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of Mexico

MEXICO ECONOMIC OUTLOOK

2018 – 2020

Prepared for the Fall Meeting of Project LINK to be hosted by the Department of Economic and Social Affairs (UNHQ, New York) and the Economic Commission for Latin America (ECLAC), Santiago, Chile. September 5-7, 2018.

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MEXICO ECONOMIC OUTLOOK (2018-2020)

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MEXICO */

1. Overview

In the following three years, Mexico's economy will be immersed in the ups and downs of the business cycle, a traditional pattern determined by the political cycle every six years of change of government. In 2018 the economy will report a little higher growth because of the expansionary effects of the political cycle in a year of presidential election. In 2019 the economy will lose strength and decelerate in the first year of the new administration, when the delay in the execution of the federal budget also affects investment decisions. In the medium term, with reforms increasing production capacity, the economy will advance at a slightly higher rate. However, the country's capacity to grow could be affected if the U.S. takes more permanent measures to restrict trade and investment, as well as if Mexico's new leftist government takes actions that threaten private investment and property rights.

2. Recent Trends

During the first half of 2018 the economy is benefiting from the expansionary effects of the political cycle, with extra spending to finance the election process and political campaigns. However, the still-low investment ratio remains a drag, despite the series of structural reforms in place. Mexico is already affected by the anti-trade rhetoric of the Trump administration, in terms of the delay and postponement of some investments, but it is even more affected by the implementation of policies against trade and immigration by the ongoing government. Inflation has moderated during the year, after a strong rebound in 2017 that put it at more than twice the 3% target. The peso remains depreciated, since it has suffered a correction rather than a transitory adjustment. However, the currency has recovered some ground after the convincing election results. Nevertheless, financial markets remain nervous regarding trade negotiations with the U.S. and the normalization of U.S. monetary conditions.

In the first semester the economy advanced at rates a little lower than its potential growth, even in an environment of financial volatility and uncertainty surrounding trade relations with the U.S. and the intensity of political campaigns. GDP reported annual growth of 1.3% in the first quarter and 2.7% in the second. The economy advanced at a rate of 2.0% in the first half of the year, lower than the 2.5% reported in the same period a year before. 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 declined in 2018, after reaching a peak of 6.8% in 2017. However, after hitting a floor of 4.5% in May, it has trended up to 4.8% in July as the peso was under depreciation pressures in the month prior to July's election. In general, prices are moving more consistently with the structure of price formation and under more normal conditions. Some financial volatility will still remain throughout the year, caused by uncertainty regarding trade negotiations with the U.S., the Federal Reserve's rate cycle, and the implementation of policies that affect trade and investment with Mexico. The decrease of inflation in 2018 also has to do with the positive effect generated by the high comparison base in 2017, but it will end the year at above the 4% upper limit.

The Mexican peso remains depreciated, since it has corrected the lags accumulated in the past. Domestic monetary policy has tightened further in the first half of the year, mainly to reduce the risk of capital outflows generated by the monetary reversal in the U.S. and to fight the still-high inflation. To recover competitiveness and make the bonds market more attractive, policymakers will continue to act at least in synchrony with the Federal Reserve's rate hike cycle. The policy rate has increased from 3.0% at the end of 2015 to 7.75% at present. Further monetary tightening could be necessary in the event of a more aggressive currency depreciation and stubborn inflation. This way, Mexico will deal with the financial volatility—generated by global monetary tightening—by using the more effective dual system of shock absorbers: the exchange rate and the interest rate.

Fiscal and monetary policies remain tight in 2018, mainly to prevent the government debt from accelerating again. The economy was running with increasing fiscal imbalance during the first three years of the administration (2013-2015), which also imposed pressures on the external imbalance. The persistent fiscal deficit produced an acceleration of the government debt, increasing almost 15 percentage points of GDP in the first four years of the government. Moreover, given the currency gains generated by the central bank as a result of the significant peso's depreciation and some budget adjustments, the government was able to reduce the public debt to 47.2% in 2017 from 49.4% in 2016.

Mexico's ongoing 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 has moved 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. With Mexico's new government, coming from a left-wing party, there is a potential risk of a reversal of some reforms already implemented if the president delivers on his campaign promises.

3. 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 that the country maintains the 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 improve 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; that policy expansion, however, implied wider fiscal and external imbalances. Our assumption establishes that these major imbalances are kept at levels that do not represent a risk for macroeconomic stability.

The second assumption considers a further deepening of structural changes. The fiscal reform will continue to improve the efficiency of the tax system and fiscal policy will adopt a structural discipline in the execution of the federal budget in the medium term, while the energy reform will increase the production capacity in the oil industry (crude oil and refined products). The country could also implement changes that do not require Congress approval, particularly those reinforcing institutions and the application of the law. In the longer term, there is a possibility of another round of reforms, including the modernization of monetary policy. All this will have the potential to increase the economy's capacity to grow and promote social well-being over the next decade.

The third assumption includes further advance of the global economy in the next two years. U.S. growth will be around 3% this year, and will adjust to 2.5% in 2019. For 2020, the economy is expected to lose steam coinciding with the last year of the current administration. In the longer 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 in the end, preserving some benefits for the three countries involved. Europe and Asia will continue to advance.

Domestic monetary policy is expected to stay restrictive for the remainder of the year, and for some time next year as inflation will still stay above the 3% target. The central bank's 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 at still-financeable levels. In the longer term, fiscal policy is expected to be managed by the effective application of the structural rule in order to contribute better to macroeconomic stability. There is also a possibility that monetary policy will be assigned a double mandate: growth and inflation, by the middle of the six-year term of the next administration (2021).

The international market of oil will remain subject to some volatility generated by geopolitical events in the short term. However, prices in general will show an upward trend in the following three years as the global economy advances. The price for the light crude in New York (WTI) will average around $62.50 dollar per barrel (dpb) this year, will advance to $64 next year, and will go up to $65 in 2020. The price for the Mexican crude will average around $60 dpb this year, $61.50 next year, and around $62.50 in 2020.

4. Forecast Summary

Our Baseline scenario outlines an economy with further improvement this year, although 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 around 2.3% this year (after 2.0% in 2017), decelerating to 1.5% in 2019 as a result of the political change, and reaccelerating to 2.5% in 2020 as the new government is settled down. 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 at a rate still-above the 4% target's upper limit, after reaching almost 7% in 2017. 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 2020, inflation will reduce a little further given the economy's slack generated by the deceleration in the previous year. 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 in 2018 if volatility worsens as a result of a market overreaction to the Fed's monetary normalization or to potential anti-market actions from the new government that starts at the end of 2018.

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 be needed, since the country still 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. In the medium term fiscal policy could be subject to a structural rule and monetary policy could adopt a dual mandate.

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. In the medium term, 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 wider fiscal imbalance given the accommodation of public policies with more social content implemented by the new government.

Improvement in production capacity generated by implemented 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 (expected to be between 3.0% and 3.5%).

5. Uncertainties

A potential downside scenario could still materialize in the medium term, mainly associated with the implementation of policies—by the incoming leftist government—that threaten private investment and property rights. 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 recession in the northern neighbor. Under that scenario, the U.S. weakness will have a 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, beyond a still-possible NAFTA breakup, the materialization of a prolonged global trade war could generate a severe and extended downturn for Mexico.

6. Summary Table

TABLE 1.- MACROECONOMIC INDICATORS

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Gross Domestic Product																
Real GDP (bill. 1993 pesos)	1740.9	1819.1	1860.8	1882.1	1782.6	1873.8	1942.5	2013.2	2040.5	2097.7	2166.7	2229.5	2275.0	2328.2	2362.7	2422.2
Change (%)	2.3	4.5	2.3	1.1	-5.3	5.1	3.7	3.6	1.4	2.8	3.3	2.9	2.0	2.3	1.5	2.5
Nominal GDP (bill. pesos)	8379.7	9315.8	10080.9	10825.6	10658.1	11712.8	12851.3	13860.9	14263.5	15312.2	16256.5	17627.3	19090.2	20470.8	21725.2	23266.0
Change (%)	8.3	11.2	8.2	7.4	-1.5	9.9	9.7	7.9	2.9	7.4	6.2	8.4	8.3	7.2	6.1	7.1
GDP in Dollars (bill. dls.)	768.9	857.4	922.5	972.7	788.7	927.5	1033.9	1052.5	1111.9	1151.0	1023.5	943.3	1008.5	1065.9	1090.2	1147.3
Change (%)	12.2	11.5	7.6	5.4	-18.9	17.6	11.5	1.8	5.6	3.5	-11.1	-7.8	6.9	5.7	2.3	5.2
National Income and Savings																
Personal Disp. Income (real %)	1.7	3.6	1.4	0.5	-5.8	4.5	3.0	3.1	0.7	2.2	2.6	2.3	1.4	1.7	1.0	1.9
Gross Savings (% of GDP)	19.5	19.7	19.1	19.6	17.5	17.8	17.5	18.1	18.5	19.2	20.9	21.4	21.2	20.3	19.9	19.9
Prices (1993=1.0)																
GDP Deflactor (%)	5.87	6.39	5.79	6.17	3.95	4.55	5.84	4.07	1.53	4.42	2.79	5.35	6.16	4.78	4.58	4.46
Consumer (% average)	3.99	3.63	3.97	5.13	5.30	4.15	3.37	4.14	3.81	4.00	2.72	2.82	6.04	4.82	4.56	4.38
Consumer (% end of period)	3.33	4.05	3.76	6.53	3.57	4.40	3.82	3.57	3.97	4.08	2.13	3.36	6.77	4.52	4.44	4.08
Foreign Exchange Market (ps/dls)																
Interbank (average)	10.895	10.846	10.930	11.155	13.512	12.629	12.429	13.168	12.832	13.305	15.881	18.689	18.901	19.184	19.913	20.272
Change (%)	-3.5	-0.4	0.8	2.1	21.1	-6.5	-1.6	5.9	-2.5	3.7	19.4	17.7	1.1	1.5	3.8	1.8
Interbank (end of period)	10.778	10.881	10.866	13.538	13.058	12.365	13.973	12.870	13.410	14.740	17.249	20.619	19.660	20.013	20.548	20.856
Change (%)	-4.3	1.0	-0.1	24.6	-3.5	-5.3	13.0	-7.9	4.2	9.9	17.0	19.5	-4.7	1.8	2.7	1.5
Conversion (average)	10.898	10.865	10.928	11.130	13.514	12.629	12.430	13.169	12.828	13.303	15.884	18.687	18.929	19.205	19.928	20.278
Change (%)	-3.4	-0.3	0.6	1.8	21.4	-6.5	-1.6	5.9	-2.6	3.7	19.4	17.7	1.3	1.5	3.8	1.8
Conversion (end of period)	10.627	10.809	10.920	13.815	13.082	12.350	13.948	12.966	13.512	14.748	17.209	20.636	19.735	20.095	20.635	20.949
Change (%)	-4.7	1.7	1.0	26.5	-5.3	-5.6	12.9	-7.0	4.2	9.1	16.7	19.9	-4.4	1.8	2.7	1.5
External Sector (bill. dls.)																
Current Account Balance	-7.698	-3.239	-9.711	-16.834	-8.625	-5.611	-12.855	-15.463	-30.517	-23.999	-29.775	-23.321	-26.295	-27.649	-24.572	-28.220
Trade Balance	-7.587	-6.133	-10.074	-17.261	-4.681	-3.009	-1.409	0.018	-1.195	-2.790	-14.597	-13.065	-12.804	-17.075	-11.408	-14.027
Oil Price (dls/barrel)	42.71	53.04	61.64	84.38	57.40	72.46	101.13	101.96	98.44	85.48	43.12	35.65	46.73	60.00	61.50	62.50
Total External Debt	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	245.497
Financial Sector																
Monetary Base (mill. ps)	380034	449821	494743	577543	632032	693423	789326	890352	954930	1071756	1188653	1348458	1527740	1712591	1898632	2125395
Change (%)	11.7	18.4	10.0	16.7	9.4	9.7	13.8	12.8	7.3	12.2	10.9	13.4	13.3	12.1	10.9	11.9
Money Supply: M1 (mill. ps)	1066138	1215636	1346715	1479691	11248158	1825607	2092045	2369805	2546034	2869237	3193560	3640125	4143699	4665039	5191516	5836925
Change (%)	12.8	14.0	10.8	9.9	660.2	-83.8	14.6	13.3	7.4	12.7	11.3	14.0	13.8	12.6	11.3	12.4
Interest Rate (Cetes 28) (%)	9.20	7.19	7.19	7.68	5.43	4.40	4.24	4.24	3.75	3.00	2.98	4.15	6.69	7.60	7.00	6.50
Public Sector (% of PIB)																
Economic Balance	-0.12	0.11	0.05	-0.07	-2.57	-3.16	-2.42	-2.52	-2.29	-3.13	-3.40	-2.47	-1.10	-2.48	-2.89	-3.41
Primary Balance	2.51	3.00	2.64	2.02	-0.10	-0.98	-0.79	-1.06	-0.97	-1.76	-2.04	-0.99	0.37	-0.97	-1.26	-1.65
Labor and Employment																
Minimum Wage																
Nominal (%)	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	10.4	8.5	7.5
Real (93=1) (%)	0.5	0.4	-0.1	-1.1	-0.6	0.7	0.7	0.1	0.5	-0.1	2.8	2.6	3.3	5.3	3.8	3.0
Manufacturing Wages																
Nominal (%)	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	11.4	9.4	8.3
Real (93=1) (%)	0.8	0.7	0.1	-0.6	0.0	1.2	1.1	0.5	0.9	0.3	3.3	3.1	4.2	6.3	4.6	3.7
Employment (million people)	32.580	33.230	33.460	33.675	33.446	34.021	34.505	34.933	35.267	35.861	36.688	37.458	37.998	38.583	38.961	39.553
Change (%)	1.1	2.0	0.7	0.6	-0.7	1.7	1.4	1.2	1.0	1.7	2.3	2.1	1.4	1.5	1.0	1.5
Open Unemployment Rate (%)	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	4.44	3.98
U.S. Economy																
GDP (%)	3.5	2.9	1.9	-0.1	-2.5	2.6	1.6	2.2	1.8	2.5	2.9	1.6	2.2	3.0	2.5	1.5
Consumer Inflation (%)	3.37	3.22	2.87	3.81	-0.32	1.64	3.14	2.08	1.47	1.61	0.12	1.27	2.13	2.80	2.60	2.40
Note.- Forecasts start in 2018																

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