
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	4.15	6.67	6.50	7.00
Public Sector (% of PIB)																	
Economic Balance	-0.62	-0.25	-0.12	0.11	0.05	-0.07	-2.52	-3.11	-2.43	-2.60	-2.33	-3.22	-3.52	-2.63	-2.51	-3.03	-3.48
Primary Balance	2.16	2.24	2.49	2.96	2.60	2.00	-0.10	-0.96	-0.79	-1.11	-0.99	-1.80	-2.12	-1.22	-1.12	-1.61	-1.94
Labor and Employment																	
Minimum Wage																	
Nominal (%)	4.5	4.5	4.5	4.0	3.9	4.0	4.6	4.9	4.1	4.2	4.3	3.9	5.6	5.5	9.6	7.5	5.5
Real (93=1) (%)	0.0	-0.3	0.5	0.4	-0.1	-1.1	-0.6	0.7	0.7	0.1	0.5	-0.1	2.8	2.6	3.4	3.1	0.9
Manufacturing Wages																	
Nominal (%)	5.5	5.3	5.0	4.4	4.1	4.5	5.3	5.4	4.5	4.7	4.7	4.3	6.1	6.0	10.5	8.3	6.1
Real (93=1) (%)	0.9	0.7	0.8	0.7	0.1	-0.6	0.0	1.2	1.1	0.5	0.9	0.3	3.3	3.1	4.3	3.8	1.4
Employment (million people)	31.790	32.240	32.580	33.395	33.912	34.217	34.185	34.769	35.397	35.970	36.315	36.733	37.346	37.901	38.439	39.104	39.487
Change (%)	0.1	1.4	1.1	2.5	1.5	0.9	-0.1	1.7	1.8	1.6	1.0	1.2	1.7	1.5	1.4	1.7	1.0
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	3.88	3.68	3.58	4.54
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	2.6	2.9	1.5	2.0	2.5	2.0
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	1.27	2.05	2.22	2.60

Note.- Forecasts start in 2017

*/ Mexico Economic Outlook. Center for Economic Forecasting of Mexico (CKF). October 2017.
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