

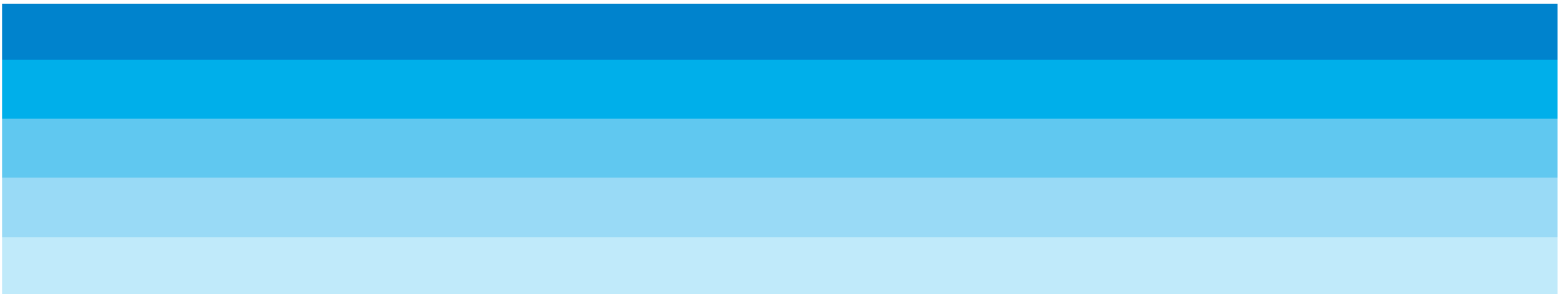
Outlook on Mexico

So far, a tale of macro stability but still moderate growth: what is the outlook?

Jorge Sicilia, BBVA Research

GIC Meeting

Monterrey, 1 February 2016

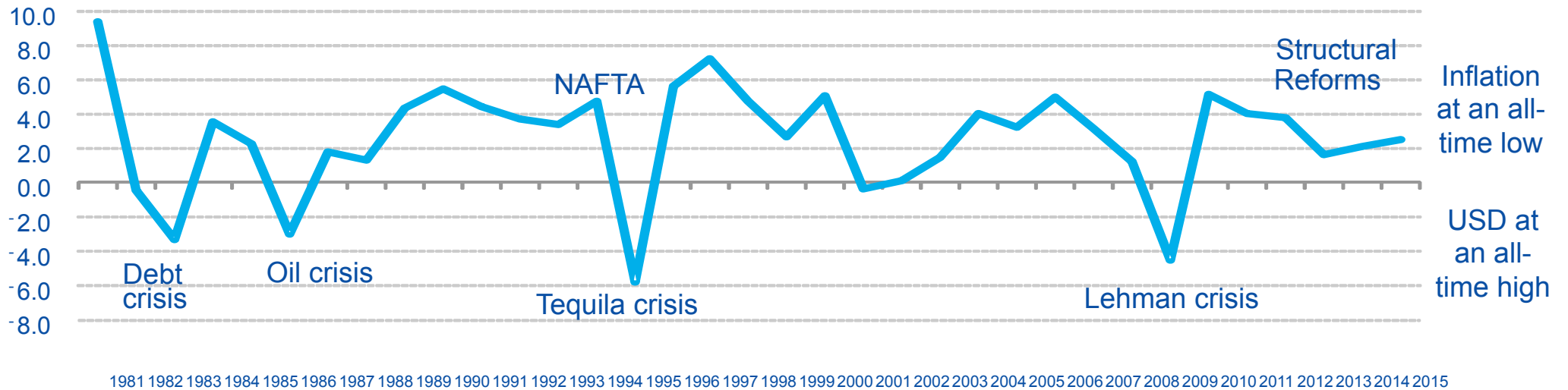




Contents

1. A structural outlook of the Mexican economy: a journey through strength and weaknesses
2. Recent developments: growth, markets, vulnerabilities
3. Second generation of economic reforms

The long and winding road



1981 1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015

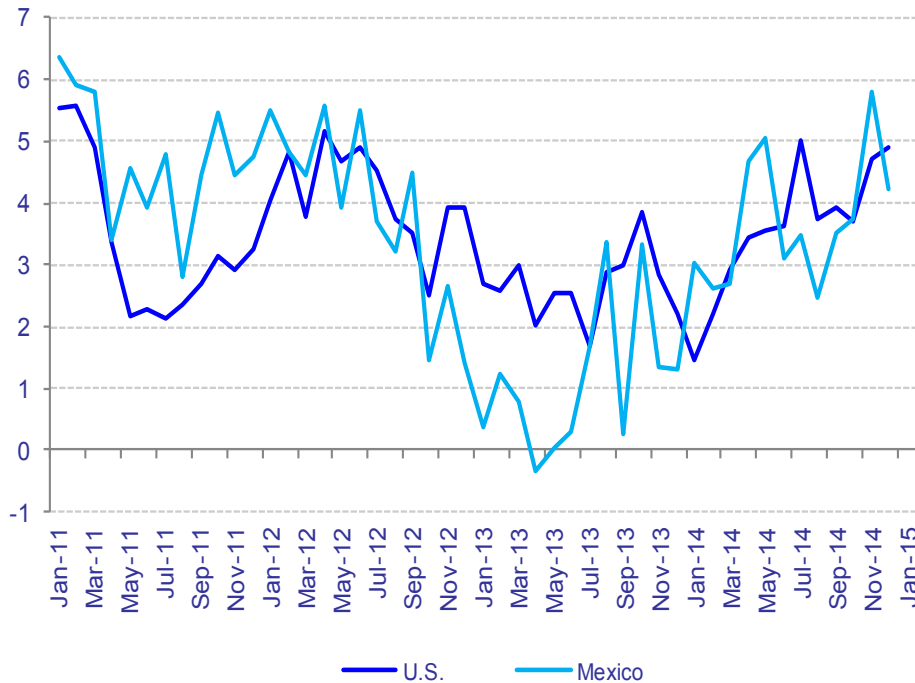


1986	1993	1994-95	1997	2000	2013
Mexico joins GATT	Central bank autonomy	Flexible exchange rate	Ruling party loses lower house majority	Ruling party loses presidency	Structural reforms: Telecom, Labor, Financial, Antitrust, Education

Strengths: (i) highly integrated to the US economy

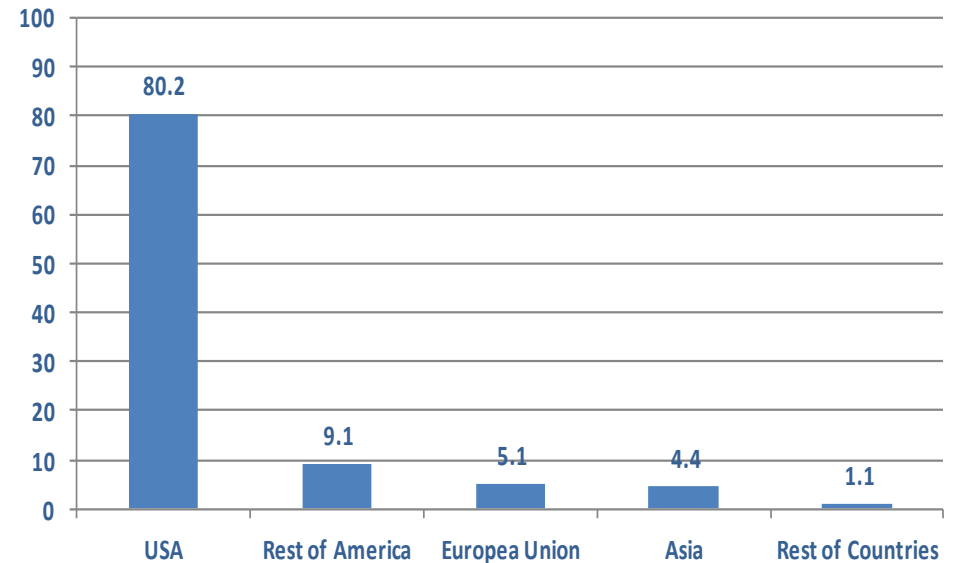
Manufacturing

(Annual percentage change, sa)
Source: BBVA Research



Exports by destination in 2014

(structure, %)
Source: BBVA Research

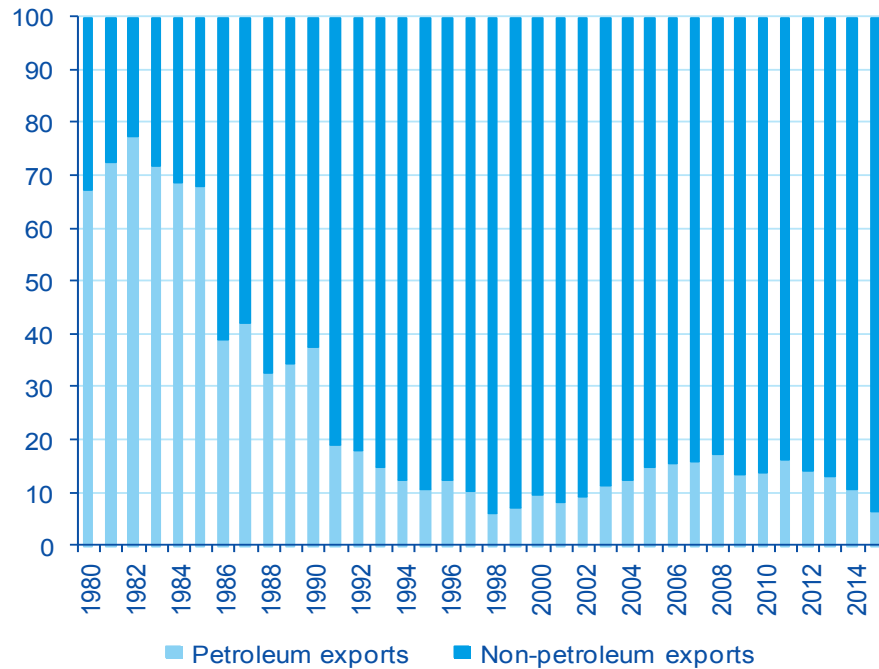


Strengths: (ii) with an export structure relying less on petroleum and more on manufacturing

Mexican exports

(% share in total exports)

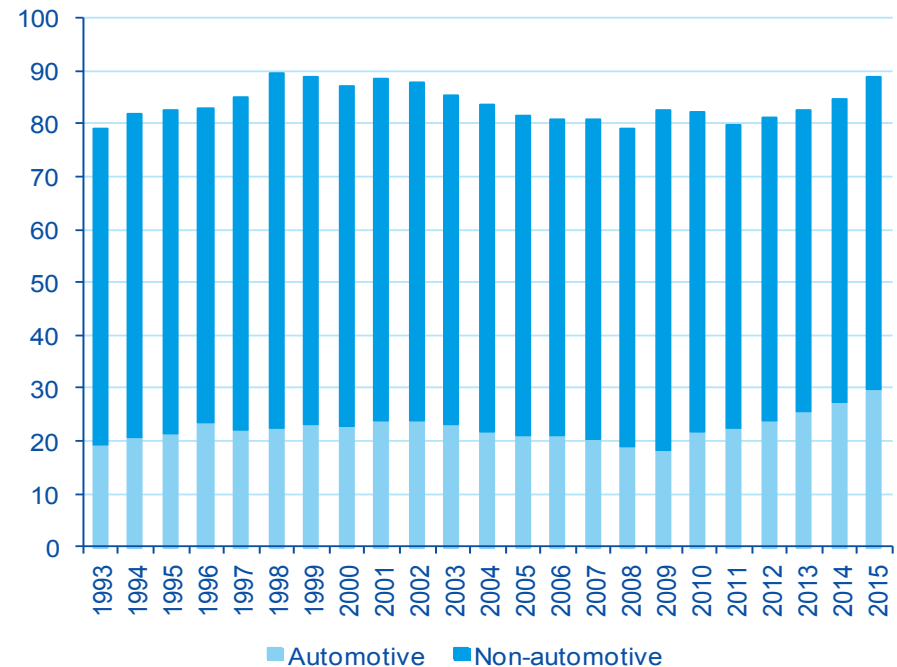
Source: BBVA Research with INEGI data.



Mexican manufactured exports

(% share in total exports)

Source: BBVA Research with INEGI data.

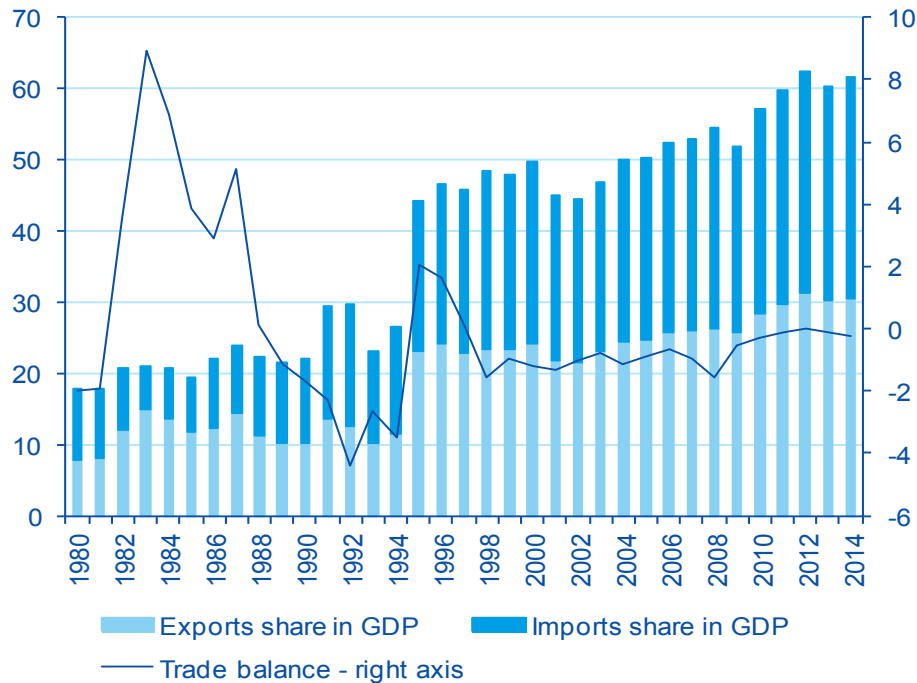


Strengths: (iii) A very open economy (with free trade agreements with more than 50 countries)

Openness index and trade balance

(% share in GDP)

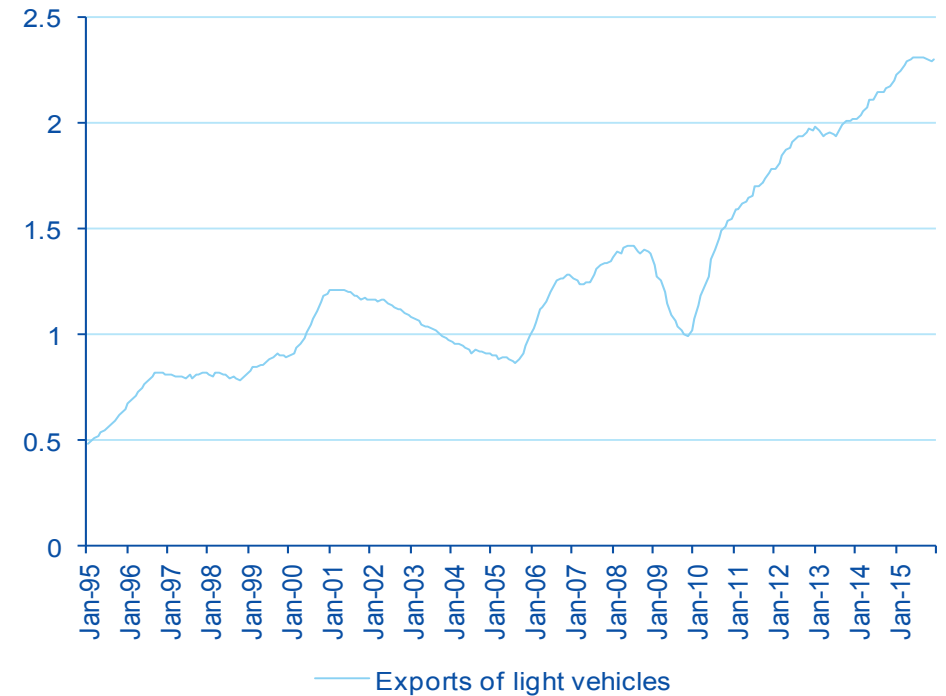
Source: BBVA Research with INEGI data.



Exports of light vehicles

(units in millions, 12mma)

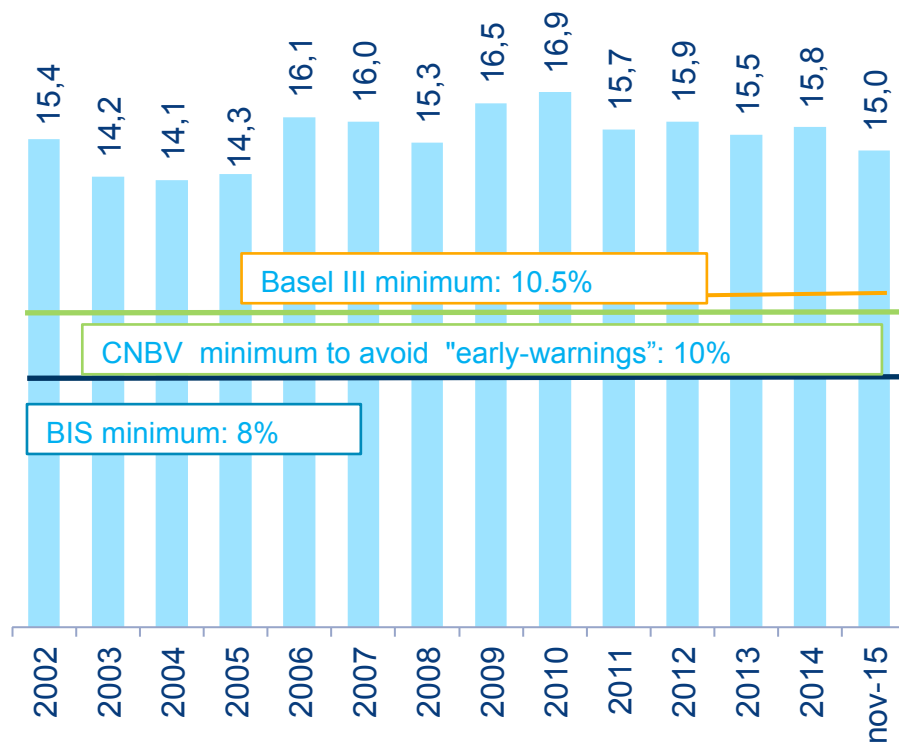
Source: BBVA Research with AMIA data.



Strengths: (iv) A sound and solvent banking system

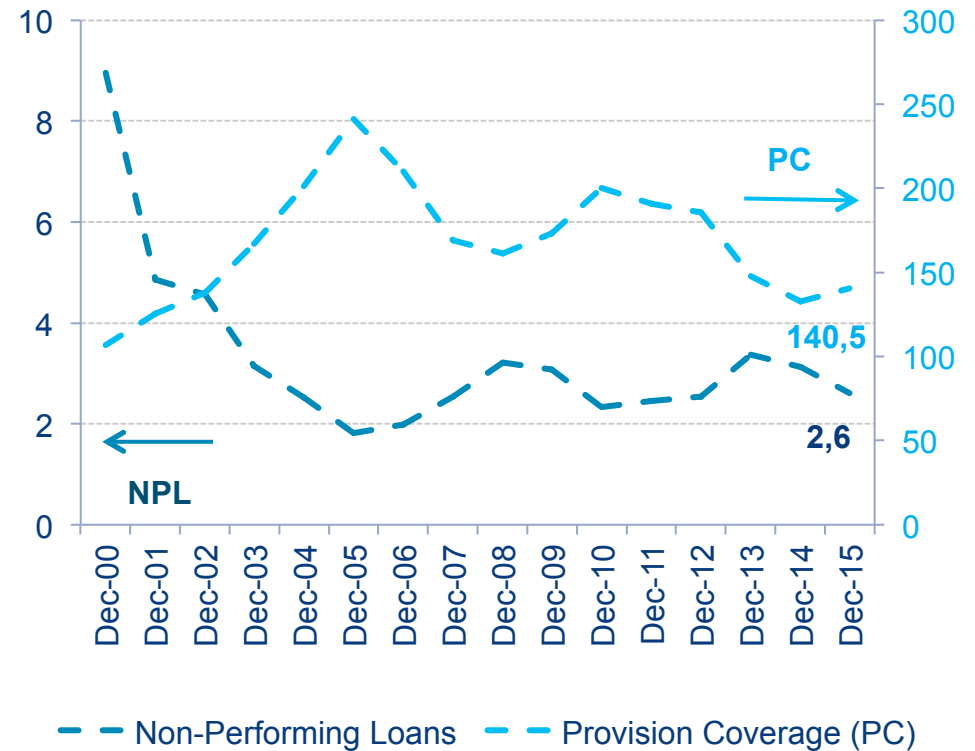
Bank's Capital Adequacy Ratio, %

Source: CNBV



Non-performing loans (NPL) and Provision coverage (PC) ratios

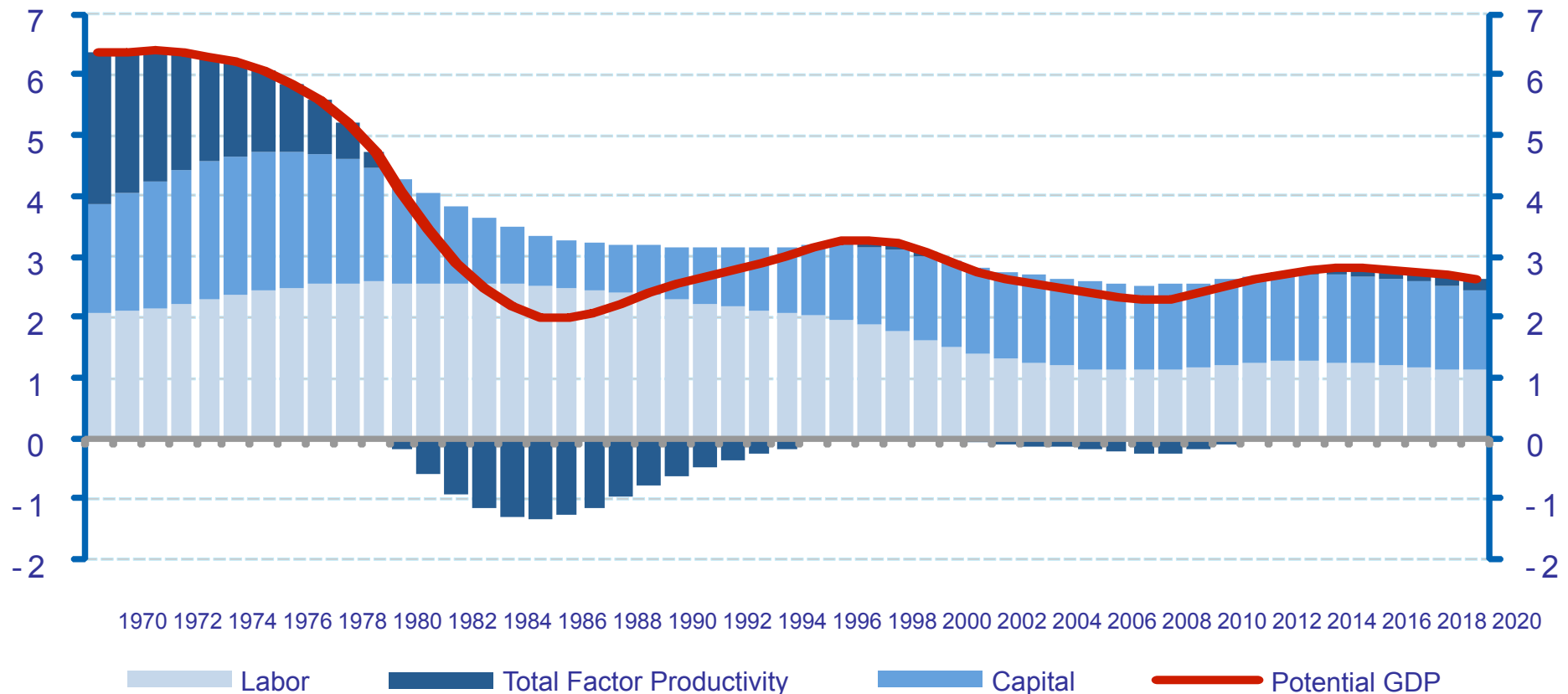
Source: CNBV



Weaknesses: (i) Low GDP per capita (stable relative with the US) with no contribution from TFP

Potential GDP growth (%)

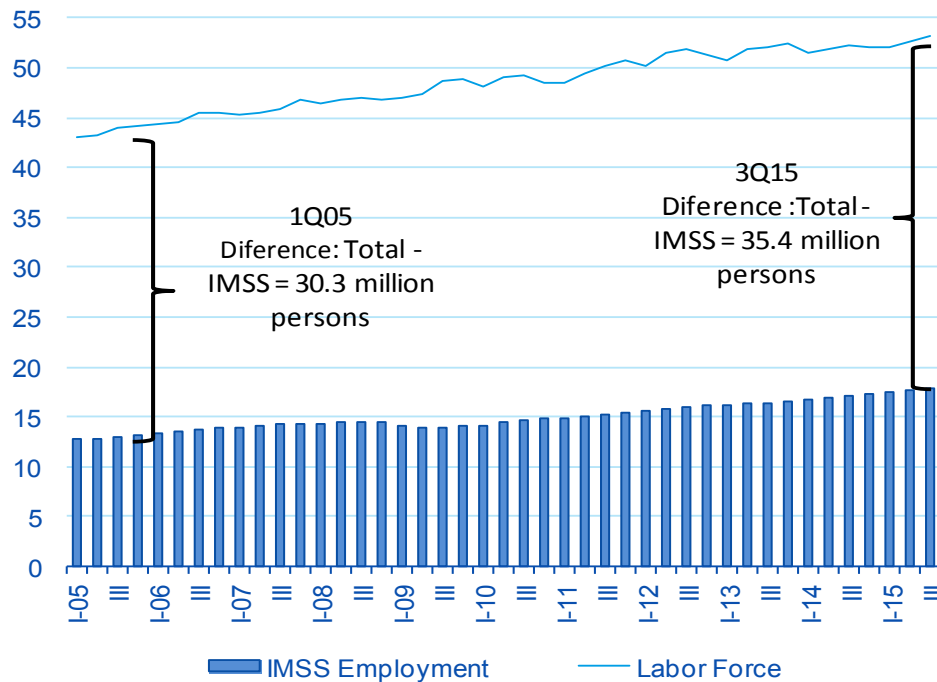
Source: own estimation



Weaknesses: (ii) relatively high informality and an improvable legal environment...

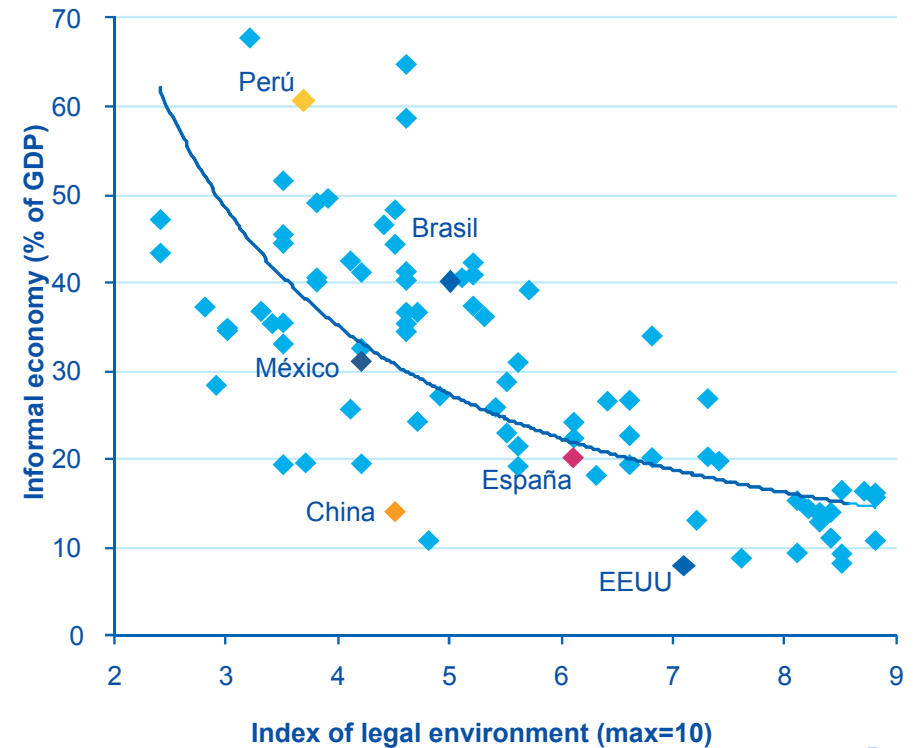
Total and formal private employment (figures in millions of workers)

Source: BBVA Research with data of INEGI



Informal economy and legal environment (% of GDP and Index)

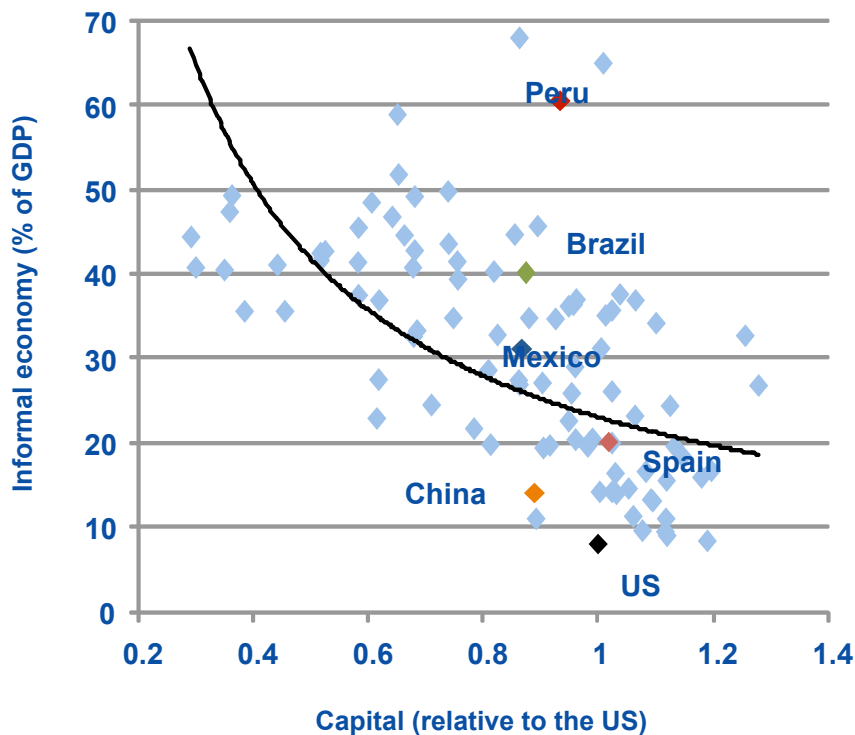
Source: Schneider (2009) and Property Rights Alliance with World Bank data



Weaknesses: (ii) ... keeps productivity and investment down

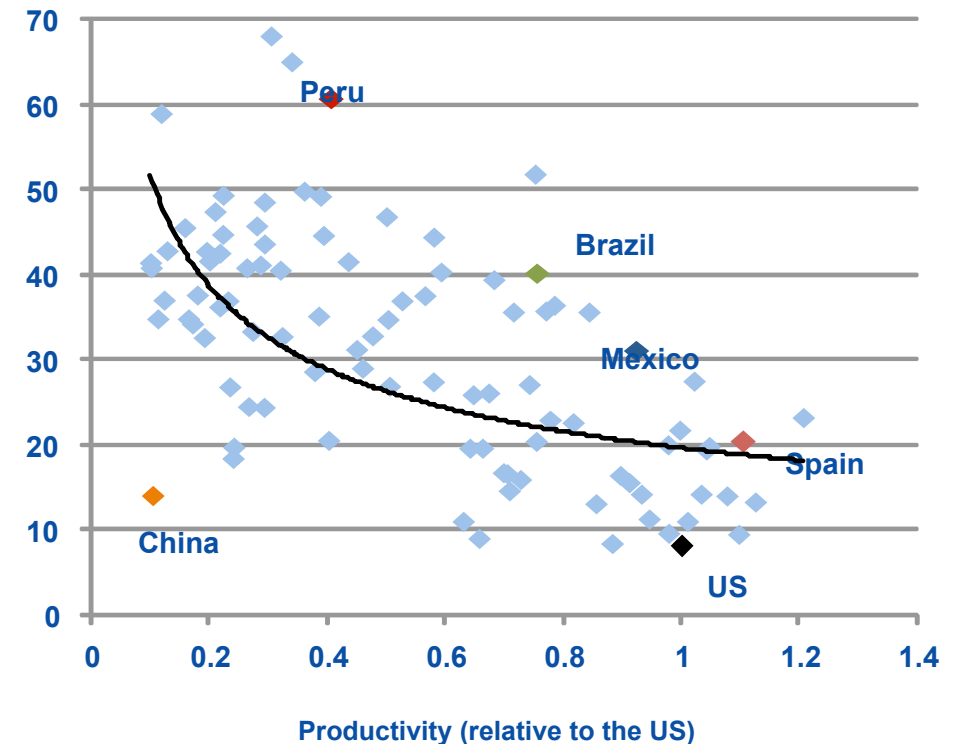
Informal economy (% of GDP) and ... Capital

Source: Schneider (2009) and Hall and Jones (1998)



Productivity

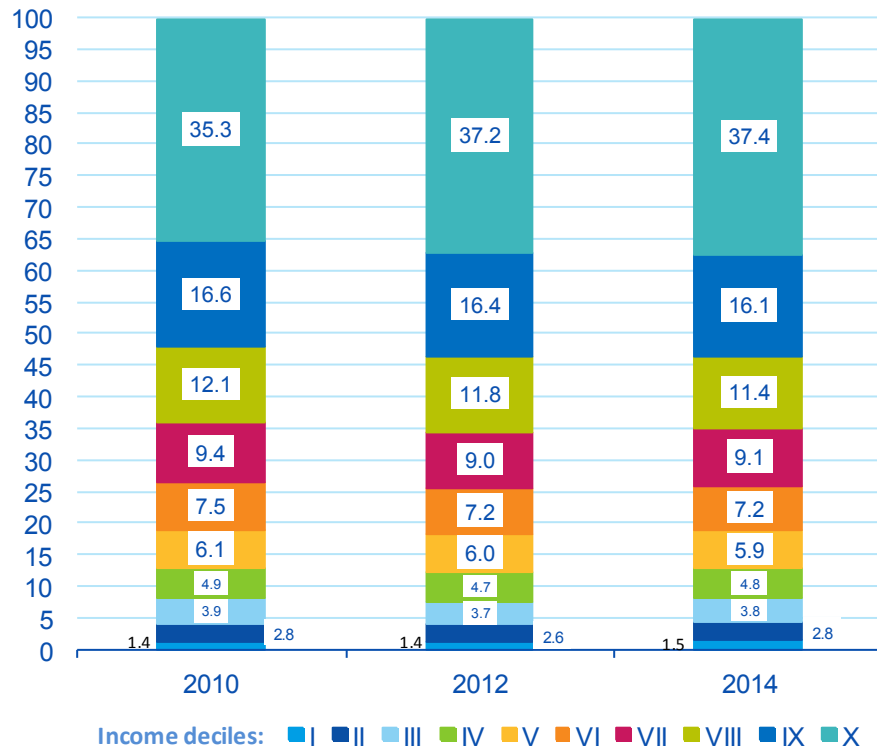
Source: Schneider (2009) and Hall and Jones (1998)



Weaknesses: (iii) ... and prevents wages from growing. At the same time, inequality is high

Quarterly monetary current income by decile (% of total income)

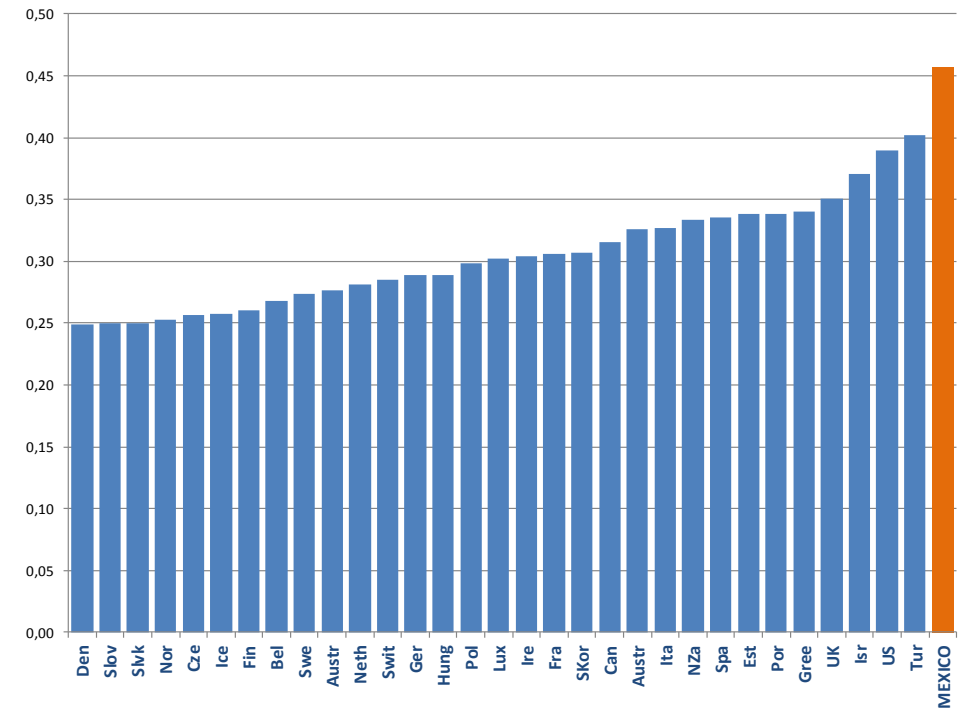
Source: BBVA Research with data from INEGI



Income Inequality, Gini Index. OECD countries

Gini coefficient, 0 = complete equality; 1 = complete inequality

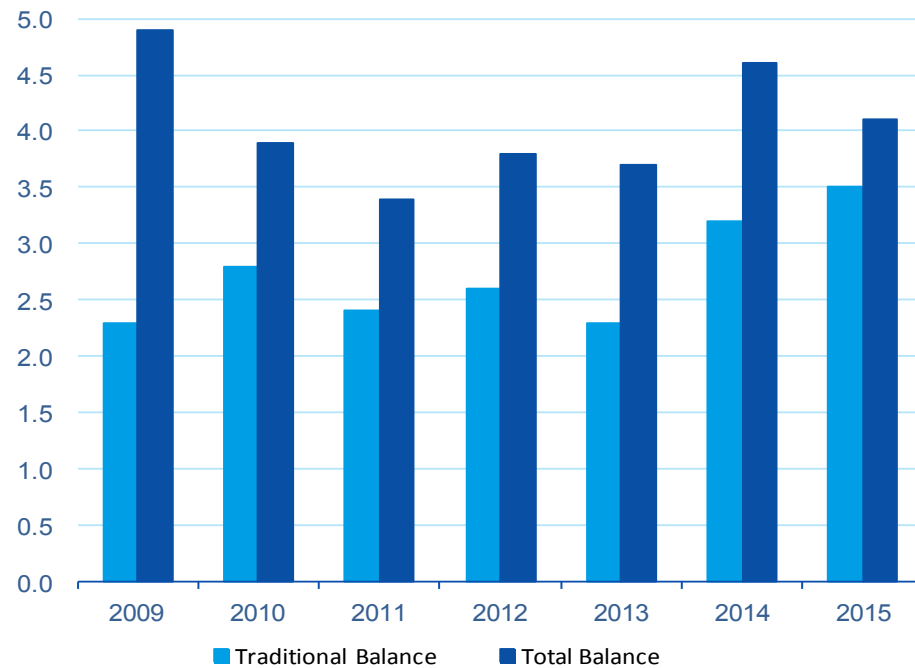
Source: OECD, 2012



Weaknesses: (iv) Traditional and total public sector balance has remained high as proportion of GDP

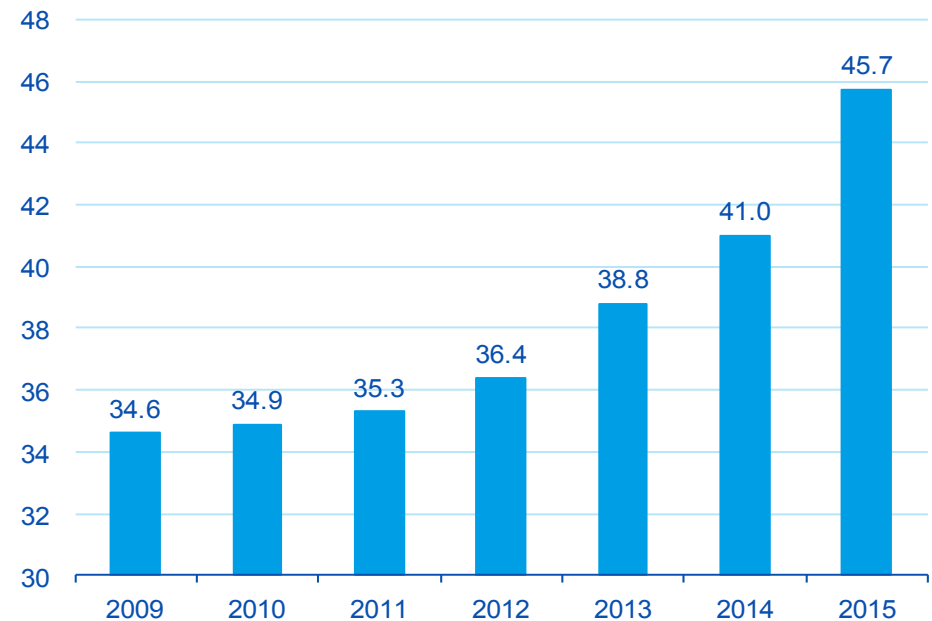
Traditional and total public sector balance (% of GDP)

Source: BBVA Research with data of Ministry of Finance (SHCP)



Total public sector gross debt (% of GDP)

Source: BBVA Research with data of Ministry of Finance (SHCP)

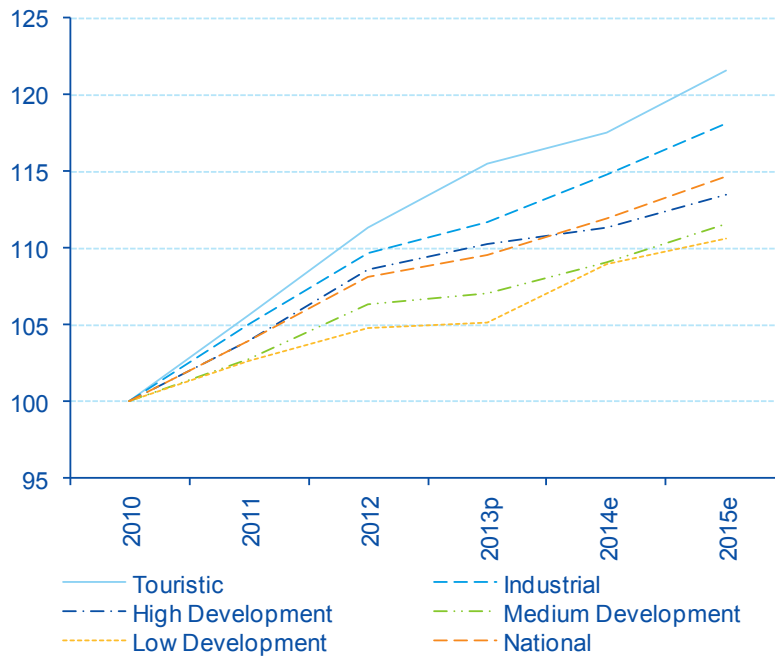


High heterogeneity

Regional and national economic activity over 2010-15e (2010=100)

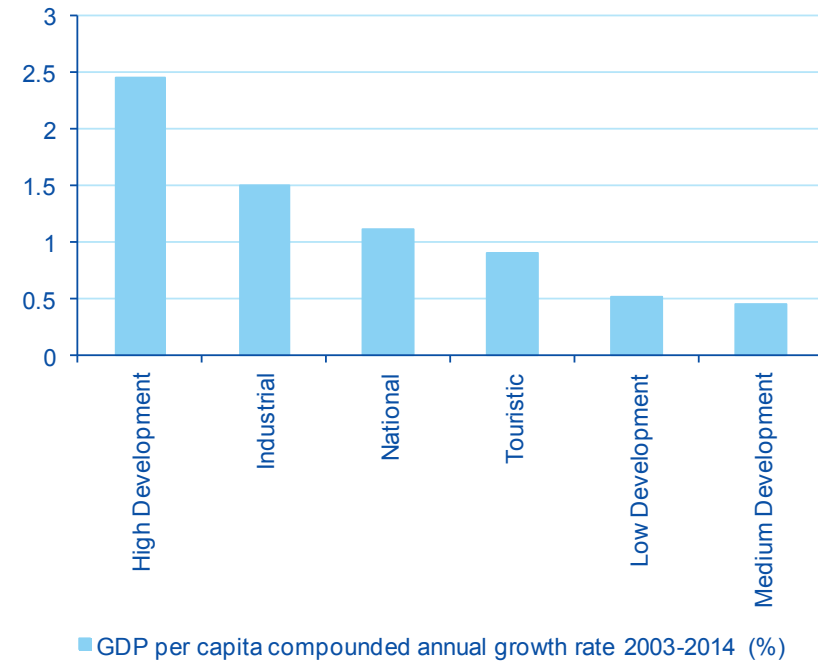
p/preliminary data; e/in-house estimates

Source: BBVA Research with INEGI data



Regional and national GDP per capita (Compounded annual growth rate %)

Source: BBVA Research with INEGI data



Regions are divided by economic vocation and level of development: High Development: DF; Touristic: BCS and Q Roo; Industrial: Ags, BC, Coah, Chih, Jal, Méx, NL, Qro, Son, Tamps; Medium Development: Camp, Col, Dgo, Gto, Hgo, Mich, Mor, Nay, Pue, SLP, Sin, Tab, Tlax, Ver, Yuc, Zac; Low Development: Chis, Gro and Oax.



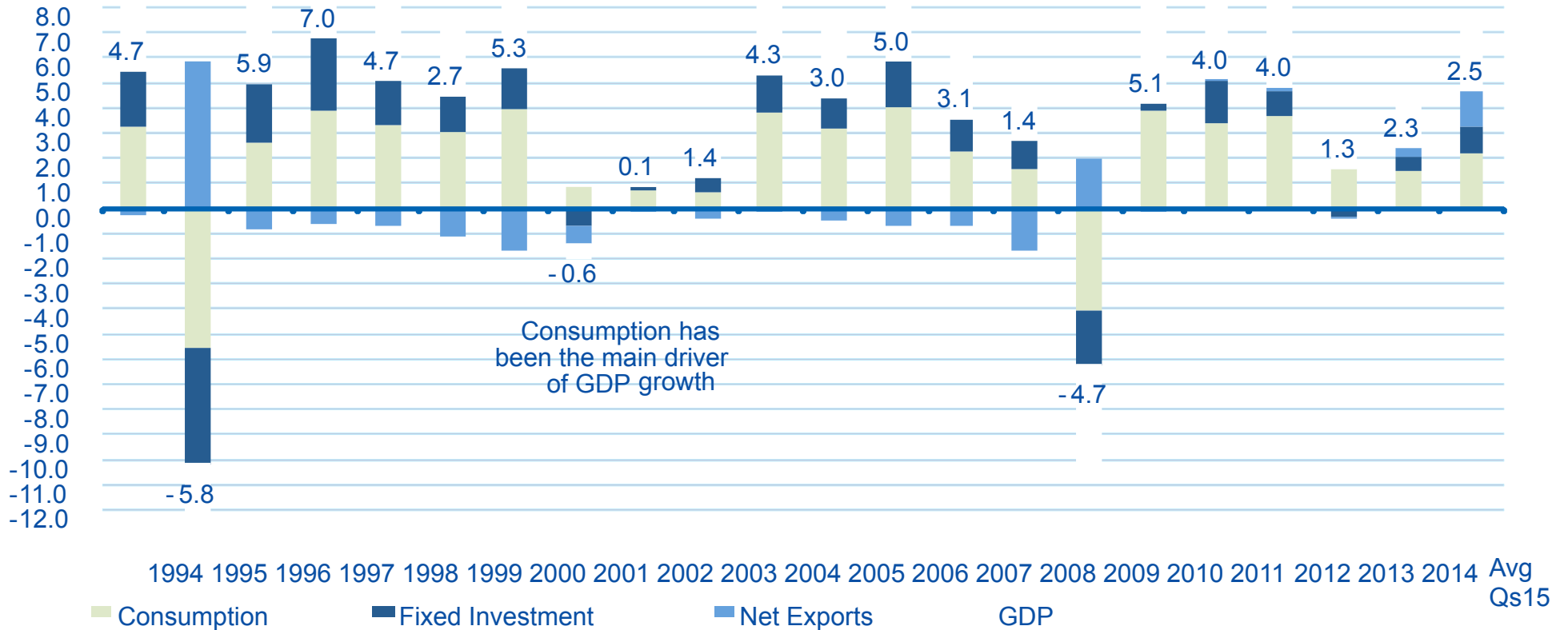
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In this recovery, GDP growth has been lower than expected and relied mainly on consumption

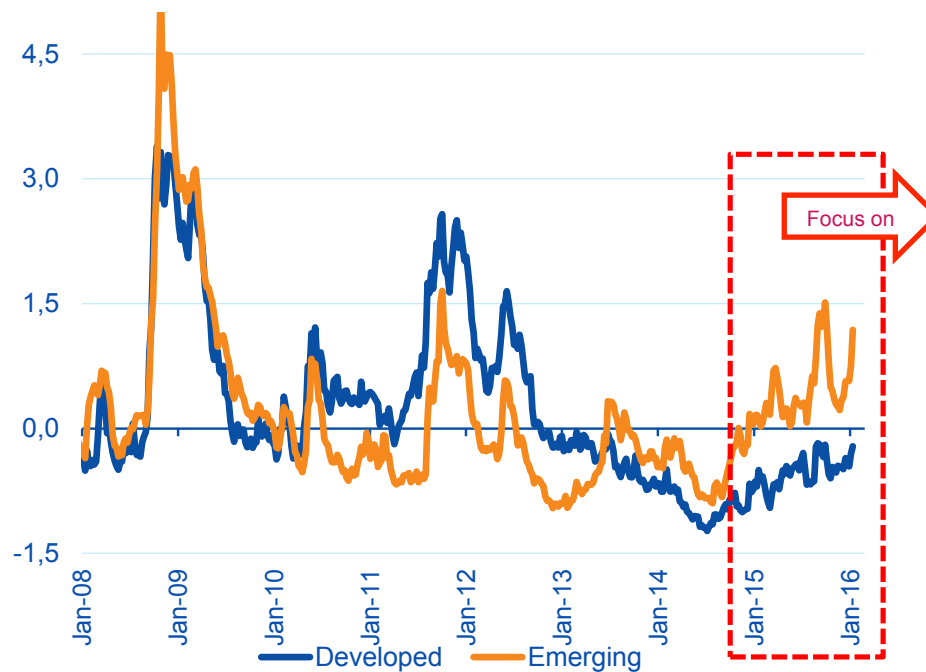
GDP's contribution to growth by component (percentage points of total growth)

Source: BBVA Research with data from INEGI

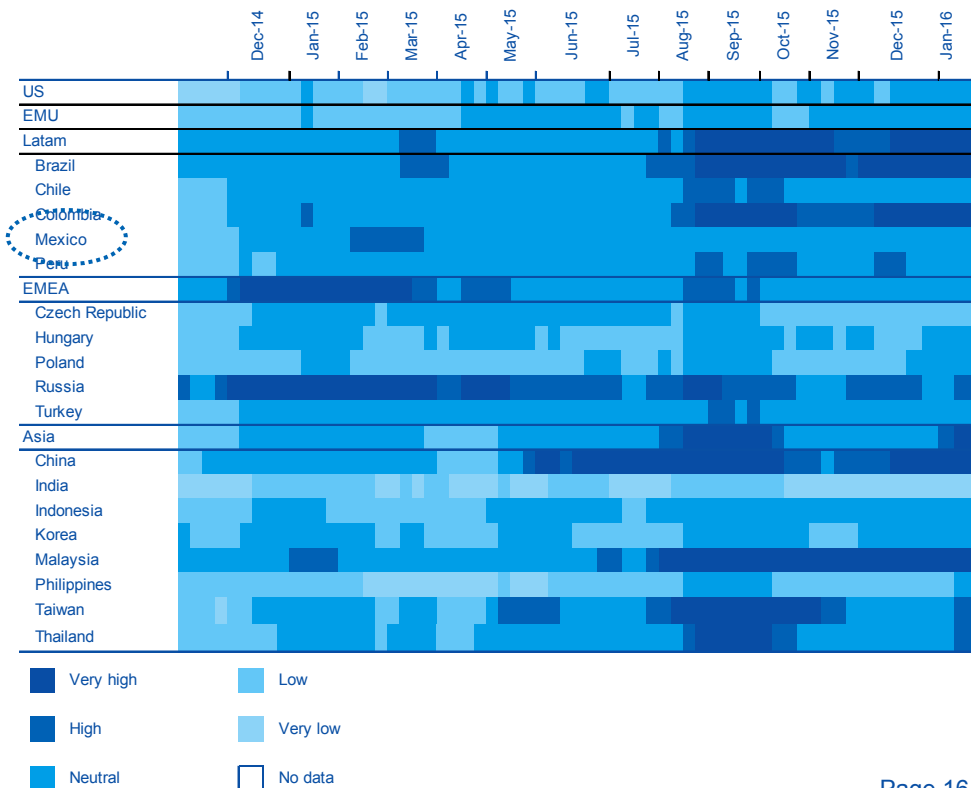


Recent developments in financial markets: higher financial stress in EM

BBVA Research Financial Stress Index
(normalized index)
Source: BBVA Research



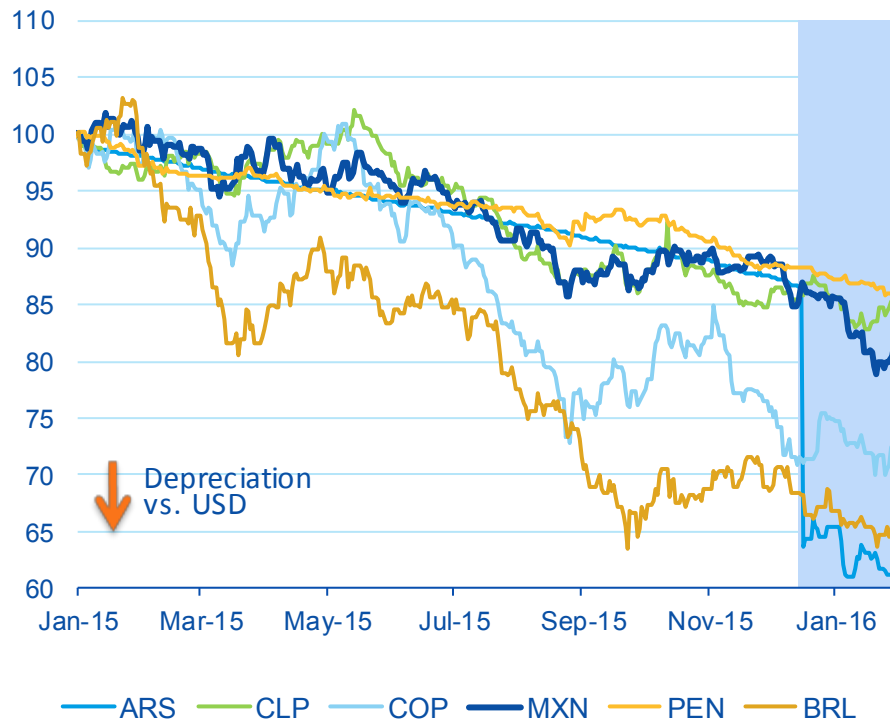
BBVA Research Financial Stress Index regional map for EM.
Source: BBVA Research



Recent developments in financial markets: evolving like other “crisis”

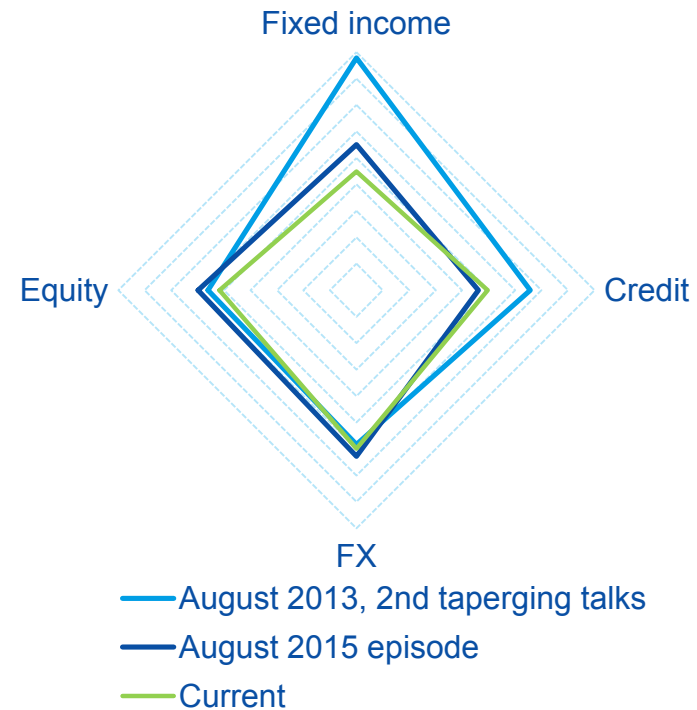
EM BBVA footprint FX performance vs USD (Base 100 January 2015)

Source: Bloomberg and BBVA Research



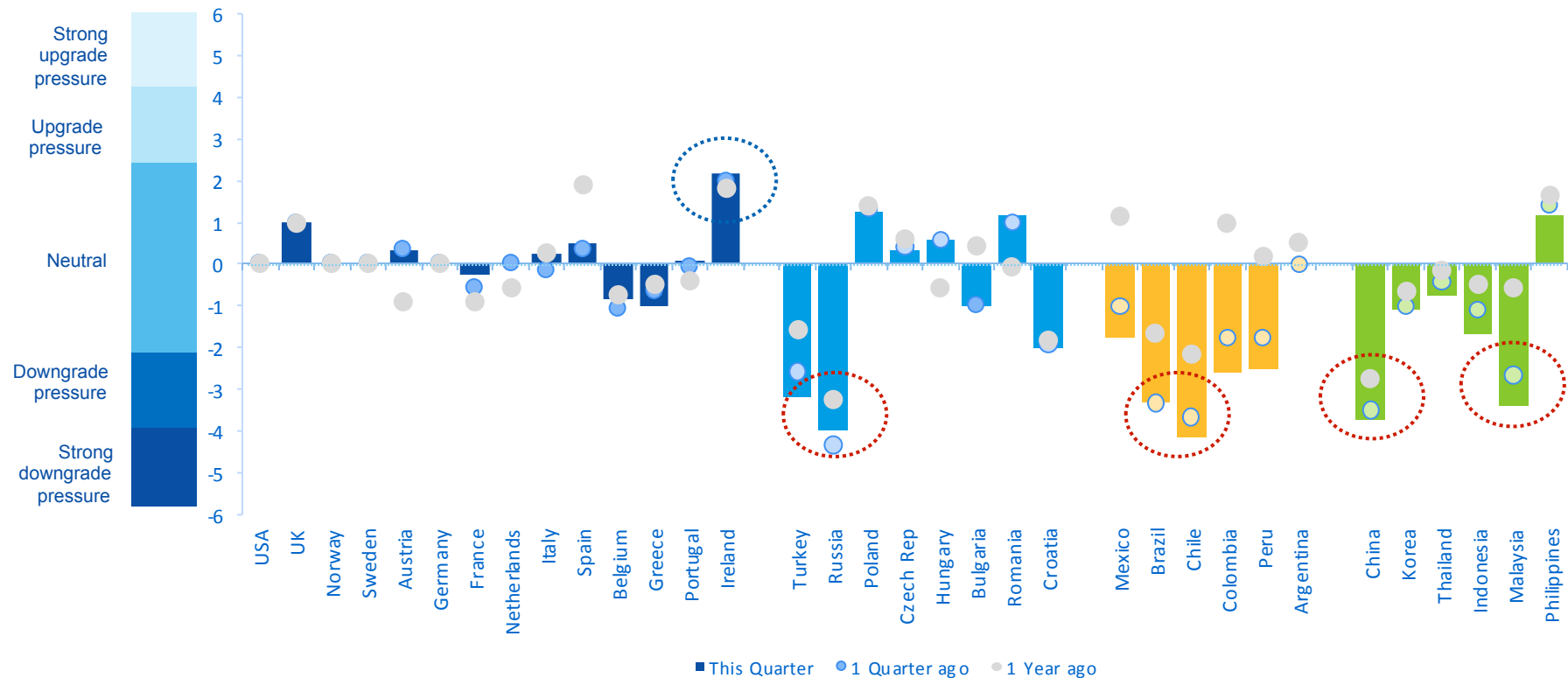
BBVA Research Volatility Index: by assets

Source: BBVA Research



Recent developments in financial markets: pressure on ratings not focused on Mexico

Agencies' rating downgrade pressure gap (January 2016)
(difference between CDS-implied rating and actual sovereign rating, in notches)
Source: BBVA Research

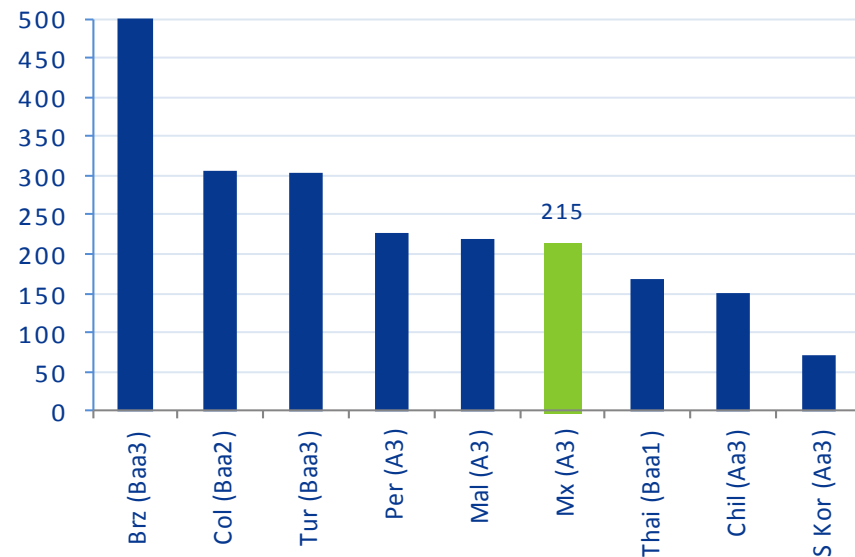


But risk perception is starting to rise

Emerging-markets CDS

bp

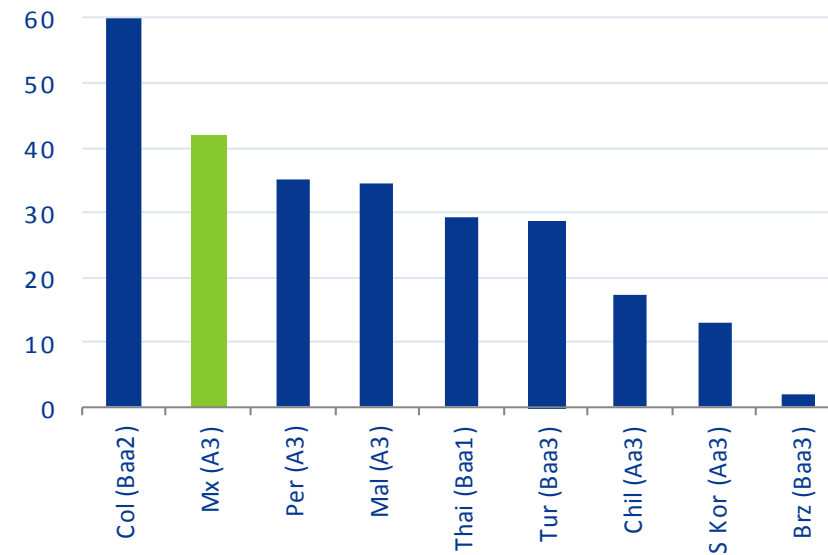
Source: BBVA Research, Bloomberg



Emerging markets CDS change

Year-to-date, bp

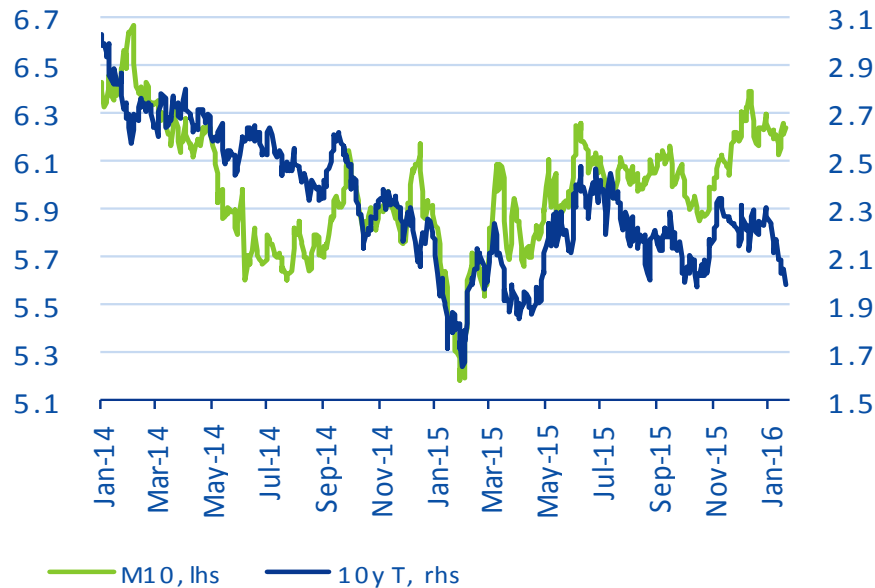
Source: BBVA Research, Bloomberg



Very recent developments show little impact on long term rates also at the start of the year

M10 and 10yT yields %

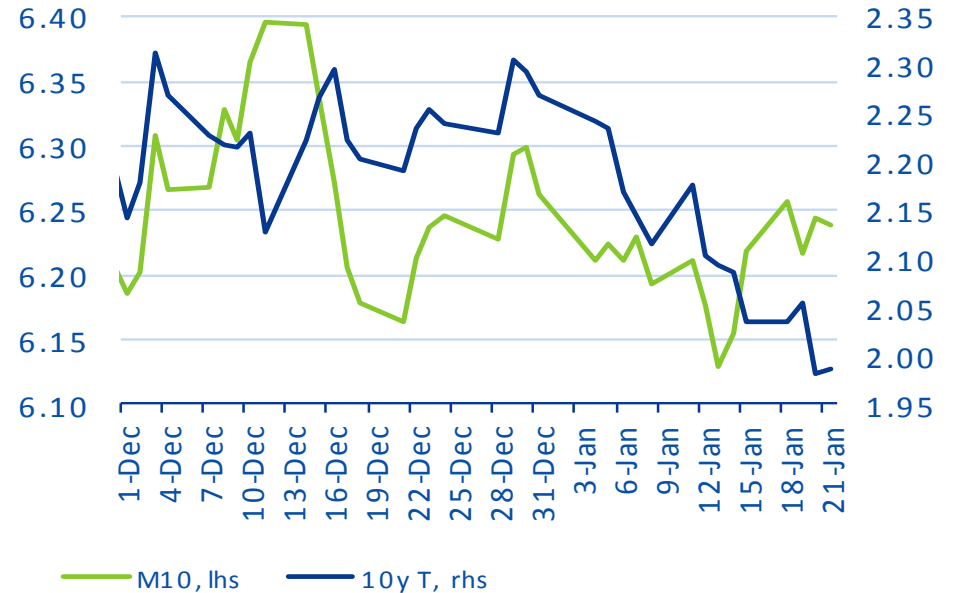
Source: BBVA Research, Bloomberg



M10 and 10yT yields

Last two months, %

Source: BBVA Research, Bloomberg

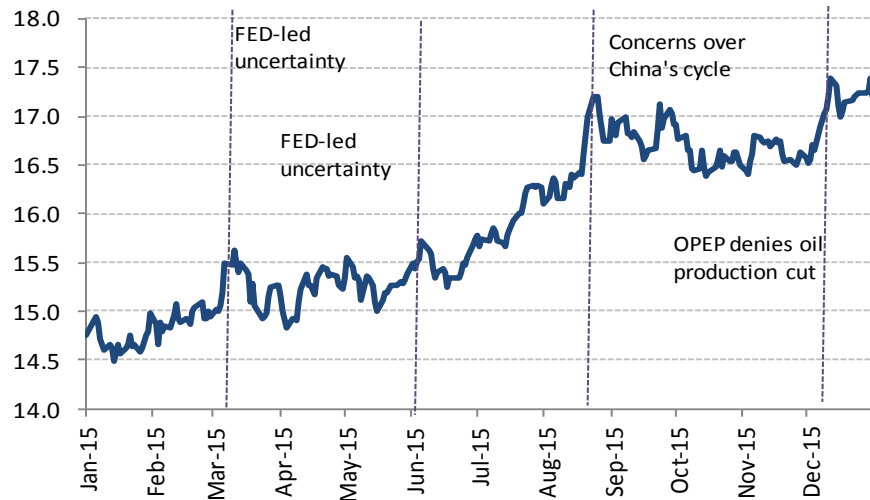


Very recent developments show too high volatility in the MXN depreciation: no fear of floating?

Exchange rate and Mexican oil price

(ppd and USD per barrel)

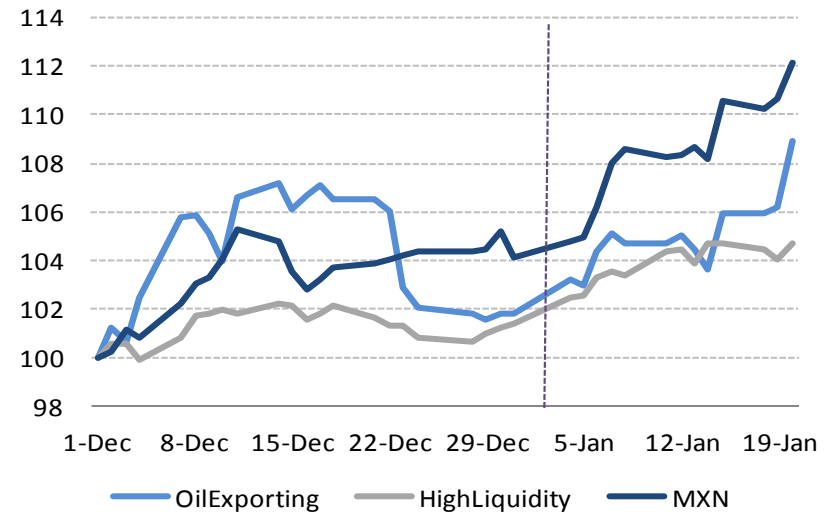
Source: BBVA Research and Bloomberg



High liquidity currencies. Currencies from oil-exporting countries and MXN *

(Index 12/1/2015 = 100)

Source: BBVA Research and Bloomberg



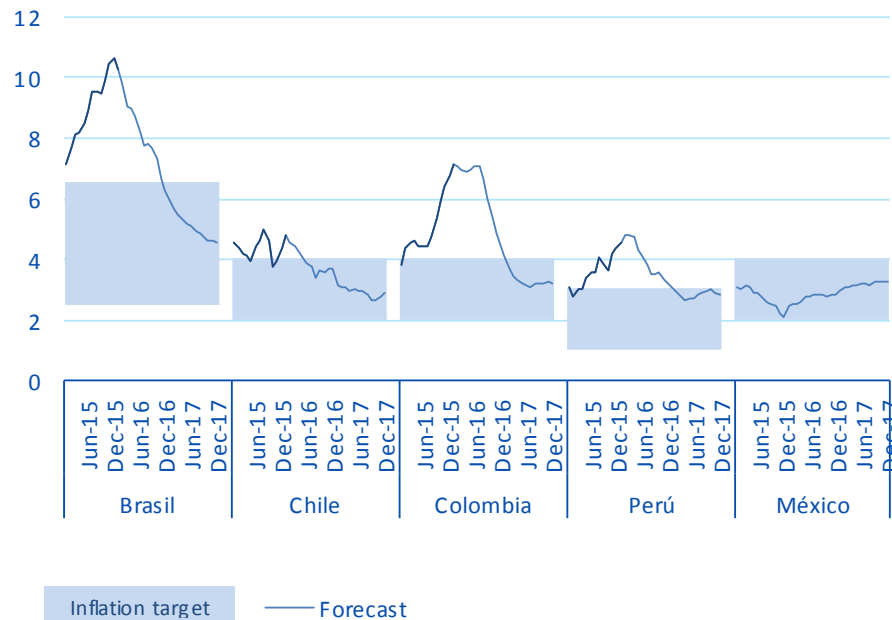
* Oil exporting countries: Brazil, Colombia, Russia, Norway, Canada. High liquidity currencies: South Korean Won, Singapore dollar, Taiwan dollar and Hong Kong dollar.

So far, so good: as opposed to peers, inflation in Mexico is likely to remain comfortably on target

Inflation in IT countries

%YoY

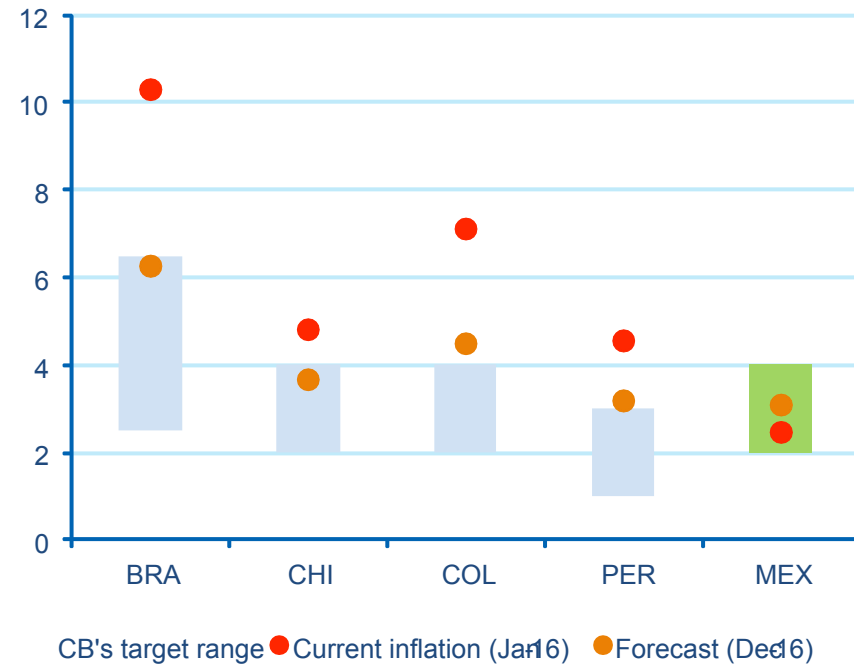
Source: BBVA Research, Bloomberg, Central Banks



Inflation in inflation-targeting (IT) countries

%YoY

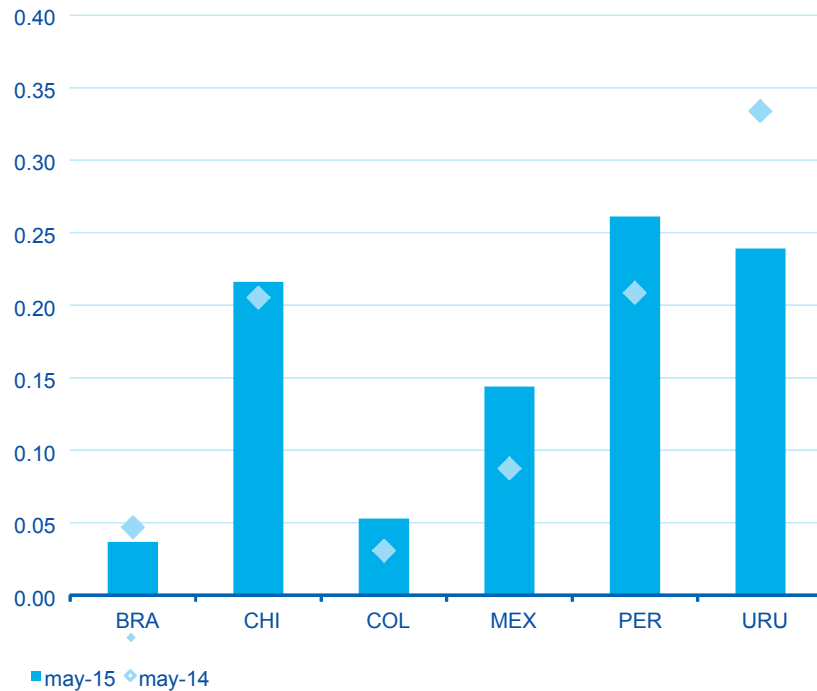
Source: BBVA Research, Bloomberg, Central Banks



In Mexico the pass-through is limited and the peso seems to have overreacted compared to fair value

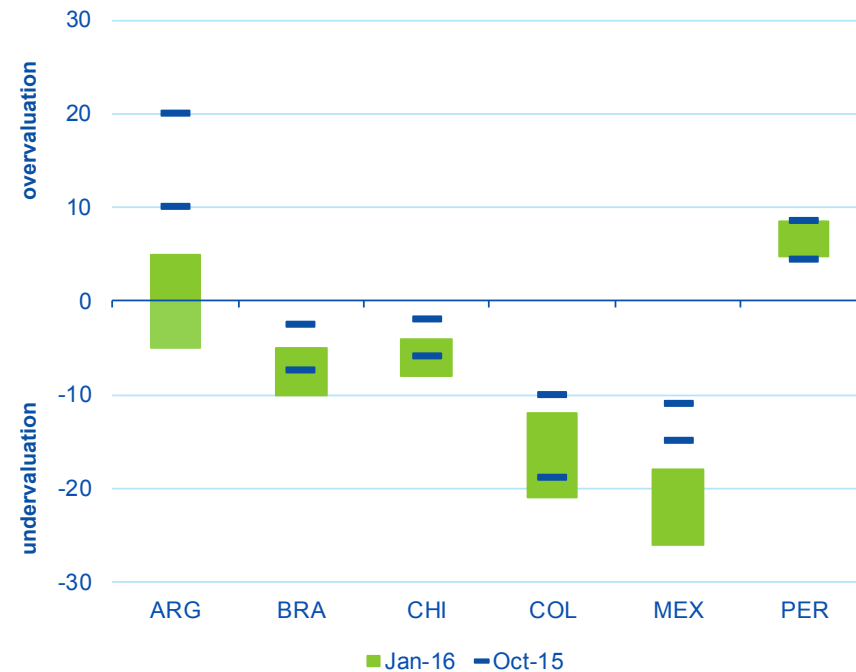
Pass through to inflation from a 1% depreciation of the exchange rate to the USD

Source: BBVA Research



Exchange rate vs USD: over-undervaluation (%)

Source: BBVA Research



Financial markets: What can we read from recent developments and if so, how does Mexico fare?

Is it a belated re-pricing of the Fed's liftoff?

Unlikely!

Is it a downward revision of the baseline

Not likely yet!

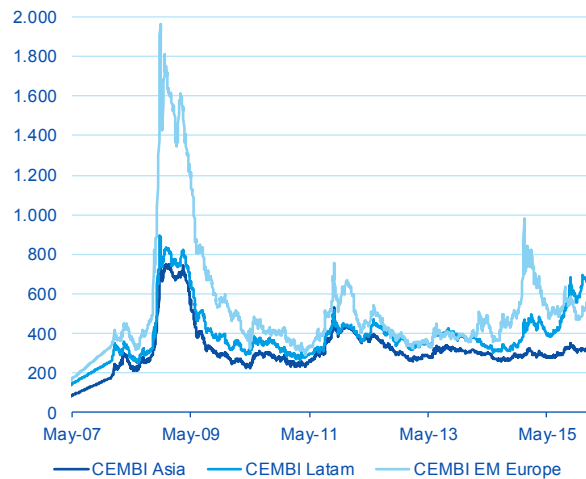
Is it the threat of risk scenarios going forward in this new world?

Probably! Uncertainty about China (growth, rebalancing and FX policy) and persistently **low oil prices** raise the risk of **second round effects** (*higher vulnerabilities in corporates affecting banks and sovereigns, especially in the oil sector*) that could become self-fulfilling.

Financial markets: Are they pricing a 2nd round of tail risks on corporates, sovereign & quasi-sovereign?

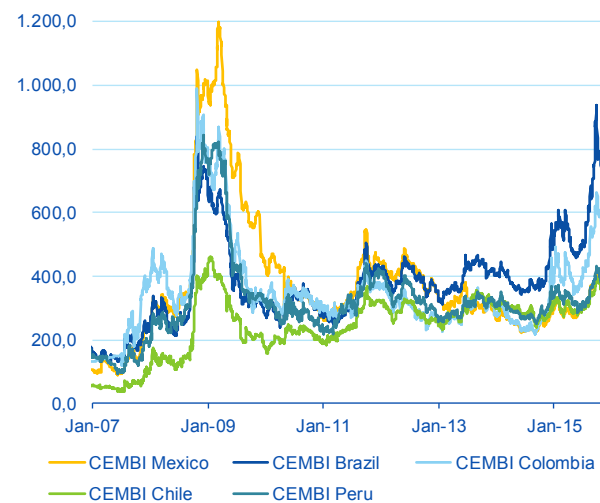
EM Corporate debt index (spread bp)

Source: JP Morgan BBVA Research,



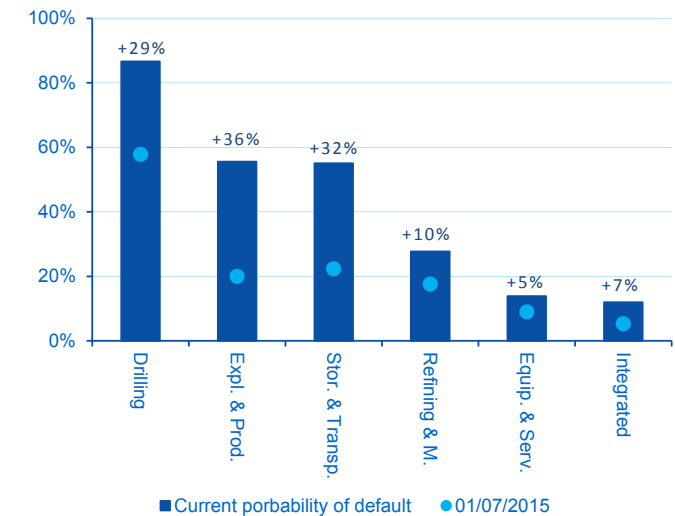
EM Corporate bond index (spread bp)

Source: JP Morgan, BBVA Research



US: estimated probability of default in the Oil and Gas sector

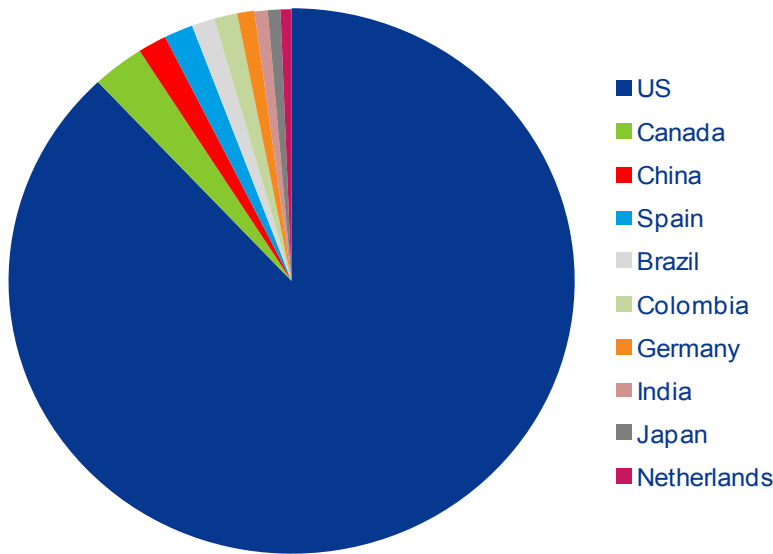
Source: Bloomberg and BBVA Research



(*) S&P 500 subsector default probability (weighted average of default probability implied in CDS of S&P500 energy companies). Assuming rate of recovery of 70%

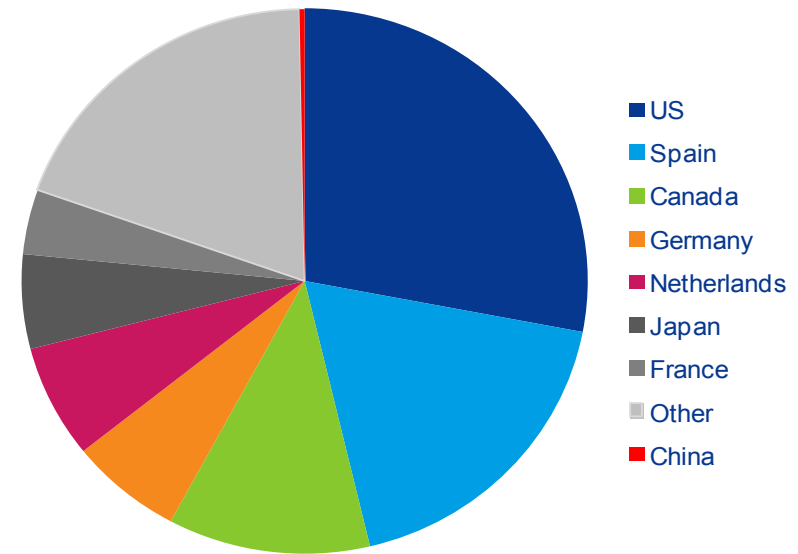
The **direct** impact of China's slowdown on Mexico should be quite small

Mexico, exports of goods to its partners
(Top 10 trade partners, millions, US dollars)



Source: BBVA Research, WEO

FDI to Mexico by country
(% of total, 2014)



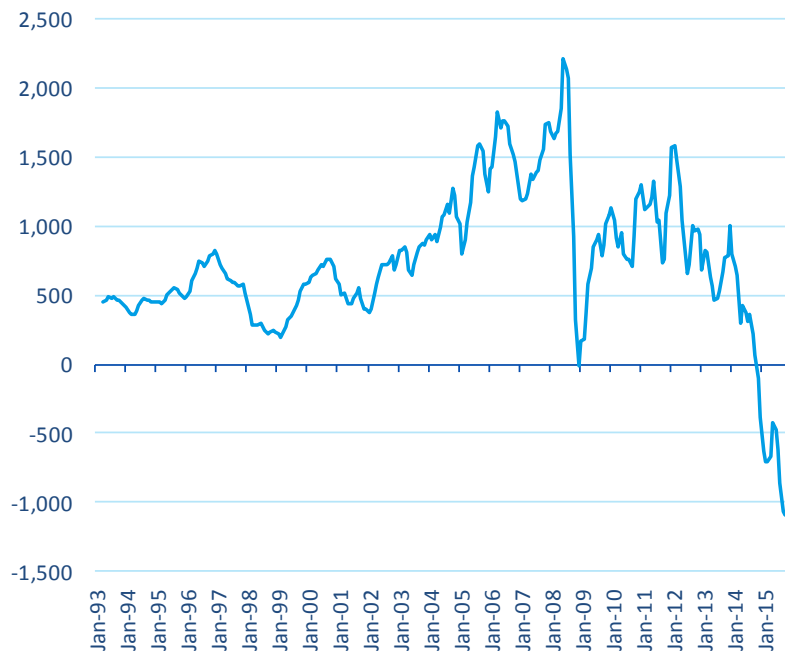
Source: BBVA Research, SE

Is Mexico too dependent on oil?... a deficit in oil trade balance, a higher current account deficit

Monthly oil trade balance

(figures in USD millions)

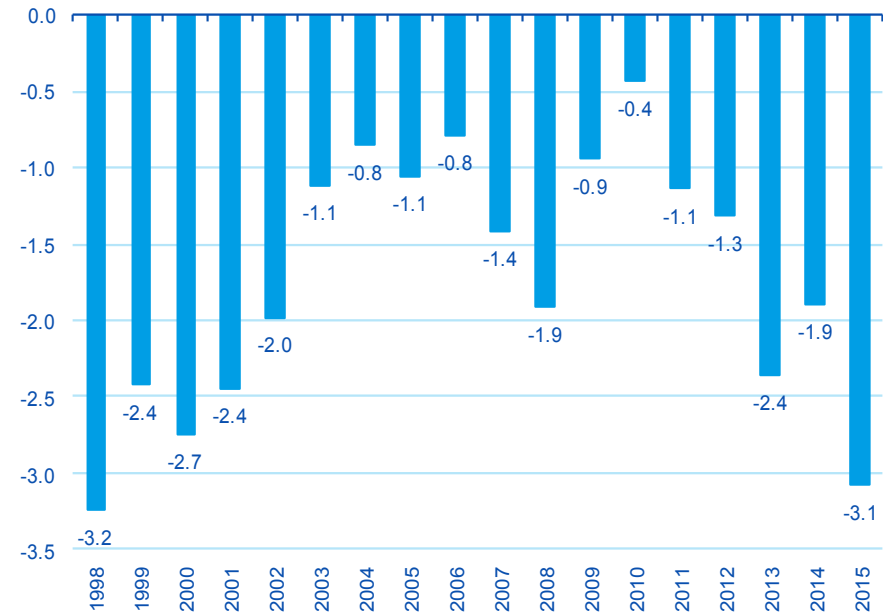
Source: BBVA Research with data of INEGI



Current account balance

(% of GDP)

Source: BBVA Research with data of INEGI and Bank of Mexico

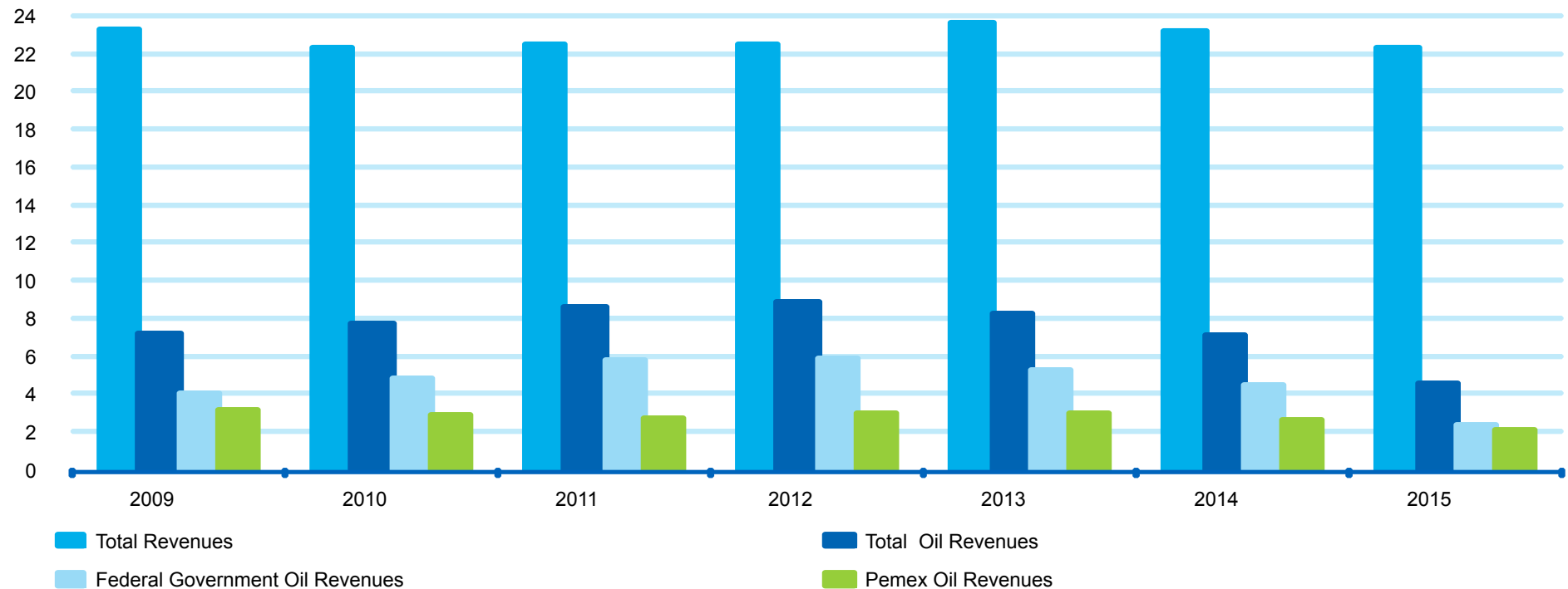


Is Mexico too dependent on oil?... importance in fiscal revenues

Fiscal revenues

(% GDP)

Source: BBVA Research with data from the Ministry of Finance



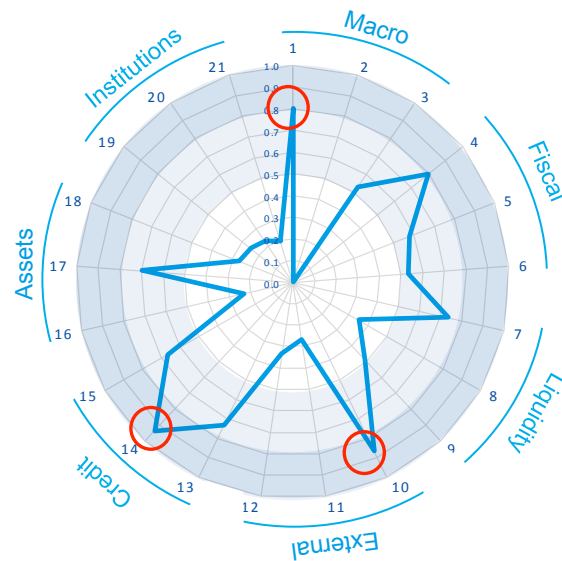
How vulnerable are emerging countries?

Emerging countries: vulnerability radar 2015

(Relative position for the emerging developed countries. Max risk=1, Min risk=0)

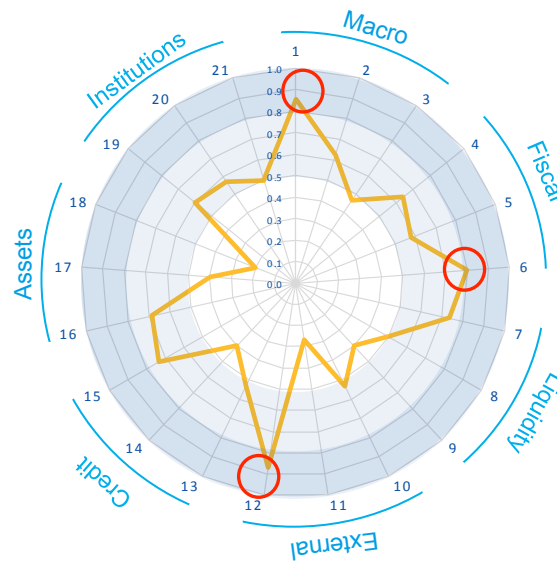
Source: BBVA Research

Emerging Europe



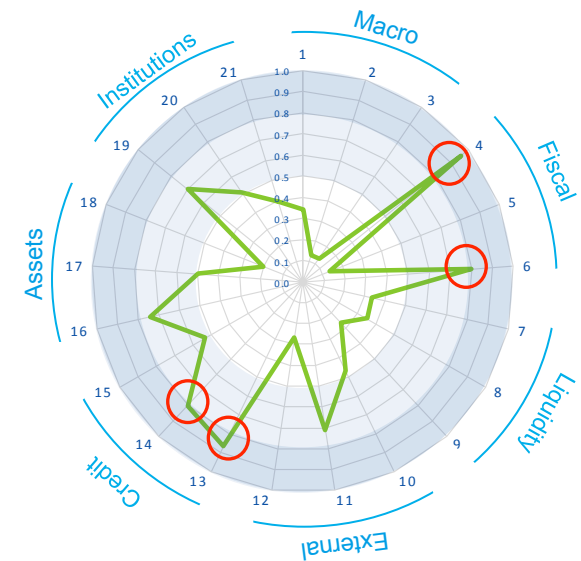
External debt is the most worrisome vulnerability together with **corporate debt**

LatAm



Current account balances and **Public debt** at high vulnerability levels

Emerging Asia



Fiscal balances and public debt levels have increased **fiscal vulnerability**. **Corporate and household debt** at risk levels

High risk
 Risk to monitor
 Safe

Macro: (1) GDP (%YoY) (2) Prices (% YoY) (3) Unemployment (% LF)

Fiscal: (4) Structural balance (%) (5) Interest rate – GDP % YoY (6) Public debt (% GDP)

Liquidity: (7) Debt by non-residents (% total) (8) Financial needs (% GDP) (9) Financial pressure (% GDP)

External: (10) External debt (%GDP) (11) RER appreciation (%YoY) (12) CAC balance (% GDP)

Credit: (13) Household (% YoY) (14) Corporate (% YoY) (15) Credit-to-deposit (%)

Assets: (16) Private credit to GDP (% YoY) (17) Housing prices (% YoY) (18) Equity (%)

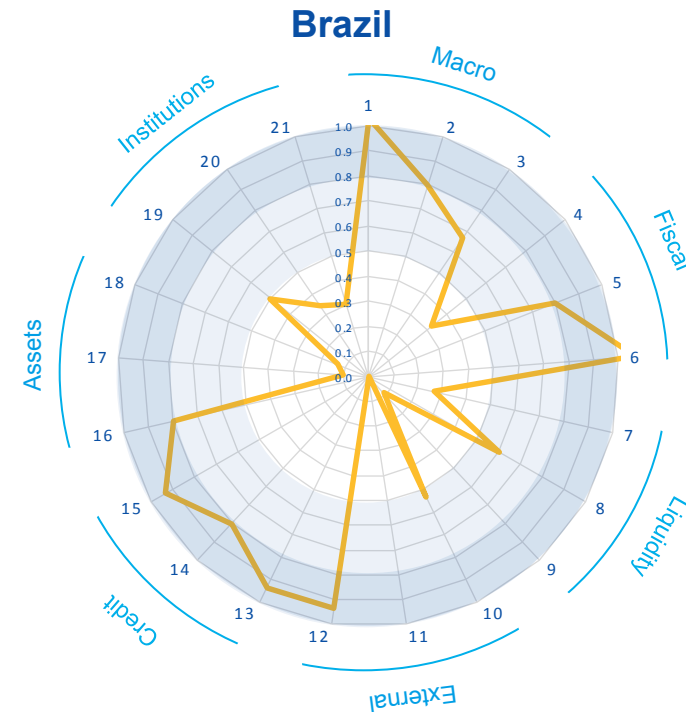
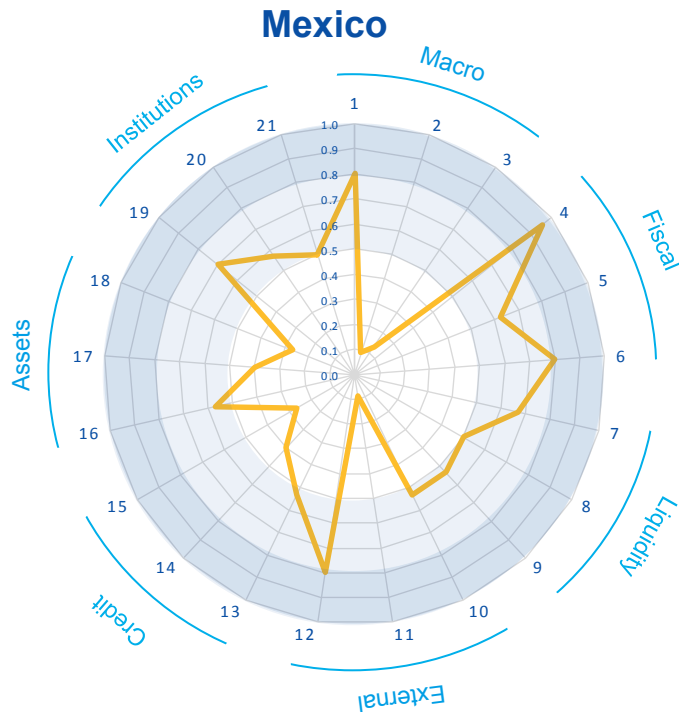
Institutional: (19) Political stability (20) Corruption (21) Rule of law

How vulnerable is Mexico?

Emerging countries: vulnerability radar 2015

(Relative position for the emerging developed countries. Max risk=1, Min risk=0)

Source: BBVA Research



High risk
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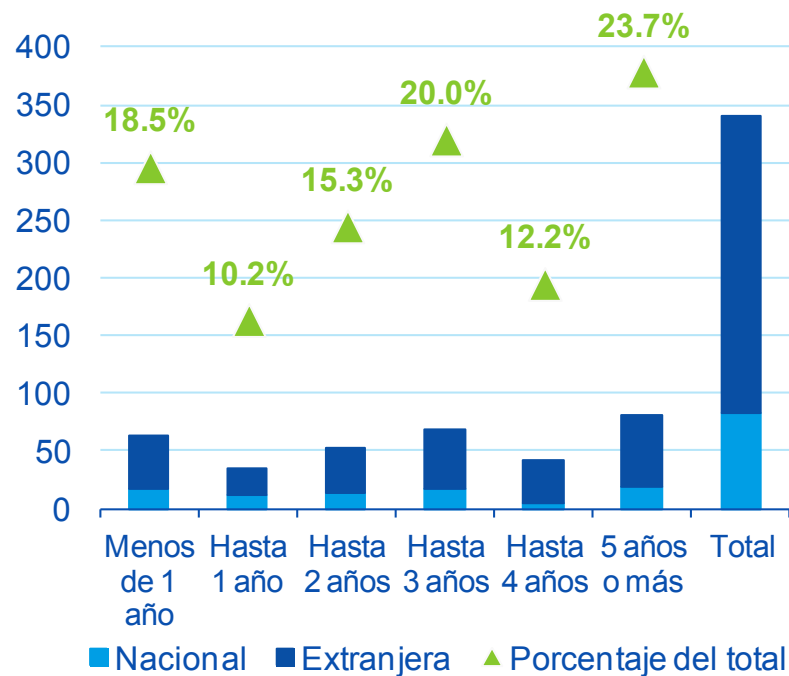
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Foreign currency debt by Mexican firms

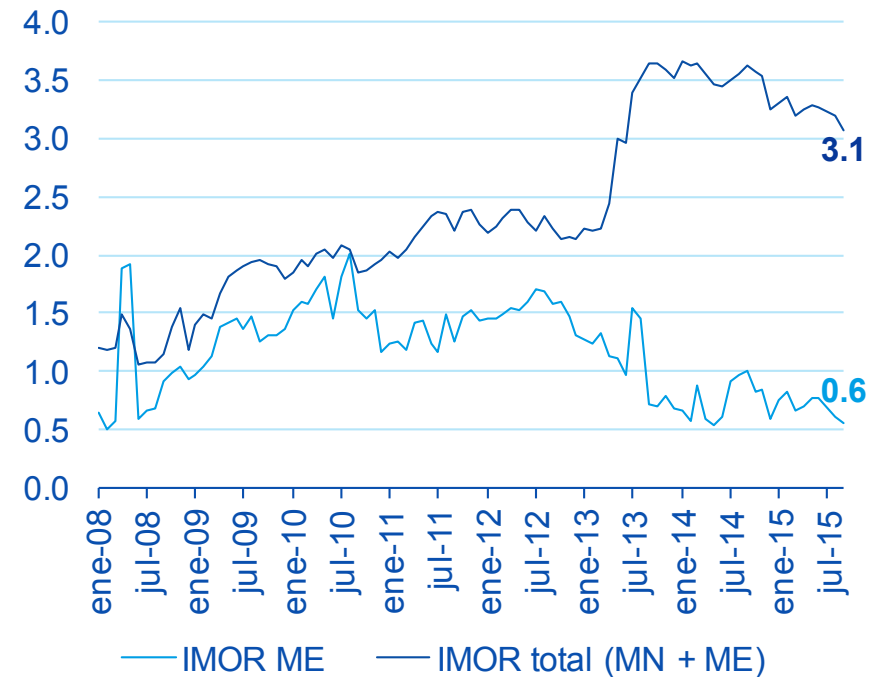
Corporate vulnerability is limited

Bank loans in foreign currency by term to maturity (3Q15)

Thousand million real and % of total



Pass due loans (IMOR) of corporates for local and foreign currency loans (%)





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A few comments on the reforms

Telecommunications and
competition reform

New entrants and new benefits

Energy reform

It is more than petroleum

Education

Key but so many things to fix

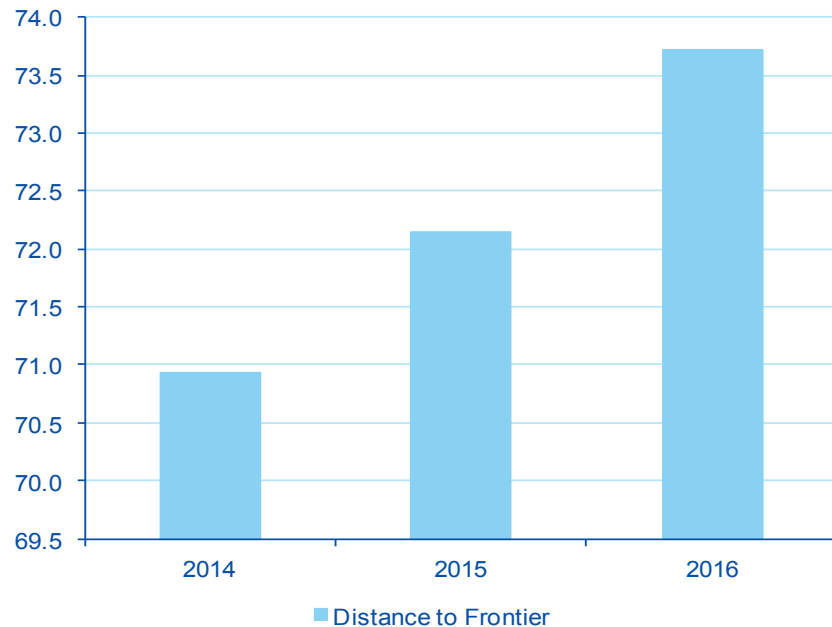
What is missing?

The ease of doing business has improved with structural reforms

Ease of doing business in Mexico

(0-100 scale, 0= worst performance, 100 = the frontier)

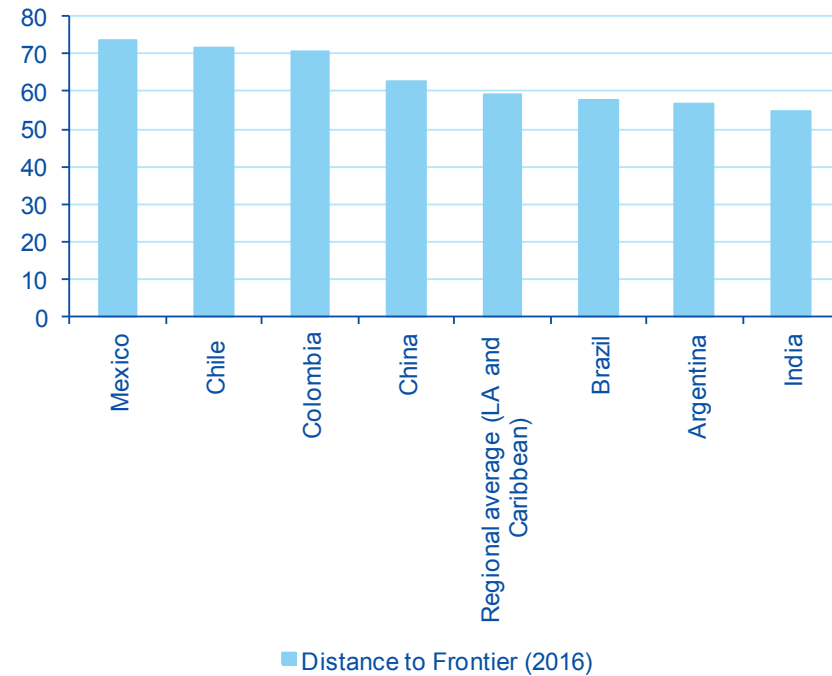
Source: BBVA Research with WB data.



Ease of doing business in various countries

(0-100 scale, 0= worst performance, 100 = the frontier)

Source: BBVA Research with WB data.



Where are we?

Mexico has built a solid framework for macroeconomic stability in the past 20 years. It has helped to differentiate the country from other EM's in these times of global turbulence, which does not mean that it is immune to the volatility.

However, the growth track-record has been poor. This is a consequence of stagnant productivity

Recent reforms will help with this, but...

Other reforms are needed, especially on Rule of Law, for the country to exploit its full potential

Outlook on Mexico

So far, a tale of macro stability but still moderate growth: what is the outlook?

Jorge Sicilia, BBVA Research

GIC Meeting

Monterrey, 1 February 2016

