MEXICO: ECONOMIC COUNTRY REPORT 2018-2020

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Executive Summary

Mexico has been going through a period of slow expansion since the early 90s (an annual average of 2.5%), when economic growth was resumed after the "lost decade" during the 80s. Numerous structural reforms have been implemented but they have not managed to raise the potential growth.

On December 1, 2018, for the first time in history a populist leftist government will take office. Its focus will be on raising growth to 4% by taking the following steps: a) fighting corruption, b) investing in social programs, c) investing in highly inefficient state-owned energy companies (PEMEX and CFE), d) repealing the recently implemented structural reforms, in particular the energy and education reforms, e) relocating the federal governance structure across the country, and f) substantially raising the minimum wage. All of the above will be done while lowering the primary fiscal balance.

This summary presents the analysis of the most relevant results of the 2012-2018 presidential administration, and highlights the main aspects of the policies of the new government, along with the baseline scenario for 2018-2020.

1. Recent Trends

Perhaps one of the most relevant aspect of this report is this year conclusion of the presidential administration of Enrique Peña (2012-2018). Therefore, it is important to briefly overview his administration's work regarding the main macroeconomic variables that are under analysis in this report.

We must start by saying that during this period there were no recessions, and the average growth rate of the GDP was 2.7%, per capita GDP was 1.1% and the employment growth rate was 1.5%. This evolution can be viewed as a favorable outcome of the fiscal and labor reforms[2] that were implemented at the beginning of his six-year term.

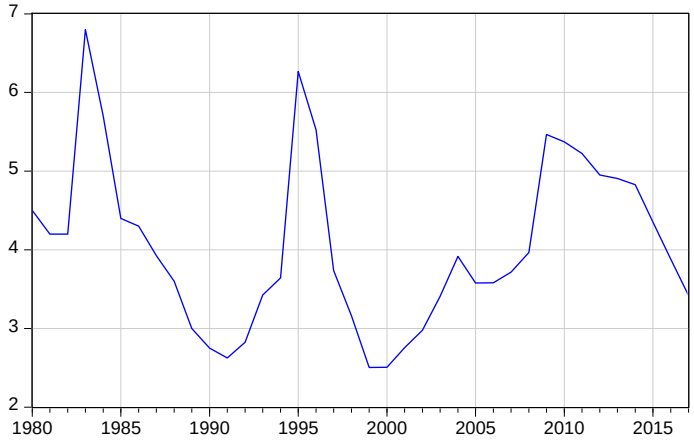
Possibly, this explains why the unemployment rate was very low (Figure 1), although most jobs generated in this period were precarious.[3]

[2] This encouraged firms to formalize their workers.

[3] It implies new jobs with less than 36 hours or with over 48 hours a weak that receive less than two minimum wages.

FIGURE 1

MEXICO: UNEMPLOYMENT RATE, 1980-2017



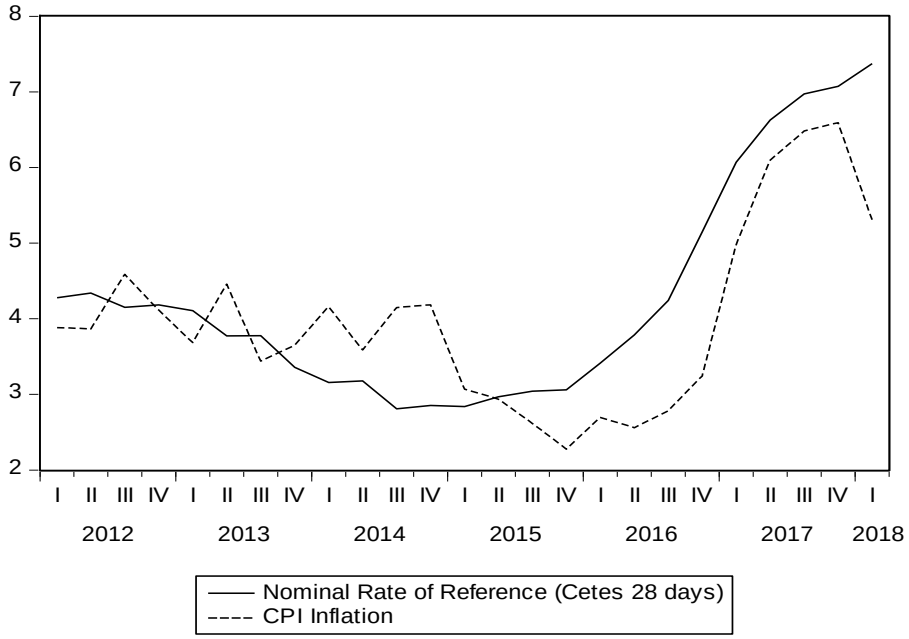
Source: National Institute of Statistics and Geography (INEGI) (2018).
http://www.inegi.org.mx/sistemas/bie/cuadrosestadisticos/GeneraCuadro.aspx?s=est&nc=621&c=25447

Inflation remained in line with expectations (around 3% in annual terms),[4] except for considerable inflation outbreaks starting in 2017, as a result of higher energy prices and increases in minimum wages, which, in turn, prompted a monetary policy reaction, Figure 2.

[4] In 2015, it reached a historic minimum of 2.13%.

FIGURE 2

MEXICO: INTEREST RATE AND INFLATION, 2012Q1-2018Q2

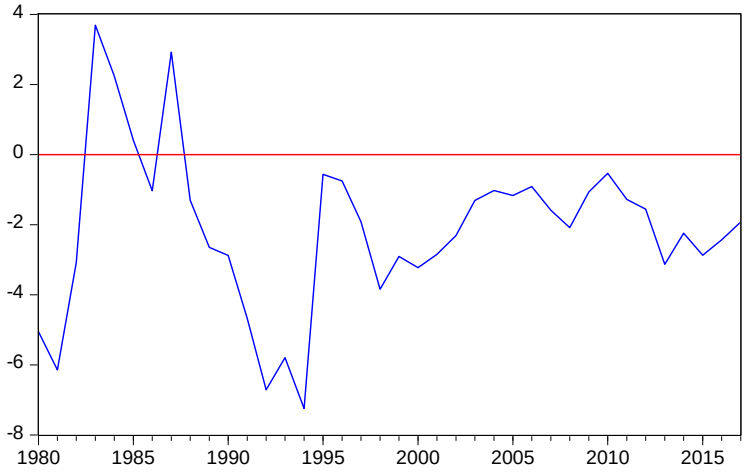


Source: Banco de México (2018). http://www.banxico.org.mx/Indicadores/consulta/Instrumentos.action

Another significant outcome, which reflected a proper conduct of economic policy, is the fact that the current account deficit as a share of GDP remained at manageable levels that never came to pose a risk to the economy, Figure 3.

FIGURE 3

MEXICO: CURRENT ACCOUNT DEFICIT (% GDP), 1980-2017



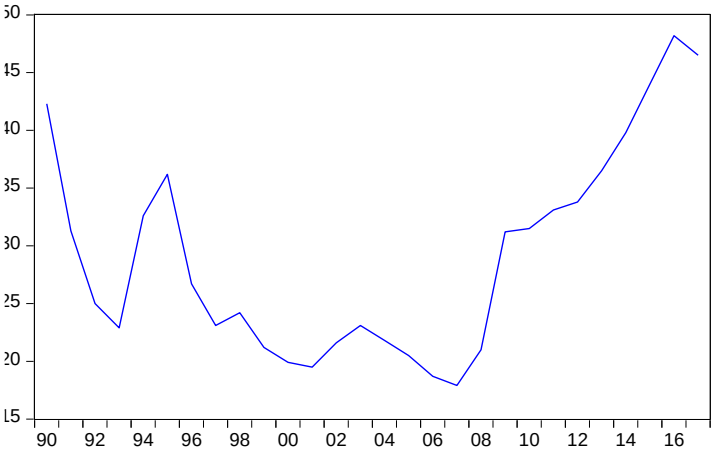
Source: Office for the Treasury and Public Credit (SHCP) (2018). http://www.hacienda.gob.mx/POLITICAFINANCIERA/FINANZASPUBLICAS/Estadisticas_Oportunas_Finanzas_Publicas/Paginas/unica2.aspx

However, the variable that was probably the biggest cause for concern in the markets was the accelerated growth of total public debt as a share of GDP.[5]

Indeed, although deficit and debt increased in the wake of the Great Recession, it should be pointed out that the speed at which the latter grew is very notable since 2013, precisely when the outgoing administration took office, Figure 4.

[5] This did not derive from higher public spending, or from lower fiscal revenue. Rather, it seems to be attributed to an inappropriate refinancing of public debt.

FIGURE 4
MEXICO: PUBLIC DEBT/GDP, 1990-2017



Source: Office for the Treasury and Public Credit (SHCP) (2018).
http://www.hacienda.gob.mx/POLITICAFINANCIERA/FINANZASPUBLICAS/Estadisticas_Oportunas_Finanzas_Publicas/Paginas/unica2.aspx

This required a start of a fiscal consolidation process, so the primary fiscal surplus reached 1.4% of GDP in 2017, basically by sacrificing government investment expenditure that will inevitably have a strong negative impact on the long-term economic growth.

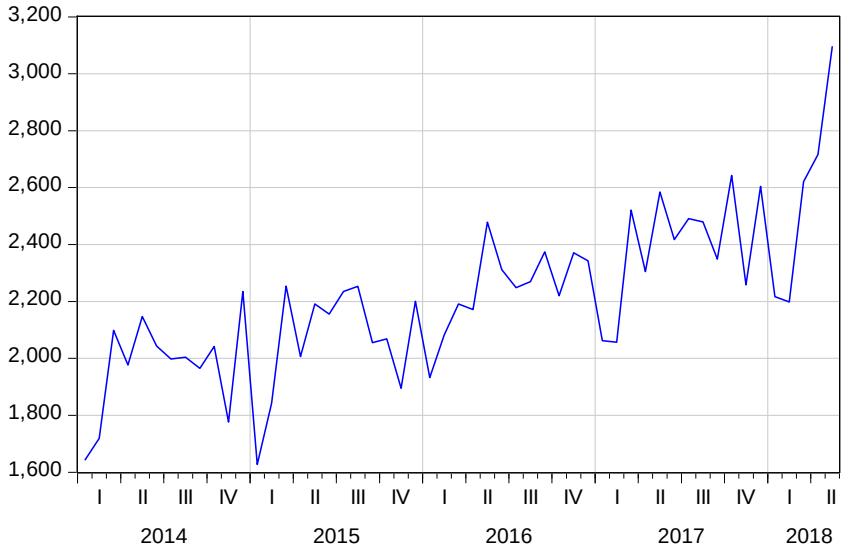
Throughout this period, the tax collection efficiency strongly increased (by approximately 6% of GDP), which allowed to face the reduction of fiscal revenues with a greater slack, as a result of the drop in international crude oil prices and the decrease in the volume of oil exports. Nevertheless, the tense social situation prevailing in Mexico makes it hard to think that this efficiency can grow further. Therefore, the incoming government will face strong fiscal challenges for 2019-2024, which is discussed in Section 5.

Finally, July 1, 2018 was a historic day, when the radical left (organized around the new political party MORENA)[6] won the elections at all levels of government (the legislative and executive branch in all states where the elections were held). It was an overwhelming victory that grants the president elect a broad room for maneuver in leading the country during the next term (2019-2024). It even allows to easily make constitutional changes, since he won in all congresses and state governorships, in addition to having a majority in the chambers of Senators and Representatives. This issue is also discussed in Section 5.

On the other hand, the variables referring to revenues from abroad, such as Remittances (Figure 5) and Foreign Direct Investment (Figure 6) have had a positive development.

[6] This party officially emerged in 2014, and has congregated numerous sectors and individuals of the political parties of the left (PRD, PT) and of the right (PAN), as well as of the official party (PRI), that is still in office.

FIGURE 5
TOTAL REMITANCES TO MEXICO: MILLIONS OF US DOLLARS, 2014Q1-2018Q2



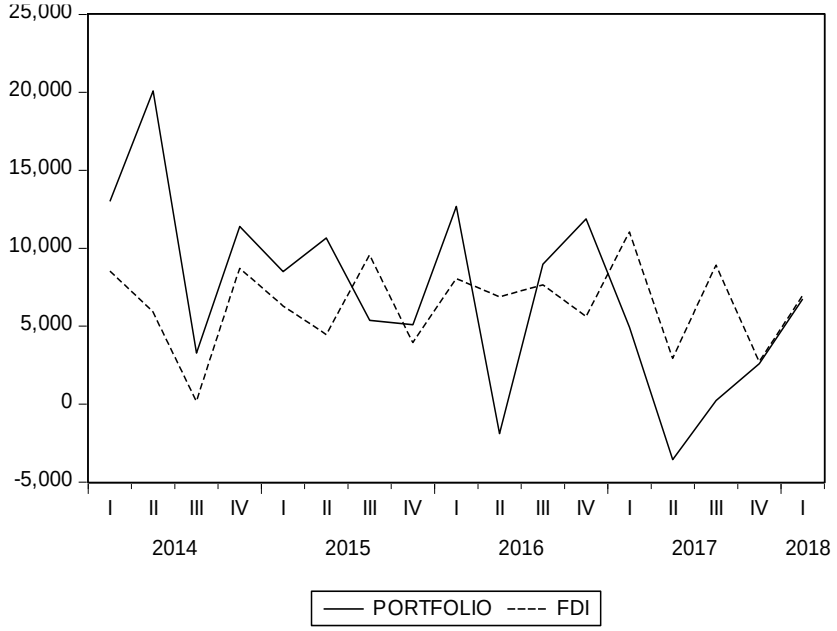
Source: Banco de México (2018).
http://www.banxico.org.mx/SieInternet/consultarDirectorioInternetAction.do?sector=1&accion=consultarCuadro&idCuadro=CE81&locale=es

Portfolio Investment has observed considerably fluctuations, as it reflects the unease in international markets in light of the generated risks and uncertainties relative to the political changes and the international environment, Figure 6.

The notable performance of the U.S. economy has fostered the flow of remittances to Mexico due to the lower unemployment levels of the Mexican population in the USA. On the other hand, threats of mass deportations and of taxing the remittances, along with the depreciation of the Mexican peso against the U.S. dollar prompted greater flows of remittances to Mexico.

FIGURE 6

MEXICO: PORTFOLIO AND FOREIGN DIRECT INVESTMENT, MILLIONS OF US DOLLARS, 2014Q1-2018Q1



Source: Banco de México (2018).
http://www.banxico.org.mx/SieInternet/consultarDirectorioInternetAction.do?sector=1&accion=consultarCuadro&idCuadro=CE139&locale=es

So far, the incoming Mexican administration and the president Trump have had a positive initial approach, which has eased the financial markets and has mitigated the pressures on capital flows (Portfolio), and, thus, on the exchange rate. The signing of the NAFTA or else, a bilateral Mexico-U.S. agreement, is more likely now, which has restored investors' confidence.

Given all of the above, it is reasonable to assume that market confidence has recovered, and that this confidence is behind the substantial appreciation of the Mexican peso, which has eased away from the MXN/USD 22 exchange rate to fall below the MXN/USD 20.

3. Assumptions of the National Policy and External Environment

3.1 Assumptions of the National Policy

Despite the victory of a populist government that has promised to substantially increase the social spending and expenditure in the energy sector, the incoming secretary of finance has stressed that the fiscal policy will maintain a highly conservative stance to subdue the growth of public debt as a percentage of GDP, as well as to maintain the primary surplus achieved last year. Although no new taxes are in the pipeline, additional cuts in some public expenses will be made. Specifically, it has been stressed that savings will be generated by taking the following steps: a) fighting corruption; b) decreasing the benefits and wages of public servants at all levels; c) divesting assets, such as the presidential plane and the aviation fleet of the government; d) working 6 days a week in Federal Government; e) lowering the wages and reorganizing (concentrating) the purchases of the Federal Government and of the governments across all states. This would allow to raise the social spending and investment without affecting the fiscal balance, and would allow to continue reducing total public debt.

As to the monetary policy, we believe it will also remain conservative as long as domestic inflationary pressures do not subside, and insofar as uncertainties persist around the monetary normalization in the U.S., as well as the trade-related threats from Donald Trump, and their possible impact on FX markets.

In this sense, the incoming administration has repeatedly emphasized that it would respect the autonomy of Banco de México, which represents a factor of containment in light of any attempts of an expansionary fiscal policy and which has given confidence to the markets. All of the above has prompted the appreciation of the exchange rate over the recent weeks.

3.2 Assumptions of the External Environment

In 2017, Mexico has not only been an attractive destination for investment but also for tourists, consolidating itself as the 8th most visited destination in the world, and the 2nd most visited in the American continent, only behind the United States. We highlight this point for two reasons. First, as a note on the growth of an important sector of the Mexican economy, which generates jobs and captures foreign currency. Secondly, as a sign of confidence with which the world sees Mexico.

The NAFTA renegotiation was rescheduled away from the Mexican and U.S. electoral periods, and new talks among the three countries will resume in August. This topic has become increasingly troubling, and reaching a reasonable agreement seems increasingly likely. However, it should be acknowledged that Donald Trump's character and negotiation style could alter expectations on this issue, even more considering his anti-globalization and highly protectionist stance. The renegotiation is a topic that causes high uncertainty. We offer further comments in Section 5 of this report.

The crude oil price is very likely to continue increasing in view of the positive growth expectation for the U.S. economy and the world economy, and in view of the lower oil supply by Iran. This could affect Mexico's trade balance and public finances, if domestic energy prices are not raised, given that Mexico is a net importer.

Thus, higher international energy prices and the likely growth of inflation in the U.S., caused by the expansionary fiscal policy, can have a spillover effect on the Mexican economy for the first time in many years.

4. Forecast Summary

The forecast we are presenting for 2018-2020 is inertial (baseline scenario) and it assumes no drastic changes in the domestic policy or the current form of NAFTA. We work with the assumption that the policy will continue to focus on maintaining fundamentals in check. Furthermore, we estimate that the recovery of the U.S. industrial sector and that of the rest of the economy will continue, as will its positive effect on the production and exports of Mexican manufacturing.

Given these assumptions, we forecast a stable GDP growth rate at around 2.5% for the forecast horizon, which will be characterized by low unemployment rates and sound fundamentals. See the summary table at the end of this report.

5. Policy Issues and Uncertainties

Although the central bank of Mexico (Banco de Mexico) does not have an exchange rate target, the authorities' concern over subduing the currency depreciation in the early months of the year was evident, as they applied every available measure, from raising the interest rate to auctioning U.S. dollars.

The NAFTA renegotiation is the most sensitive aspect in the political landscape. Talks were recently reopened by the current administration and the incoming one to reassure the markets and to maintain foreign investment flows.

Any analysis of this issue must be cautious, and must take into account that the dialogue with Donald Trump is asymmetric, since he enjoys being a rough negotiator. We estimate this to be a moment of great uncertainty because, if a clear agreement that is beneficial to all three parties is not reached, regional trade will have to submit to the WTO regulations, despite President Trump's statement that he would also disregard these regulations. In this context, the Mexican government has begun preparing for alternative scenarios with measures that have yet to be announced. In any case, we would see considerable uncertainties related to FDI, capital flows and trade disruptions. The trade links between the two countries cannot be overstated, as Mexican exports are largely manufactured with U.S. counter parts, and their value chains are deeply intertwined.

The recent negotiations have strengthened between Mexico and the U.S. In contrast, Canada has basically been left at the margin.

Although on several occasions the incoming administration has stated that there will be no expropriations and that they will abide by the law, it is very likely to attempt realizing important constitutional changes that can tear down the structural reforms that have been implemented in recent years. This could lower domestic and foreign investment. The repeal of energy and education reforms is of particular concern, since they are key factors of long run economic growth. In particular, the former is highly relevant to capitalize PEMEX and the Federal Electricity Commission, as they do not have sufficient government funding to modernize them and make them competitive and exhibit a surplus. However, the incoming

administration has announced that it will make considerable investments to capitalize these entities. Specifically, it will invest in the rehabilitation of six refineries and will build two more. In addition to considerable investment that is required, this project will bear fruit in a period of over 4 years at best. This will prompt the persistent growth of the following: a) imports of energy products, b) inflationary pressures, and c) pressures on public finances.

Given its populist nature and the numerous promises made by the president-elect, it is very unlikely that new taxes will be introduced or that the existing ones will be raised. This grants great uncertainty on maintaining macroeconomic fundamentals.

Another factor of uncertainty refers to the lack of political and administrative expertise of many new government officials, as well as to the antagonistic relations among them. This could hinder the exercise of public expenditure, particularly during the first year, and would affect private investment.

Generally, the first year of each incoming administration –even when it comes to the official party- is characterized by a lower and erratic pubic spending that affects growth. We believe it may be even worse in this case.

Three aspects could alter the growing flow of remittances to Mexico. The first one is the materialization of the Trump's promise to tax remittances. This factor is of critical importance, as it could become one of the sources of funding to construct the border wall. The second perceived risk is the continuation of the normalization process of the U.S. monetary policy. The increment in the interest rate will lead to higher unemployment rate, and, considering that the construction and services sectors are crucial sources of jobs for Mexicans, it would lower the flow of remittances. Finally, the depreciation of the Mexican peso against the U.S. dollar has fomented the flow of remittances, as the yield in Mexican pesos has increased. Therefore, a possible stabilization of the exchange rate would not be neutral during the decision-making to transfer remittances.

5. Summary Table for Forecast

TABLE 1
MEXICO: FORECAST BASELINE SCENARIO, 2018-2020

VARIABLE	*2018*	*2019*	*2020*
*GDP**	1.91	2.24	3.19
*Private Consumption**	2.1	2.1	3.25
*Government Consumption**	-0.9	1.87	1.59
*Gross Private Fixed Capital Formation**	3.24	2.08	4.8
*Government Investment**	-2.09	1.54	1.42
Trade Balance (Billions of Current U.S. Dollars)	-12.84	-10.66	-12.36
*Inflation rate (CPI)**	4.2	3.91	3.72
*Wages (Medium Real Wage)**	-0.19	1.36	1.95
Unemployment Rate (%)	3.6	3.1	3.4
Current Account Balance (% GDP)	-2.4	-2.2	-2.5
Primary Surplus (% GDP)	1.2	1.0	0.0
Government Debt (% GDP)	46.0	46.5	47.0

Source: Own calculations based on *Eudoxius. Macroeconometric Model of the Mexican Economy*. Loria (2018). Estimation: August 9, 2018. Note: * Annual Growth Rates.