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Research

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Mexico
Economic
Outlook

2nd Quarter 2017 | Mexico Unit

Index

1. In summary 1

2. Global environment: global growth consolidates but there are still risks 3

3. We expect GDP to grow by 1.6% in 2017, and, if favourable aspects prevail, it could grow by more 6

3.1 In 2017 the increased dynamism of the export sector could make up for the reduced dynamism of consumption and the somewhat unfavourable prospects for investment 6

3.2 Inflation continues to rise 19

3.3 The monetary tightening cycle continues, given the inflationary risks 22

3.4 The appreciation of the Mexican peso stands out favourably in an environment of greater demand for emerging market assets 24

4. Indicators and forecasts 26

Closing date: **12 may 2017**

1. In summary

The general improvement in consumer confidence data, the growth in world trade and, above all, the uptick in investment in China thanks to the monetary and fiscal stimulus measures taken there in 2016, are the main factors behind the acceleration in economic activity during the first few months of the year. We expect worldwide growth to be 3.3% in 2017 and 3.4% in 2018, in both cases 0.1 pp higher than our previous forecasts.

One of the main characteristics of the improved performance of the world economy is without doubt the consolidation of the recovery in the US. Although the likelihood of the new administration's being able to implement fiscal reform and of this having a positive effect in the short term has declined, the economy continues to grow above its potential, supported by the acceleration of investment and a labour market that is close to its full employment level. So, the US economy is expected to grow by 2.3% this year and 2.4% in 2018.

The solid growth of the US economy, together with the recent statements by several high-ranking officials in the Trump administration in favour of a sensible renegotiation of the North America Free Trade Agreement (NAFTA), make the economic panorama for Mexico less gloomy than it was at the beginning of the year. In January it seemed likely that NAFTA would come to an end or that there would be significant increases in tariff and non-tariff barriers to Mexican exports to the US. This likelihood is now greatly reduced in our opinion. In fact, our baseline scenario, to which we assign a 70% probability, is that NAFTA will be renegotiated and that the results will be beneficial for all three countries involved.

Mainly as a consequence of this, but also based on greater dynamism in external demand, we are revising our growth forecasts upwards, from 1.0% to 1.6% for 2017 and from 1.8% to 2.0% for 2018. The revision for 2017 is supported by three factors: a) improved performance by the external sector. We expect the US manufacturing sector to post significant growth this year, which will be reflected in renewed dynamism of Mexican exports, which we estimate will grow at an annual rate of 4.5%.; b) an upward revision of GDP growth figures for the second half of last year and higher-than-expected growth in 1Q17. These changes produce a positive base effect for growth in the first quarter of the year; and c) a less restrictive monetary policy than we were anticipating in January as the downward pressures on the peso ease.

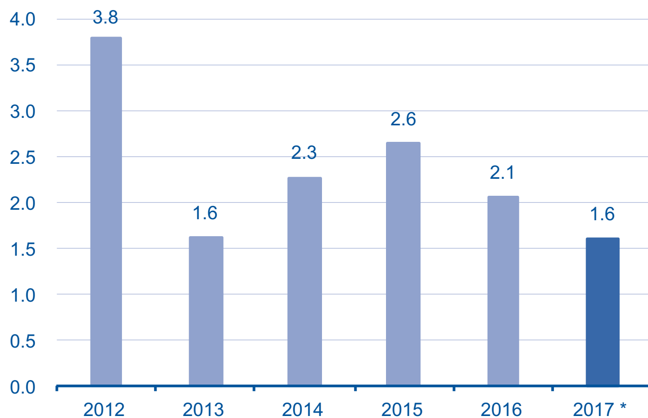
The domestic financial variables also reflect the shift towards a less gloomy panorama. The peso has appreciated significantly - by nearly 15% - since Donald Trump took office, the biggest currency appreciation worldwide. The improved prospects of a NAFTA 2.0 reduce the probability of our seeing falls like those at the beginning of the year. Largely in connection with this appreciation, implied inflationary expectations on the bond market have shown a significant downward trend, which has translated into expectations of a less restrictive monetary policy and a decrease of more than 50 bps in yields on long-term government bonds compared to the beginning of the year.

Given this significant appreciation of the peso, we have moderated our forecasts of increases in inflation, although it will continue to increase, reaching 6.0% during the summer. We expect it to start falling in 4Q17, ending the year at around 5.6% (0.4 pp less than forecast in January). In January 2018, a highly favourable base effect will allow a decline of 1.2 pp to 4.4%, and from February of that year we expect to see a gradual downward trend, with inflation ending the year slightly below 4.0% (3.9%), within the central bank's target range.

Based on these prospects for inflation, and in the absence of generalised second-order effects, the end of the cycle of monetary tightening is closer and will be reached at lower levels than we expected in January. In short, we expect less restrictive financial conditions than we did at the beginning of 2017.

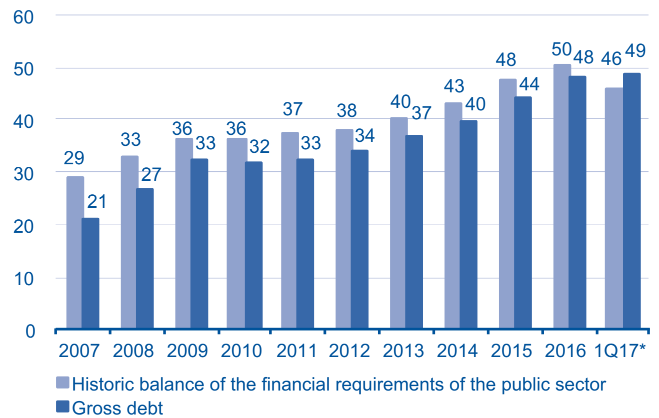
As regards public finances, the efforts made towards fiscal consolidation over the course of the year and the central bank's operating surplus will allow a primary surplus of at least 0.5% of GDP to be achieved and the ratio of public sector debt stock (SHRFSP) to GDP to stop growing in 2017. Meeting these objectives will go some way towards ensuring that the rating agencies do not downgrade Mexico's sovereign debt rating. Nevertheless, the federal government will have to continue with a policy of containing programmable expenditure in view of the pressure that will continue to be exerted on public finances by spending on pensions, payments to states and municipalities and the cost of the debt in the coming years.

Figure 1.1 Quarterly GDP (Chge. % QoQ and YoY, sa)



p= preliminary; sa = seasonally adjusted. * 2017 = estimated
Source: BBVA Research based on information from INEGI (National Statistics Institute).

Figure 1.2 Gross debt and public sector financing requirement* (as % of GDP)



* To calculate total debt stock and public debt we used the preliminary GDP figure for the first quarter and a GDP deflator of 5.2%.
Source: BBVA Research based on Ministry of Finance and INEGI data

The improvement in the panorama strengthens our expectation expressed three months ago as regards the high probability that the effects of the current US administration's economic policies on the Mexican economy would end up being cyclical rather than structural. Nonetheless, the risks have not dissipated entirely, and we now face a long period of trade negotiations in which the various players' statements may bring an end to the favourable conditions experienced in the past few months. Also, geopolitical risks and fluctuations in the prices of commodities and financial assets could lead to renewed bouts of uncertainty and volatility for the Mexican economy.

2. 2. Global environment: global growth consolidates but there are still risks

Gradual acceleration and more restrained extreme scenarios

During the second half of 2016, the global GDP growth rate stood at 0.9% QoQ, and the most recent data point to similar rates for the beginning of 2017, which compares positively with the 0.8% recorded on average since 2011. The overall improvement in confidence indicators, along with the advance of global trade are behind this acceleration in activity. The performance of the advanced economies continues to be particularly positive thanks to the consolidation of the USA recovery and Europe growing at rates that are above their potential. On the contrary, Latin American will emerge this year from the recession, although with a moderate growth.

The global economy continues to accelerate

Improved global behaviour is accompanied by some clarification regarding the course of the economic policy in USA, where expectations of a rapid reflation have been limited, or at least the timing of measures to support changes in that direction has been limited. Therefore, the government appears to be considering moderate proposals on a possible renegotiation of the NAFTA, while it continues to face obstacles in pursuing policies to restrict immigration. Nevertheless, the difficulty of pushing forward with the reform of the health care system has also revealed problems with getting other measures approved, such as those linked with tax cuts or the infrastructure expenditure plan, which eliminates the likelihood of a strong fiscal impulse in the short run.

Financial markets have remained calm over the last months, recording low volatility in spite of the high uncertainty. Financial tensions have relaxed, especially in the emerging economies, which were more negatively affected at the end of last year due to the uncertainty after the US elections. Europe is an exception to this trend, as the uncertainty about the elections in France has widened the debt spread in France and the periphery.

Moving towards monetary policy normalisation

The combination of a cyclical upturn, the reversal of inflation from negative rates and, above all, the moderation or disappearance of deflationary risks have provided the basis for the central banks to leave ultra-expansionary policies behind. The Fed, which leads this process has brought forward its third rate increase to March. The rise in rates has not caused any adverse effects on the financial markets, fundamentally because it is broadly in line with the progress made by the economy, which is nearing full employment, and also because the Fed is maintaining its gradual exit message. In addition, the Federal Reserve is discussing how to approach the third phase of the exit strategy, i.e. the reduction of the balance sheet (once the -QE- bonds purchase programme is completed, and as interest rate increases are consolidated). But it is something that will probably not happen until next year and will be put in place passively.

The ECB is also more optimistic about growth, but still not very confident about inflation reaching its medium term target. Thus, the announced QE recalibration is been taking place since April, reducing monthly purchases of public and private debt, from 80 billion to 60 billion euros. This reduction in purchases and some changes in the ECB`s communication are a first step in the exit strategy. In this regard, the monetary authority is expected to change its forward guidance to prepare the market for the timing and order that will follow. According to our scenario, we expect the ECB to continue reducing the bond purchases during the first part of 2018 and to not extend them beyond the summer, to start the upward cycle of rates at the end of the same year.

In short, we are facing a normalisation process for monetary policies, which, until now, were very accommodative. Therefore, an increase in financing cost can be expected at global level on the projected horizon. Communication policy will be key into this process, to prevent mistakes like the famous “taper tantrum” (overreaction in 2013 of the bonds market to the withdrawal of stimulus) in the USA. The tightening of financing conditions not only depends on the intervention rates set by the central banks but also on the long term interest rates. In this case, there are factors that continue to pin down the long end of the curve, such as elevated uncertainty, the lack of safe-haven assets and certain regulatory features.

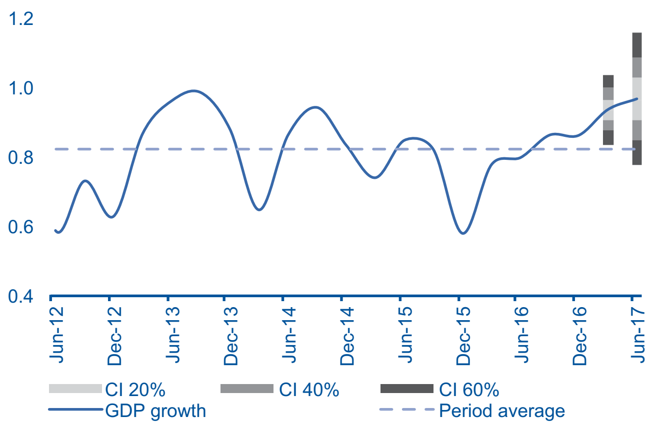
Slightly upward revision of growth but still with risks of a downturn

Overall, growth forecasts for 2017-18 are only marginally revised. The positive start of the year move them up for the Eurozone and especially China, while for the Latin American countries are rather more negative this year (with the notable exception of Mexico). As a result, expected global growth is 3.3% for 2017 and 3.4% for 2018, which, in both cases, is 0.1pp higher than our previous forecasts.

Risks associated with increased protectionism remain

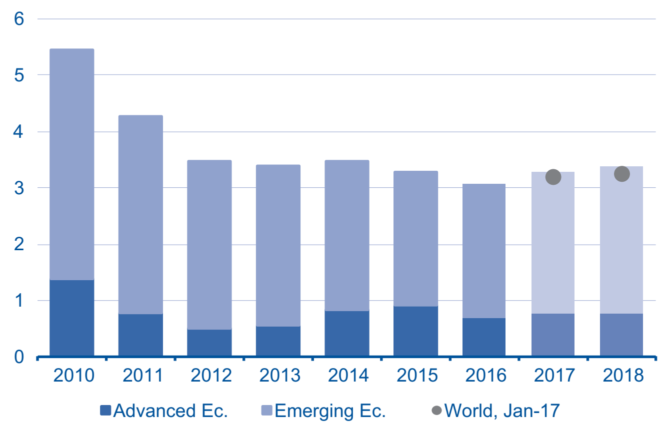
In spite of the above, the risk events that are perceived, if produced, would mostly reduce growth. In particular, beyond the uncertainty that is still associated with the measures about to be approved in the USA, doubts centred around the election results in France and Italy, due to the highly negative impact they could have on the Eurozone stability in the (unlikely) event of overcoming strongly anti-European options. Additionally, there is also the risk associated with the Chinese economy, where the recent strength of investment may slow down the imbalance reduction process. Other significant elements that remain uncertain and which will be important to consider in the coming months include the evolution of the negotiations on Brexit, the multiple open geopolitical events and the risks associated with the normalisation of monetary policy, especially in the USA.

Figure 2.1 Global GDP growth Forecasts based on BBVA-GAIN (%, QoQ)



Source: Haver and BBVA Research

Figure 2.2 Global growth by region (%, year-on-year)



Source: BBVA Research

United States: growth just above 2% in 2017-2018

The investment underpins the upturn in activity in the USA

The probability that the new administration could implement the promised fiscal reforms and that they would have a positive impact on the projected horizon has decreased and, at any event, its impact on growth should be limited in an economy that is continuing to grow above their potential. GDP growth continues to be 2.3% for 2017 and 2.4% for 2018, supported by acceleration in investment, which will benefit from the improvement in expectations, stable oil prices and the recovery of the housing market. This should compensate the expected moderation in consumption due to higher inflation and a more gradual improvement in the labour market. In this context, the Fed is expected to continue with the gradual normalisation of monetary policy, although we are now expecting two additional rises this year (up to 1.50%) and two more in 2018, up to 2%.

China: upward growth revision due to improved recent data, as a result of its economic policy support

After relatively stable economic growth throughout last year (around 6.7% for the year), the signs of certain acceleration in 4Q16 appear to be confirmed at the beginning of 2017. The available indicators point to a growth close to 7% in annual terms, caused by investment, which continues to benefit from the support of an accommodating monetary policy and fiscal stimulus. Despite the upward revision of GDP growth forecasts in 2017-2018 of around 0.5%, we continue to expect a deceleration in growth on the projected horizon, from 6.7% in 2016 to 6.3% this year and 5.8% in 2018. Despite of the significant increase in industrial prices due to an increase in commodity prices and shrinking supply, inflation remains moderate (2.3% expected in 2017 and 3% in 2018). However, apart from the improved expectations, based on a more growth-oriented economic policy, the risks will increase in the medium term as the growth pattern adjustment process has halted and could accentuate the financial fragilities derived from a recovery based on the increase of the indebtedness of the economic agents.

Europe: a little more growth, with no significant risk of inflation

Risks in Europe are mostly political

GDP growth may have gained traction at the beginning of this year (around 0.5% QoQ) supported by improved global demand and confidence. However, the above-mentioned risks make difficult to think about greater forward acceleration in an economy that has already been growing above its potential since 2015. However, we have slightly revised growth to a 0.1% rise in 2017 and 2018, to 1.7% in both years, reflecting the more positive data, which, as in the case of the USA or China, are based more on foreign trade and investment than on private consumption. BBVA Research scenario also estimates a moderation in inflation from the first half of the year, as the sharp increase seen since the end of 2016 was mainly due to the base effect of energy prices and the increase in unprocessed food prices. On the other hand, core inflation remains stable and at low levels while, wage growth is highly contained. Therefore, we have slightly revised the inflation forecast upwards to 1.8% in 2017, but we are keeping a price change of 1.6% for 2018, while we still expect core inflation to be at around 1.5% by the end of 2018.

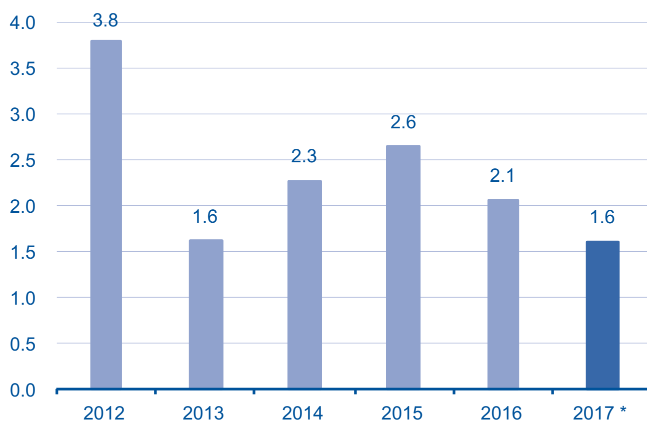
3. We expect GDP to grow by 1.6% in 2017, and, if favourable aspects prevail, it could grow by more

3.1 In 2017 the increased dynamism of the export sector could make up for the reduced dynamism of consumption and the somewhat unfavourable prospects for investment

In 2016 seasonally adjusted GDP growth was 2.1%, less than 2014 (2.3%) and 2015 (2.6%). For 2017 we estimate GDP growth of around 1.6% (Figure 3.1). This growth rate could have an upward bias if the external sector continues to evolve as positively as it did in the first quarter of 2017, making up for the weakness seen in private consumption and gross fixed capital formation (GFCF) in the first few months of this year.

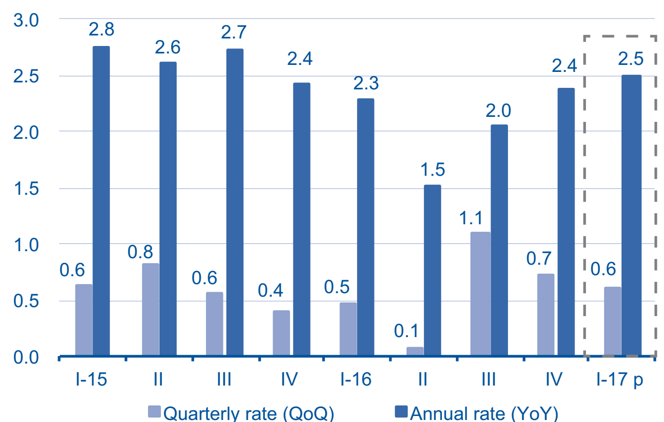
As commented throughout this section, various indicators of private consumption, such as the ANTAD (national retailers association) index in real terms of same-store sales, domestic car sales and the INEGI (national statistics institute) private consumption index refer to the weakness of this variable. The same applies to GFCF and its components. To the extent that these two variables constitute GDP on the demand side, the growth of economic activity is conditioned by how they evolve. As noted, this can be offset only by sustained dynamism in the external sector. If this occurs, the external sector could become the main GDP growth driver this year.

Figure 3.1 Quarterly GDP
(Chge. % QoQ and YoY, sa)



p= preliminary; sa = seasonally adjusted. * 2017 = estimated
Source: BBVA Research based on information from INEGI (National Statistics Institute)

Figure 3.2 Trend in annual GDP
(Chge. %)



sa= seasonally adjusted; p = preliminary data
Source: BBVA Research based on information from INEGI

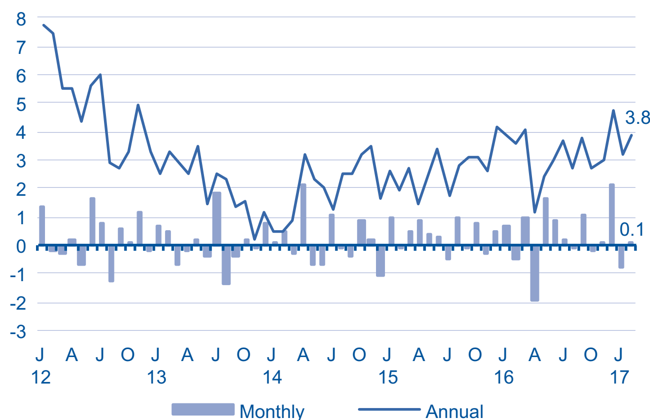
Apart from this, the preliminary figure for seasonally adjusted GDP growth in 1Q17 released by INEGI at the end of April 2017 was 0.6%. Given this figure, there is an upward bias to the GDP growth estimate for 2017 as a whole. However, we should point out that the preliminary estimate of quarterly GDP growth for 1Q16 released by INEGI at the end of April 2016 was 0.8%, later revised to 0.5% (Figure 3.2). The preliminary figure indicates that it is possible for GDP growth in 2017 to exceed 1.6%. Neverthless, it is also possible that the figure for the first quarter will be revised downwards, as it was in 2016. This would limit the possibilities of a high rate of growth in economic activity in 2017.

Lastly, as a latent risk factor, we cannot rule out events in the remainder of the year that would lead to lower GDP growth. One example of this would be if for some reason the NAFTA renegotiations run into some kind of difficulty.

3.1.1 Private consumption: slower pace of growth in 2017 than in the previous two years

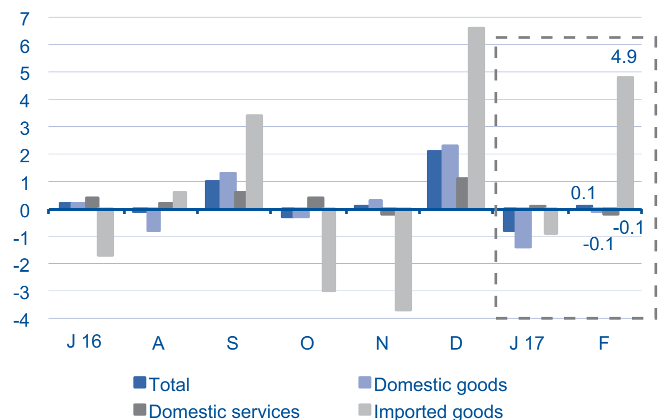
The annual average growth rate of private consumption in 2015 was 2.7%, increasing to 3.2% in 2016. Among other factors, the positive trend in private consumption was driven by the growth in real wages seen in those years, such as the average wage of workers registered with the IMSS. Also, in the years referred to, private consumption made a significant contribution to GDP growth. Various recent factors have affected private consumption. One of these has been the increase in YoY inflation, which went from 3.4% in December 2016 to 5.4% in March 2017. This higher rate of inflation has meant that from January to March 2017 real wages declined (see Figure 3.24 in the sub-section headed Employment in this section). In other words, we believe workers' lower real income will lead to a lower rate of growth in private consumption over the course of 2017.

Figure 3.3 Private consumption
(Chge. % MoM, YoY, sa)



MoM = "month-on-month"; YoY = "year-on-year"; P = preliminary.
Source: BBVA Research based on information from INEGI

Figure 3.4 Private consumption by component
(Chge. % MoM, sa)



sa = seasonally adjusted; MoM = "month-on-month"
Source: BBVA Research based on information from INEGI

Apart from this, according to seasonally adjusted figures for INEGI's monthly private consumption indicator, this variable showed a negative monthly growth of 0.8% in January 2017 (Figure 3.3). In that month consumption of both domestic and imported consumer goods contracted (by 1.4% and 0.8% respectively) with only consumption of services showing positive monthly growth (0.1%) (Figure 3.4). In February the monthly growth rate of private consumption was positive, even if limited (0.1%) and accompanied by monthly contractions in the consumption of domestic goods and services (each -0.1%), while consumption of imported goods grew strongly, by 4.9%.

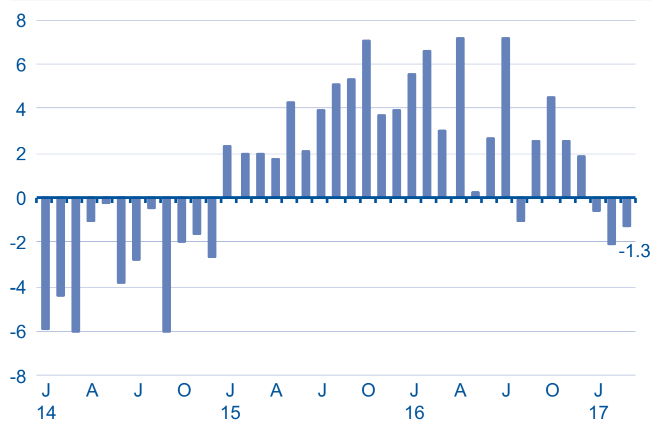
We should mention that imports of consumer goods are divided into petroleum-based imports (petrol (gasoline) and others) and non-petroleum based products. As we shall see in the sub-section on the External Sector, despite the weakness of the peso in February 2017, imports of petroleum products increased significantly. This could be an indication that the positive performance of imported goods for private consumption in February was due only to increased imports of petrol (gasoline) given growing demand. If so, then if gasoline imports had not increased as much as they did in that month, private consumption might also have posted a negative monthly growth rate, as it had in January.

The points in the last few paragraphs are relevant to the slower paced growth in private consumption that is to be expected in 2017 compared with last year. This situation will persist for as long as real wages continue to show negative annual growth rates. In this regard, the lower inflation rate expected for 2018, of around 4%, will tend to favour greater growth in private consumption from then on.

The sluggishness seen in private consumption in 1Q17 is also reflected in the negative real growth rate of the ANTAD (national retailers association) same-store sales index for January to March. According to this source, each of the first three months of 2017 saw negative annual growth rates on this index (Figure 3.5).

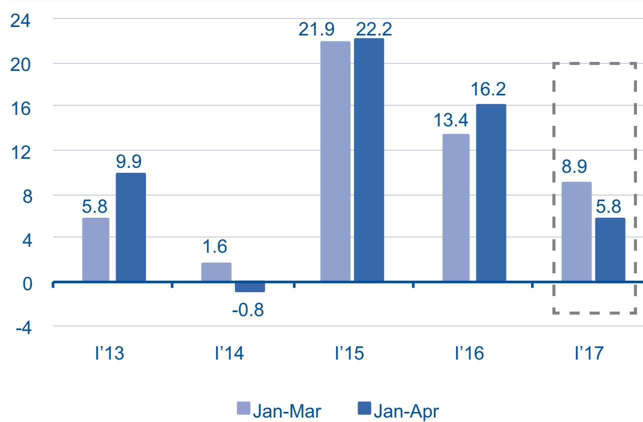
Apart from this, the lack of dynamism in private consumption can also be seen in the growth rate for car sales in the domestic market from January to March and also from January to April (Figure 3.6). If we compare the growth rates for 1Q17 with those for the same quarter in 2015 and 2016, we can see that the 2017 rates, although still positive, are significantly lower than those of the two previous years (Figure 3.6).

Figure 3.5 ANTAD same-store sales index
(Chge. % real annual rate)



Source: BBVA Research with data from INEGI and ANTAD (National Association of Self-Service and Department Stores)

Figure 3.6 Car sales in the domestic market
(Chge. % monthly)



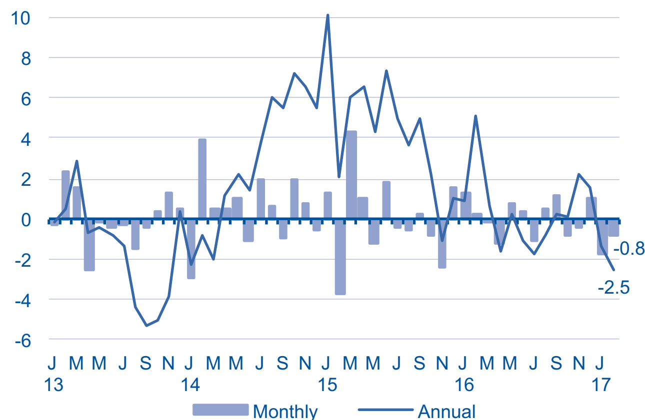
sa = seasonally adjusted
Source: BBVA Research based on AMIA information

3.1.2 GFCF index: slowdown has turned into contraction

In 2015 the average annual growth rate of the seasonally adjusted series for GFCF (gross fixed capital formation) was 4.4%. In 2016 this rate was 0.5%, and for the average of January and February 2017, the only months for which data are available, the average annual rate of growth was a negative 2.0% (Figure 3.7). The contraction in GFCF in the first two months of 2017 was due to the negative performance of its components, in particular capital expenditure on construction and on imported plant and machinery (Figure 3.8).

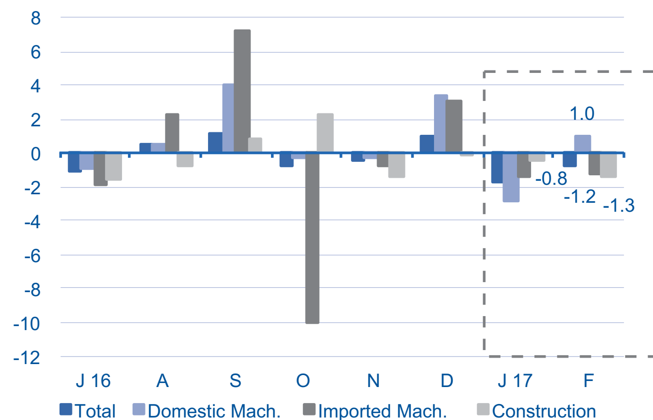
We should mention that GFCF is a variable that reflects expectations of future GDP growth as well as any uncertainty (which leads to increased caution in making investments). For example, if the renegotiation of NAFTA leads to greater caution in making investments, then GFCF can be expected to start picking up again once the renegotiation is completed. Apart from this, GFCF will also start to pick up when there are signs that GDP is growing at a higher rate than in the past few quarters.

Figure 3.7 Gross fixed capital formation (GFCF)
(Chge. % MoM, YoY, sa)



QoQ = "quarter-on-quarter"; YoY = "year-on-year"; P = preliminary
Source: BBVA Research based on information from INEGI

Figure 3.8 GFCF by component
(Chge. % MoM, sa)



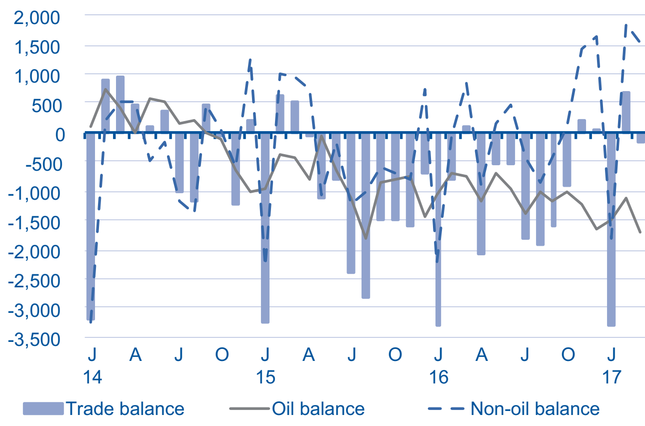
sa = seasonally adjusted; MoM = "month-on-month"
Source: BBVA Research based on information from INEGI

3.1.3 External Sector: in 1Q17 the trade deficit was smaller than in 1Q16

In 1Q17 Mexico's trade deficit was nearly US$2.9 billion. This deficit was smaller than that for the same period of 2016. The smaller deficit in the balance of trade in the first three months of 2017 was due to a surplus of nearly US$1.6 billion in the non-petroleum balance. In the same period of 2016 this account showed a deficit of nearly US$1.5 billion. On the other hand, the petroleum balance for 1Q17 showed a deficit of US$4.4 billion - more than that posted in the same quarter of 2016 (Figure 3.10).

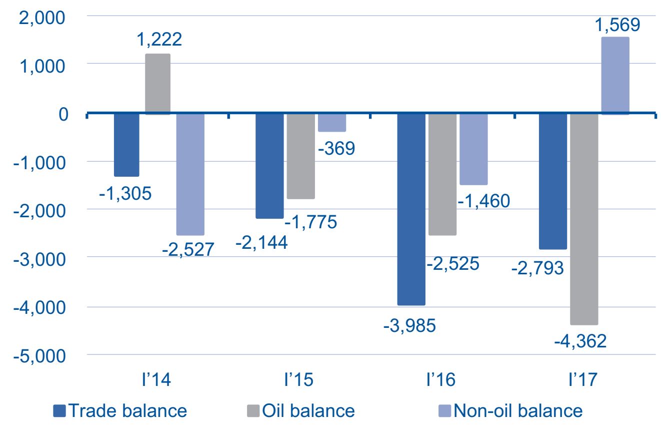
The deterioration in the petroleum balance of payments in 1Q17 was due to the increased volume of imports of these products. The YoY increase in the total volume of petroleum products imported in the quarter was 17.4% (Figure 3.11). For example, in 1Q17 the YoY increase in gasoline imports was 22.6%, while that of fuel oil was 208.1%. If imports of petroleum-based products continue to increase, oil prices remain relatively low and the crude oil export platform does not increase or even starts to decrease, the result will be continuing increases in the country's petroleum trade deficit.

Figure 3.9 Balance of trade in petroleum and non-petroleum goods (US$ billions)



Source: BBVA Research based on information from INEGI

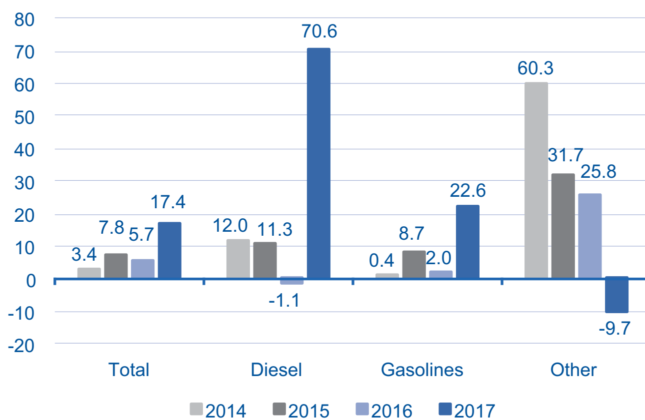
Figure 3.10 Quarterly balance of trade in petroleum and non-petroleum goods (US$ billions)



Source: BBVA Research based on information from INEGI

Another factor which contributed to the increased deficit in the petroleum balance in 1Q17 was the increase in the prices of imported petroleum products. For example, the average price of a gallon of regular gasoline in the US during the first quarter of 2016 was US$1.80. In the first quarter of 2017 the price of this type of gasoline increased by 25.5% YoY, to US$2.25 (Figure 3.12). In other words, the deterioration in the country's petroleum balance of payments in 1Q17 relative to 1Q16 was due to increases in both prices and volumes of imports of petroleum-based products.

Figure 3.11 Imports of petroleum-based products (% change YoY)



Total petroleum-based products = diesel, gasoline, fuel oil, liquefied gas and others. The original figures are in thousands of barrels per day
Source: BBVA Research based on information from the INEGI

Figure 3.12 Weekly average price of regular gasoline in the US (dollars per gallon)

Source: BBVA Research based on information from the U.S. Energy Information Administration

3.1.3.1 Exports of goods by type: exports of manufactured goods performed well

Total exports of goods had performed well since the last quarter of 2016, and continued to do so in 1Q17 (Figure 3.13). Moreover, the annual growth rate in total exports of goods in 1Q17 was 11.2% (Figure 3.14). It is worth pointing out that all the various categories of goods exported in 1Q17 posted positive rates of growth. Petroleum exports in particular stood out with an annual increase of 58.1%, although with just a 5% share of total exports their relative importance is limited.

This point is significant, and reminds us that exports of manufactured goods account for the lion's share. They grew by 9.2% YoY in the first quarter and accounted for 90% of total goods exports. Automotive exports grew by 9.6% and accounted for 30% of the total, while other manufactured exports grew by 9.1% and accounted for 60% of total exports of goods.

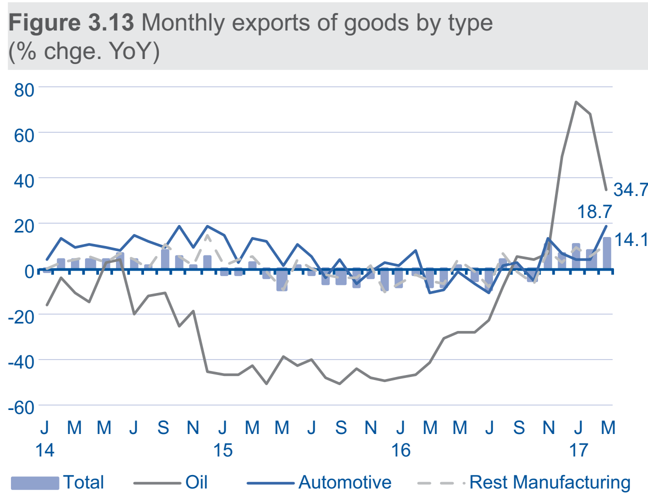


Figure 3.13 Monthly exports of goods by type (% chge. YoY)

Source: BBVA Research based on information from INEGI

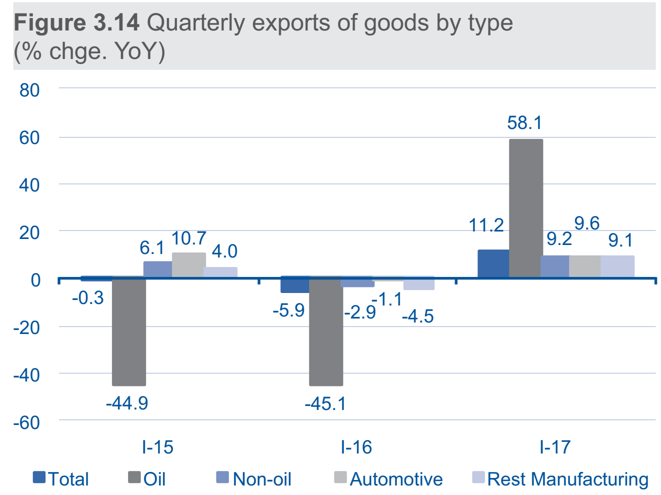


Figure 3.14 Quarterly exports of goods by type (% chge. YoY)

Non-petroleum exports include manufactured goods, agricultural and fisheries and non-petroleum extractive products

Source: BBVA Research based on information from INEGI

While exports of the various types of manufactured goods continue to grow at high rates, they will have a significant effect on other sectors of the economy as a driver of GDP growth.

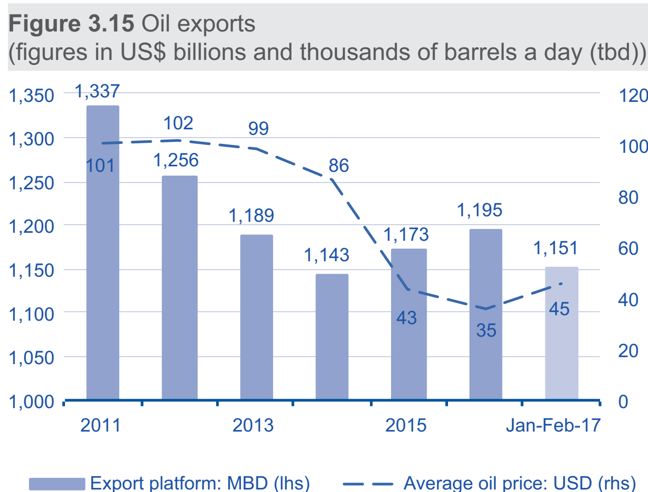


Figure 3.15 Oil exports (figures in US$ billions and thousands of barrels a day (tbd))

Source: BBVA Research based on information from INEGI

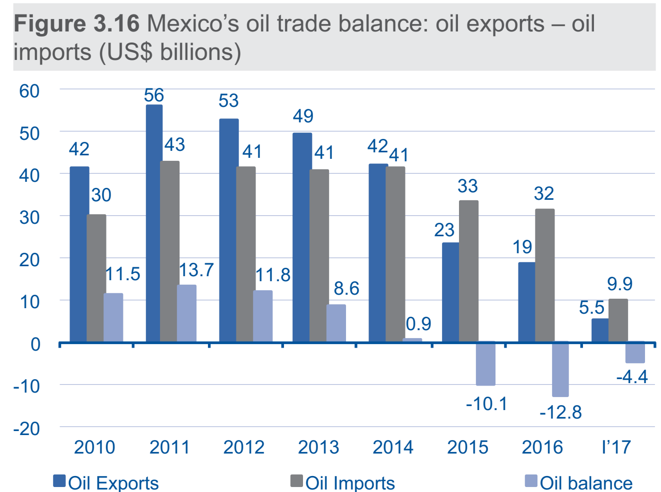


Figure 3.16 Mexico's oil trade balance: oil exports – oil imports (US$ billions)

Source: BBVA Research based on information from INEGI

Oil exports grew significantly in 1Q17. This was due to the 71.3% increase in the price of crude from 1Q16 (US$25.94 per barrel) to 1Q2017 (US$44.43). We should remember that the average price per barrel for Mexico's export crude in 2013 was US$86 (Figure 3.15), and given the current conditions in the international oil market we consider it unlikely that it will return to those levels.

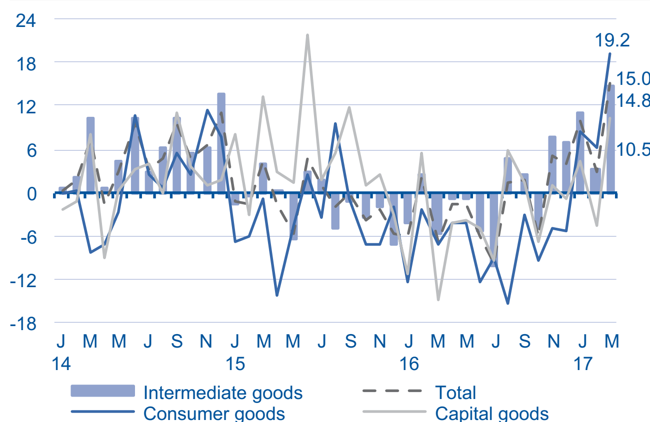
3.1.3.2 Imports of goods by type: growing at a similar rate to exports of manufactured goods

As with exports of goods, imports also started to pick up starting in the last few months of 2016, and continued to do so in the first quarter of 2017 (Figure 3.17). Also, in 1Q17 all categories of imported goods posted positive annual growth rates (Figure 3.18).

Therefore, in 1Q17 total imports of goods grew by an annual rate of 9.1%, which was less than the 11.2% growth in total exports in the same period. Imports of intermediate goods posted an annual growth of 11.4% for the quarter, which was more than the 9.2% growth in manufactured exports. We should mention that a large percentage of exports of manufactured products require imported intermediate products from which to make the end product for export. In this regard, we can expect to see the positive performance of exports of manufactured products reflected in similar dynamism in imports of intermediate products (Figure 3.18).

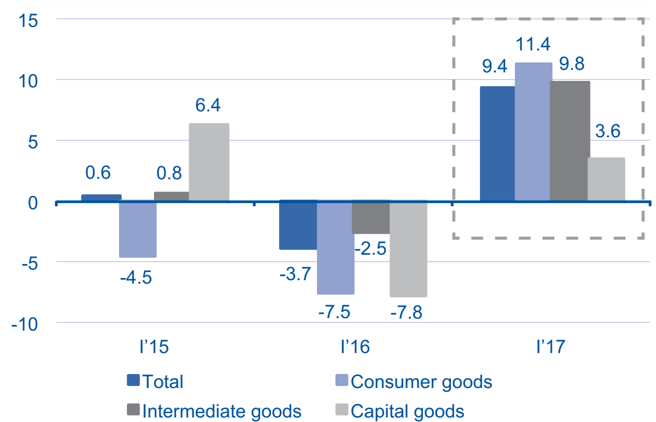
In 1Q17 imports of consumer goods also increased, at an annual rate of 9.8%. It should be borne in mind that imports of petroleum-based consumer goods increased by 69.7% in the quarter, while imports of non-petroleum based consumer goods declined by 1.5%. This point reinforces the points commented on in the sub-section on the petroleum trade balance, which showed a larger deficit in 1Q17 than in 1Q16 due to the increase in both volumes and prices of imported petroleum products.

Figure 3.17 Monthly imports of goods by type (% chge. YoY)



Source: BBVA Research based on information from INEGI

Figure 3.18 Quarterly imports of goods by type (% chge. YoY)



Source: BBVA Research based on information from INEGI

In 1Q17 imports of capital goods grew by just 3.8% YoY. This rate was less than that of the other import categories in the period. We should bear in mind also that changes in imports of capital goods tie in with those in GFCF. As commented in the sub-section on GFCF, in January and February 2017 the average year-on-year change was a negative 1.8%. In other words, the disappointing performance of total GFCF was reflected in the modest growth in imports of capital goods in 1Q17.

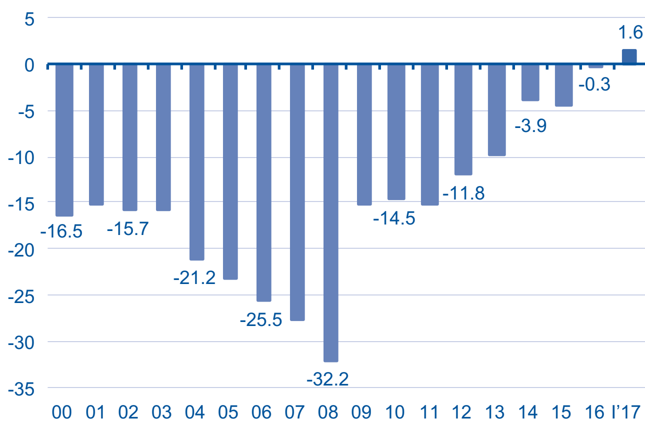
3.1.3.3 Balance of trade: the deficit in the petroleum trade balance is the current source of external imbalances

The balance of trade is made up of the petroleum and non-petroleum components. The non-petroleum balance of payments showed large deficits until 2008 (US$32.2 billion), decreasing to US$9.8 billion by 2013 but still remaining high. From 2014 the non-petroleum balance of payments fell substantially, and in 2016 it was only US$0.3 billion. This situation improved further in 1Q17 when the non-petroleum trade balance showed a surplus of US$1.6 billion (Figure 3.19).

In contrast, the petroleum balance of payments went into deficit in 2015, to the tune of US$10.1 billion (Figure 3.20). In 2016 this deficit increased to US$12.6 billion, and in 1Q17 this continued (Figure 3.16). The deficit shown by the oil balance is a result of the fall in the price of Mexico's export crude and the increased volume of imported petroleum-based products. Neither of these factors is expected to change substantially in the near future so as to reverse the deficit of the oil balance and thereby improve the overall balance of trade.

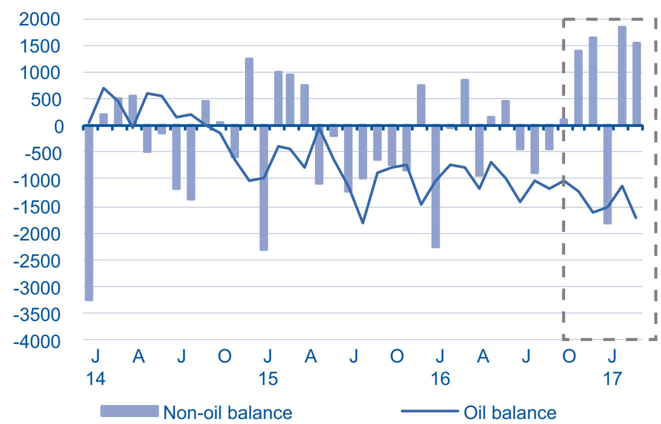
It is however possible to hope that the future positive performance of the balance of non-oil trade will help to alleviate the imbalance caused by the deficit in the oil balance. If this happened, it would be the result of highly favourable performance by the country's non-oil export sector, and in order for it to have a lasting effect it would have to be sustained over time. This point underlines the fact that the strengthening and consolidation of the country's export sector, and in particular the manufacturing export sector, is a reality that works to the advantage of its external accounts.

Figure 3.19 Balance of non-oil trade (US$ billions)



Source: BBVA Research based on information from INEGI

Figure 3.20 Balance of trade in non-petroleum goods (US$ billions)



Source: BBVA Research based on information from INEGI

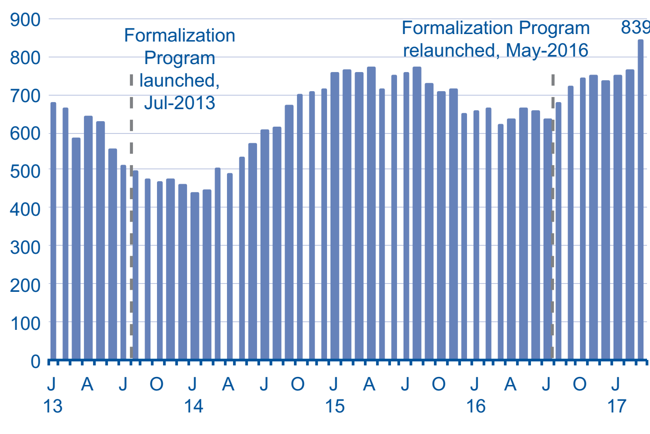
3.1.4 Recent trends in formal employment in the private sector (IMSS, Social Security) and average real wages: real wages at time of hiring

In the past few years the number of workers registered with the social security system (IMSS) has increased significantly. The total number of workers registered with the IMSS went from 16.5 million at the end of 2013 to 18.6 million in December 2016. In other words, in three years the total number of workers registered with the IMSS increased by 2.1 million. If we take the number of workers registered with the IMSS in March 2017, then the number of people in formal employment increased by nearly 2.5 million in three years and three months.

Part of the positive performance of formal employment is due to the Employment Formalisation Programme (PFE in Spanish) implemented by the labour authorities since July 2013 (Figure 3.21). This is borne out by the fact that the growth rate of formal employment increased even as growth in economic activity has slowed since 2013, as can be seen from the Total Economic Activity Index (IGAE in Spanish) (Figure 3.22).

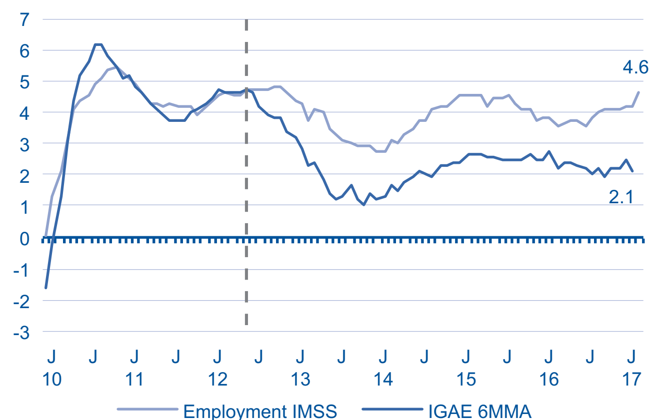
We should point out that the PFE consists of providing social security benefits to people who have a job but no social security. The "formalisation" of employment therefore consists of registering workers who did not have cover so that they can benefit from social security. The work carried out by the labour authorities in this regard has led to the growth rate in formal (i.e., Social Security-registered) employment has been twice that of the annual growth rate of the IGAE or even more. Accordingly, we estimate that between 60% and 65% of the increase in the number of workers registered with the IMSS is due to the PFE and the remaining 35% to 40% to growth in economic activity.

Figure 3.21 Increase in the total number of workers registered with the IMSS (Social Security) in 12 months (thousands of people)



Source: BBVA Research based on information from INEGI

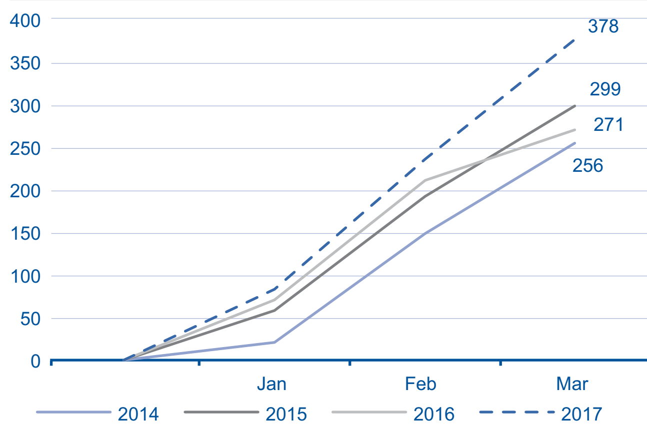
Figure 3.22 Annual growth rate of formal employment and the IGAE, 6-month moving average (Chge. % YoY)



6MMA = 6 month moving average
Source: BBVA Research with data from INEGI and STPS (Secretariat of Labour and Social Welfare)

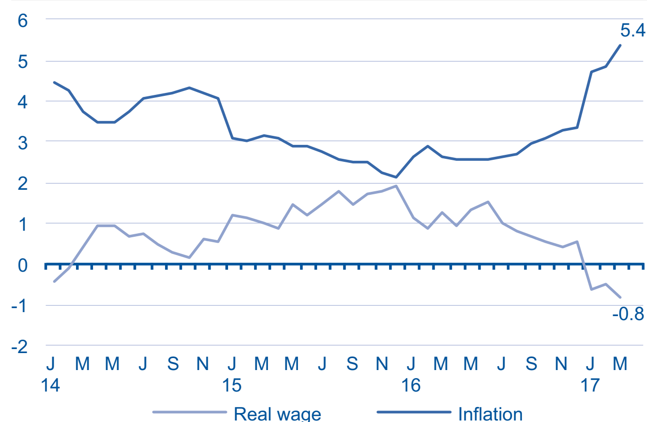
For as long as the PFE continues to produce positive results, formal employment will continue to grow strongly and the number of workers registered with the IMSS will increase significantly. By way of illustration, in the period from January to March 2014 the number of workers registered with the IMSS increased by 256,000 while in the same three months of 2017 it increased by more than 378,000 (Figure 3.23).

Figure 3.23 I Increase in the total number of workers registered with the IMSS (Social Security) over the course of the year (thousands of people)



Source: BBVA Research based on information from INEGI

Figure 3.24 Inflation and average real IMSS wages (% change YoY)



Source: BBVA Research with data from INEGI and STPS

One subject associated with the growth in formal employment is the trend in the average contribution base wage received by workers registered with the IMSS. The average base wage for IMSS contribution purposes in real terms is an indicator of changes over time in formal workers' purchasing power. An average real IMSS base salary that grows means increased purchasing power and therefore growth in private consumption. Based on the growth of this variable we can estimate the increase in GDP.

We should mention that in 2014, 2015 and 2016 the average annual growth rate in the average IMSS base salary in real terms was 0.4%, 1.4% and 0.9%, respectively (Figure 3.24). However, because of the uptick in the rate of inflation since January 2017, average real IMSS base wages in real terms declined YoY by 0.7% in 1Q17. We expect this negative rate to persist for the remainder of 2017 and possibly to be slightly positive in 2018. As a result of this persistent decline in real wages over the course of the year, wages will act as a brake on private consumption rather than driving it. This will continue until real wages start to grow again and increase workers' purchasing power.

3.1.5 Public finances: non-tax revenues sustained the increase in total budget revenue for the public sector in the first quarter of 2017, while federal payments to states and municipalities and financial costs drove total public spending

Total public sector budget revenue showed real annual growth of 33.4% in the first quarter of 2017. Importantly, this year-on-year comparison includes the amount of MXN 321.7 billion from the Bank of Mexico operational surplus. If we were to exclude this component from the budgetary revenues, the real rate of growth would be 3.1%.

If we break down total budgetary revenues into components, non-tax income (including the federal government's petroleum revenues) showed real annual growth of 283.0% in the first quarter of 2017. Excluding the central bank's operating surplus would imply an increase of 37.9% in this component in real annual terms. There was a 3.5% real annual decrease in tax revenues in the first quarter of 2017. This deterioration was due to income tax, as collection was down for the quarter by 4.1% in real annual terms, accounting for 57.2% of total tax revenues.

VAT is another major component of tax revenues, accounting for 27.4% in the first quarter of 2017. VAT grew at a real annualised rate of 2.1% in the first quarter of 2017, comparing favourably with a 4.9% annualised growth in 1Q 2016.

Public sector oil revenues accounted for 13.9% of total budget revenues in the first quarter of 2017 (13.4% during the same period in 2016). It is important to note that this revenue item increased in annual terms, with a real growth rate of 39.0% in the first quarter of 2017.

Table 3.1 Total public sector budgetary revenues from January to March (Billions of pesos)

	2016	2017	Real % change	% struct.
Total	**1,058.8**	**1,483.2**	**33.4**	**100.0**
Federal Government	848.1	1,235.1	38.7	83.3
Tax	723.1	732.5	-3.5	49.4
Income Tax	416.3	419.2	-4.1	28.3
VAT	187.2	200.6	2.1	13.5
Non-tax	125.0	502.6	283.0	33.9
Agencies & companies	78.4	84.8	3.1	5.7
Gvmnt. productive co.	132.4	163.3	17.5	11.0
Pemex	67.1	84.1	19.4	5.7
CFE	65.3	79.2	15.6	5.3
Total	**1,058.8**	**1,483.2**	**33.4**	**100.0**
Oil revenue	141.4	206.3	39.0	13.9
Non-oil revenue	917.5	1,276.9	32.6	86.1

Source: BBVA Research with Finance Ministry (SHCP) data

Table 3.2 Net public sector spending in January to March (Billions of pesos)

	2016	2017	Real % change	% struct.
Total	**1,110.3**	**1,176.3**	**0.9**	**100.0**
Projected expenditure	865.2	851.0	-6.3	72.3
Current expenditure	682.5	700.6	-2.2	59.6
Capital expenditure	182.7	150.5	-21.5	12.8
Non-projected expen.	245.1	325.3	26.4	27.7
Investments in states	158.9	199.1	19.3	16.9
Borrowing cost	66.1	100.2	44.3	8.5
Adefas* and other	20.1	25.9	23.2	2.2

Adefas: Liabilities carried over from previous years.
Source: BBVA Research with Finance Ministry data

Net public sector spending increased by 0.9% in the first quarter of 2017 (real annualised rate). This was mainly due to non-programmable spending (accounting for 27.7% of total net public sector spending in the quarter), with real annualised growth of 26.4% in 1Q 2017. Within non-programmable spending, federal payments to states and municipalities increased in real annual terms by 19.3%. Financing costs rose by 44.3% in real annual terms during the quarter.

It is important to acknowledge that the public accounts came under further pressure from payments to states and municipalities, public sector pensions and the cost of public debt in the first quarter of 2017. Our own calculations show that without financial investment and federal payments to the states and municipalities, other spending was kept in check, with a real YoY reduction of 1.9% in that quarter. And if we also omit public sector pensions and the financial cost of public debt, then the reduction in spending is even more significant, at around 6.8% in real annualised terms in 1Q2017.

The real annualised reductions in these more limited items of spending show the federal government's efforts to maintain some measure of financial discipline in the items that are more directly under its control. The federal government will have to step up its efforts to rein in spending in 2017 if it is to reach its targets of a primary surplus of 0.5% and a debt stock of 49.5% of GDP.

Table 3.3 Public spending indicators in January to March (Billions of pesos)

	2016	2017		
	Nominal	Nominal	Real	Real % change
Total net expenditures	**1,110.3**	**1,176.3**	**1,120.5**	**0.9**
Without financial investment	1,094.9	1,163.3	1,108.1	1.2
Without financial investment and participations	936.0	964.2	918.4	-1.9
Without financial investment, participations and pensions	776.1	794.5	756.8	-2.5
Without financial investment, participations, pensions and financial cost	710.0	694.3	661.4	-6.8

Source: BBVA Research con información de la SHCP

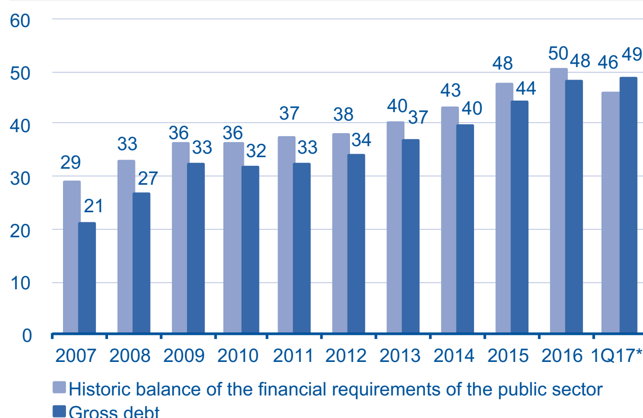
Table 3.4 Financial situation of the public sector January to March (Billions of pesos)

	2016	2017	Real % chge.
Public Balance	-61.6	309.1	n.s.
Pub. Bal. w/o Prod. Investment	56.4	398.4	573.2
Budget Balance	-51.5	306.9	n.s.
Budget Revenue	1,058.8	1,483.2	33.4
Net Budget Expenditure	1,110.3	1,176.3	0.9
Federal Govnmt. Balance	-26.1	309.2	n.s.
Agencies & Co. Balance	-25.4	-2.3	-91.4
Primary Balance	21.6	414.6	1,728.6
Budget Balance	14.6	407.1	2,547.6
Federal Government	14.0	367.8	2,409.0
Agencies & Companies	0.7	39.3	5,381.2
Pemex	-53.4	-19.5	-65.2
Other institutions	54.0	58.8	3.6
Indirectly-controlled institutions	7.0	7.6	3.6

n.s. = not significant
Source: BBVA Research with Finance Ministry data

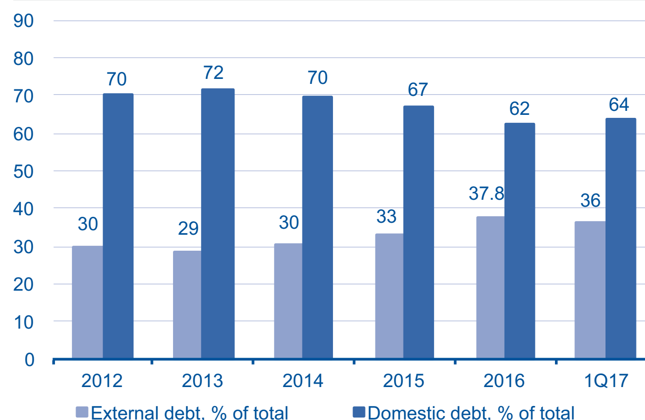
The primary public sector balance showed significant improvement in the first quarter of 2017, coming in at MXN 414.6 billion as against MXN 21.6 billion in the same quarter of 2016. The increase in the primary surplus was largely due to the federal government balance. We should point out that it will be crucial to keep a tighter rein on the finances of the federal government and the state-owned manufacturing companies in order to meet the target of a primary surplus of 0.5% of GDP for the entire public sector in 2017.

Figure 3.25 Gross debt and public sector financing requirement* (as % of GDP)



* To calculate total debt stock and public debt we used the preliminary GDP figure for the first quarter and a GDP deflator of 5.2%.
Source: BBVA Research based on Ministry of Finance and INEGI data

Figure 3.26 Percentage structure of internal and external public sector debt (% of the total debt)



Source: BBVA Research based on Ministry of Finance data

Gross public debt stood at 48.8% of GDP at the end of the first quarter of 2017. This is 0.9 percentage points higher than at the end of 2016. As regards the breakdown of this debt into domestic and external components, external debt went from 37.8% in 2016 to 36.0% at the end of the first quarter of 2017. The appreciation of the Mexican peso against the dollar during the period was undeniably a prime factor in the reduced proportion of gross external debt.

In the first quarter of 2017, the public debt stock (SHRFSP) was 17 pp of GDP higher than its level in 2007. For 2017 the Ministry of Finance sees this balance being reduced to 49.5% of GDP from 50.2% of GDP in 2016. In this regard it is important to point out that the annual deficit in the public sector financing requirement was approved at 2.9% of GDP for 2017 (compared with 4.1% and 2.9% of GDP in 2015 and 2016 respectively).

The Ministry of Finance says that the public debt stock stood at 50.2% of GDP at the end of last year. This figure is less than the forecast of 50.5% given by the Ministry of Finance in its 2017 General Economic Policy Criteria. Assuming an annual deficit of 2.9% for public sector financing requirements, a GDP deflator of 5.2% and real GDP growth of 1.6% this year, the public debt stock as a percentage of GDP would decline to 49.5% of GDP.

3.1.6 Outlook for the Mexican economy in 2017

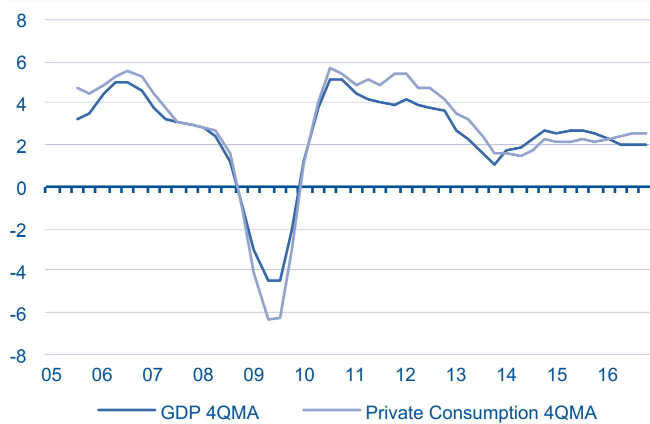
As commented at the beginning of this section, we expect the rate of GDP growth for 2017 to be 1.6%. We should point out that this will be achieved if private consumption continues to perform positively despite the slowdown in its growth, given the close link between this variable and GDP (Figure 3.25). In other words, the performance of private consumption is reflected directly and without a lag in GDP.

We also commented that another factor behind the GDP growth that we estimate for 2017 is the weakness of GFCF. So, if exports of goods and services show dynamic, sustained growth, their increased volume will favour GDP growth, both per se and by encouraging higher levels of GFCF (Figure 3.26), as has been the case in the past with a lag of two quarters.

In other words, in 2017 the export sector may become the main source, direct and indirect, of GDP growth, through an increase in volume and relative importance and by also favouring the growth of other macroeconomic variables. If the export sector continues to perform well throughout the year, the direct and indirect effects will enable the economy to grow at 1.6%, and possibly by even more than this.

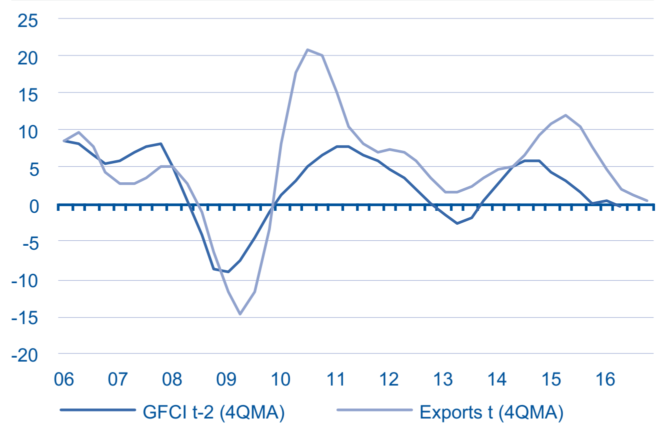
All these points are of course feasible only if no other risk factors arise during the year and have a significant impact on GDP growth. An example of this could be a sharp downward adjustment in the international price of the crude oil that Mexico exports. In this regard, in order for Mexico's GDP to grow by 1.6% or more in 2017 it is essential that favourable macroeconomic conditions persist.

Figure 3.27 GDP and Private Consumption
(% change YoY, sa)



sa = seasonally adjusted; 4QMA = four quarters moving average
Source: BBVA Research based on information from INEGI

Figure 3.28 Exports and GFCF
(Chge. % YoY, sa)



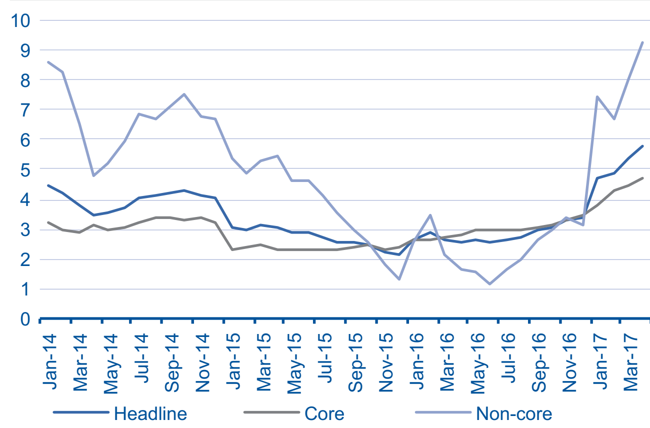
sa = seasonally adjusted; 4QMA = four quarters moving average; q-2 indicates a lag of 2 quarters
Source: BBVA Research based on information from INEGI

3.2 Inflation continues to rise

So far this year we have seen a significant increase in inflation. Headline inflation had been low and steady over the past two years (2015-16), averaging 2.8% for that period (2.7% in 2015 and 2.8% in 2016) and slightly exceeding 3.0% in only two quarters of those two years (1Q15 when it averaged 3.1% and 4Q16 when it averaged 3.2%), but from January 2017 it showed a sharp upturn, as we were anticipating. Inflation continues to rise After remaining below the permanent 3% target for 17 months in a row, it jumped 1.36% pp in January, from 3.36% in December 2016 to 4.72%. The annual rate has continued to climb, reaching 5.82% in April, well above the central bank's 3% target and even above the 4% upper limit of the range of tolerance (see Figure 3.29).

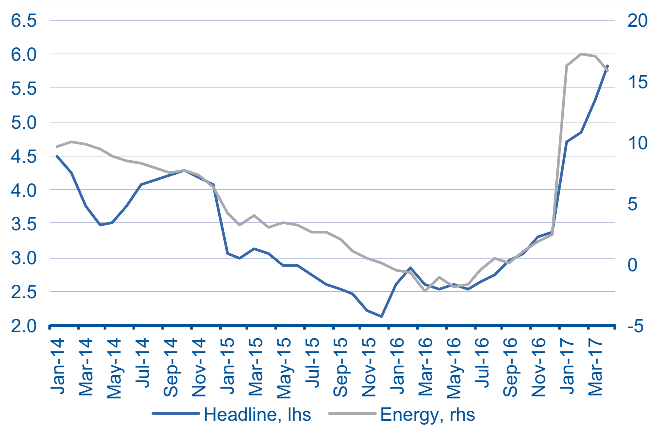
What is the explanation for this increase? Inflation has increased for two main reasons: the increased rate of pass-through to goods from the cumulative depreciation of the peso over the past two years, and the sharp increase in energy prices (see Figure 3.30). The marked uptick largely reflects a change in relative prices, but inflation of services is also showing a rising trend (see Figure 3.31), and risks of second-order effects are on the increase.

Figure 3.29 Headline Inflation and components
Chge. % YoY



Source: BBVA Research based on INEGI data

Figure 3.30 Headline inflation and energy prices
Chge. % YoY



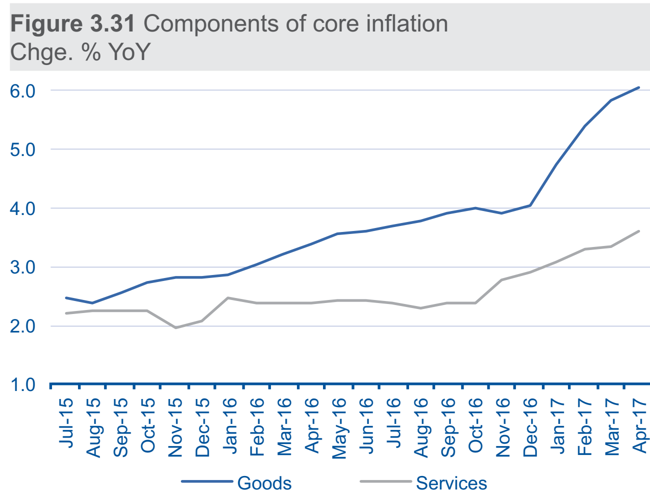
Source: BBVA Research, INEGI

The sharp increase in January 2017 is the result of the 12.7% increase in the energy price component (see Figure 3.30), which had a monthly impact of 1.2 pp on headline inflation and is explained by a fiscal policy of liberalising the prices of certain energy items, particularly gasoline and LPG. This measure had a significant impact on annual inflation (see Figure 3.31). Nonetheless, the effect of this measure on prices should be transitory. As a result of the foregoing, annual headline inflation went from an average of 3.24% in 4Q16 to an average of 4.98% in the first quarter of 2017. At the end of 1Q17 it stood at 5.35% and in April it rose further, to 5.82%. These increases reflect the strong short-term impact on headline inflation of the liberalisation of energy prices. Average annual core inflation went from 3.28% in 4Q16 to 4.19% in 1Q17. At the end of 1Q17 it stood at 4.48% and in April it rose further, to 4.72%. Within core inflation, the goods index increased by 2.0 pp between December 2016 and April 2017 (from 4.05% to 6.05%). Both sub-indices of this component showed significant increases in the period, from 4.40% to 6.77% in the case of food and from 3.76% to 5.45% in that of non-food goods. The services index also increased, albeit by less, going from 2.92% to 3.59% between December and April. While admittedly there have not yet been any generalised second-order effects on the price formation process, the uptick in the cost of services shows that there have been indirect effects on the price of services that use energy and/or other imported goods affected by the increased pass-through rate as inputs.

Although the sharp increase in inflation is due to both the above-mentioned factors, the effect of the increase on goods is more important for the inflationary trend. As shown in Figure 3.29, the increased slope in the inflation component trend suggests that, as we had envisioned, the pass-through rate increased in the early part of the year. This situation was foreseeable not only because of the additional depreciation of the peso in the wake of the US election, but also because, despite the economic slack and companies' resulting reduced pricing power, we expected that it would be difficult to keep absorbing the increase in costs through lower margins. We believe there is still some way to go in the process of passing on the effects of the currency depreciation to prices of goods; however, the risks ahead are now less than they were thanks to the peso's significant appreciation (approximately 15%) since touching bottom in January this year. The higher pass-through rate in 2017 was driven not only by the peso's level of cumulative depreciation (around 40%) but also by the currency's persistent weakness.

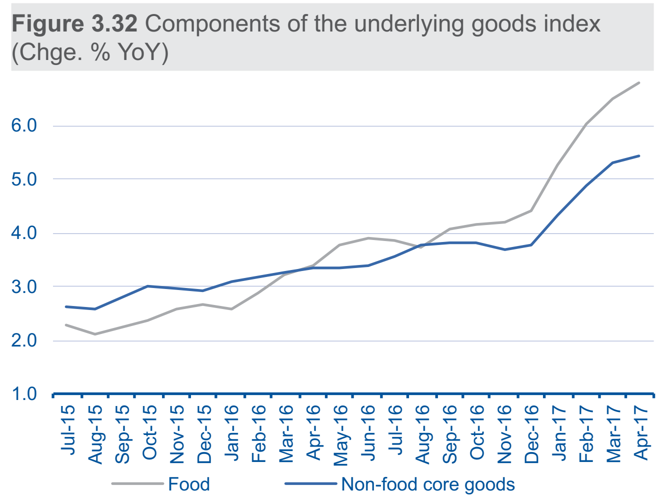
Unlike the two earlier periods of peso weakness (2008-09 and 2011-12), which lasted a short time and dissipated rapidly, the latest one ran for more than two years, from 4Q14 to January 2017. The good news is that the currency seems unlikely to change much from its current level during the remainder of the year and indeed might even strengthen further. If so, the annual rate of depreciation will tend to fall quickly in the second half of the year and might even show a negative variation towards year-end and particularly from January 2018 on. This should bring about a lower rate of pass-through in the following months. Consequently, the risks have diminished and it has become more likely in the past three months that the pass-through effect from the cumulative currency depreciation to price inflation of goods is of a passing nature. In fact, this is reflected in the reduction in medium- and long-term inflationary expectations, together with the upward trend of the peso since the end of January.

Figure 3.31 Components of core inflation
Chge. % YoY



Source: BBVA Research, INEGI and Bloomberg

Figure 3.32 Components of the underlying goods index
(Chge. % YoY)



Source: BBVA Research, INEGI

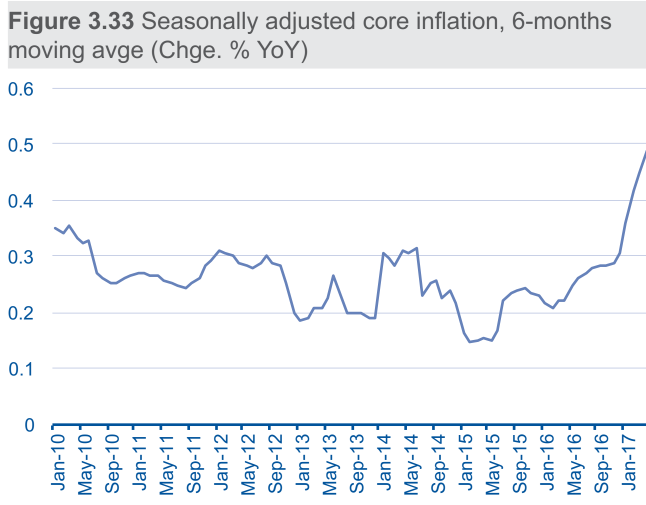
The absence of generalised second-order effects needs to be seen in the context of an environment supported by the credibility of the central bank's monetary policy, the slack in the economy and the rigidity of nominal wages, which means a contraction of real wages and therefore no wage-pressure on prices. So, while the pass-through effect is starting to fade, as reflected by lower prices for telecommunications services, for some services we see only indirect effects on pricing, and for the goods component of core inflation we continue to see changes in relative prices with a much greater upward tendency, whereas the pass-through to headline inflation is much lower, mainly due to the aforementioned absence of second-order effects.

Although the increase in inflation will be short-lived, it will continue, reaching 6.0% in the summer before easing in 4Q17 and ending the year at around 5.6%

Although, as explained, we are dealing with two changes in relative prices, both of which should prove to be of a passing nature, inflation will not show signs of moderation until September. As can be seen in Figure 3.33, the trend in seasonally adjusted monthly core inflation continues to rise, with perhaps some moderation in the last month. We believe the annual inflation rate is likely to continue to increase in the next few months, both because the pass-through still has some way to go and because of an adverse base effect (low average inflation from May to August 2016). The most important thing is for the Bank of Mexico to continue to anchor inflationary expectations and stick to its preventive strategy so as to limit the risks of second-order effects, although the rate of pass-through will no doubt decline as time goes by given the recent strengthening of the peso.

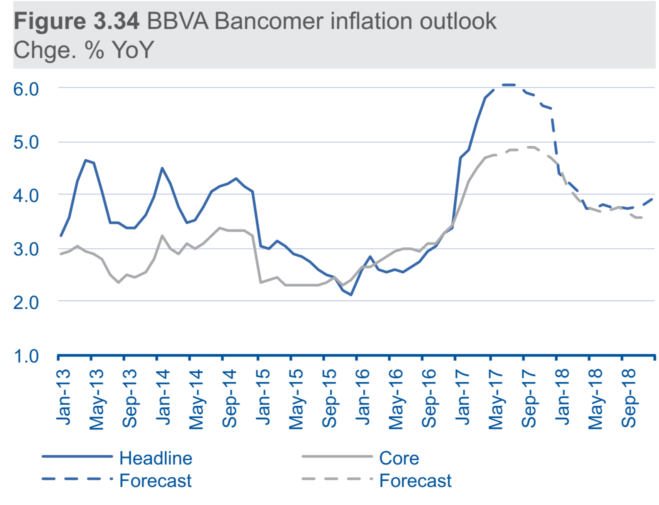
We see annual headline inflation staying at around 6.0% on average from May to September, before easing to an average of 5.7% in the last quarter. Our year-end forecast is now 5.6% (6.0% before), for two main reasons: i) the unexpected and significant strengthening of the peso in the past few months (15% since touching bottom in January), which at the same time makes it less necessary to increase prices of gasoline (more than half of which is imported), and ii) the government's decision to smooth the process of passing on world energy prices, a change which we had not foreseen, and which means that the increases of the past few months will be passed on much more gradually than they were in January. In January 2018, a highly favourable base effect will allow a decline of 1.2 pp to 4.4%, and from February of that year we expect to see a gradual downward trend, with inflation ending the year slightly below 4.0% (3.9%), within the central bank's target range.

Figure 3.33 Seasonally adjusted core inflation, 6-months moving avge (Chge. % YoY)



Source: BBVA Research, INEGI and Bloomberg

Figure 3.34 BBVA Bancomer inflation outlook Chge. % YoY



Source: BBVA Research, INEGI

Our forecasts are subject to both upside and downside risk. The main downside risks are further strengthening of the peso and a lower-than-expected dynamic in the economy resulting in an additional increase in the output gap, and the possibility of reductions in world energy prices. The main upside risks are now associated with the increased probability of our seeing second-order effects and an increase in inflationary expectations, and a possible new slide in the peso if it begins to seem that the renegotiation of NAFTA will lead to substantial changes in trading relations between Mexico and the US.

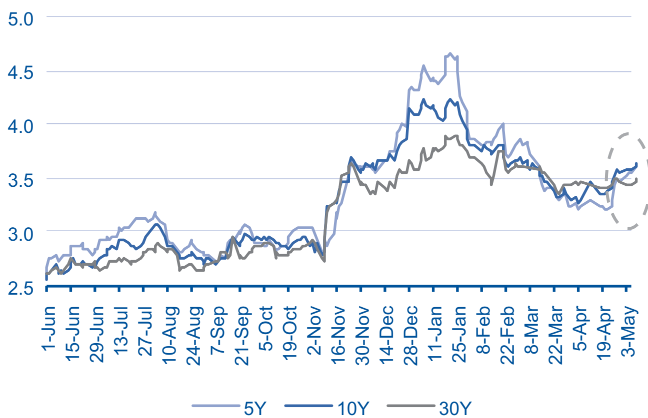
3.3 The monetary tightening cycle continues, given the inflationary risks

The improved prospects regarding the renegotiation of NAFTA, reflected in a significant appreciation of the peso in the past few months, led the central bank to ease the pace of monetary tightening during March and adopt a less restrictive stance than in previous months. Nonetheless, the persistence of inflation and a new bout of currency volatility show that the risks remain.

The significant appreciation of the peso since Donald Trump took office and the improved prospects for trade led to an abrupt fall in both analysts' inflationary expectations and yields on fixed income securities. In view of this situation, the Bank of Mexico moderated its recently adopted restrictive stance. In its latest monetary policy meeting it reduced the pace of monetary tightening, increasing the base rate by 25 bps (the previous six hikes had each been 50 bps) and stressing the absence of second-order effects and the passing nature of the inflationary shocks. Additionally, the central bank highlighted the rises in the base rate since 2015, which will largely contribute to the convergence of inflation in 2018. This statement was largely influential in the decision of many analysts to once again align the prospects for Mexico's base rate with expected movements in the US Federal Reserve's key rates.

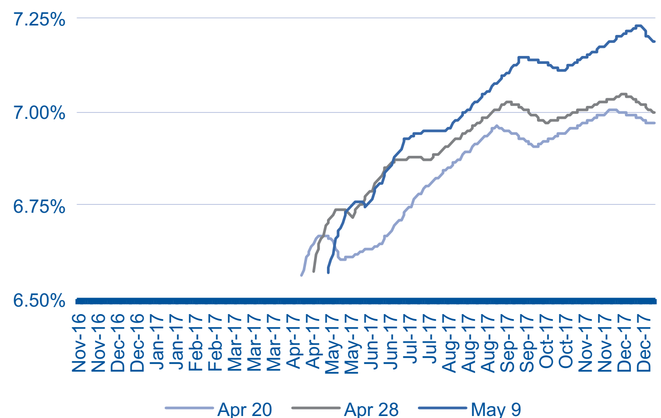
However, April's inflation figures, which exceeded consensus expectations, and a new bout of exchange rate volatility, were reflected in a slight uptick in medium-term inflationary expectations, which in our opinion will lead the Bank of Mexico to continue with the cycle of tightening during the next few months. After all, the trend in goods inflation is continuing to rise, already exceeding 6.0% YoY, and there is no sign of a let-up in the increase of service prices, which is currently running at 3.6%. All this makes us think that the risk of second-round effects cannot be ruled out. Additionally, the fall in oil prices and Trump's renewed threats to withdraw from NAFTA are clear signals that bouts of volatility will recur in the next few months. Given this environment, implied expectations of the base rate for fixed income instruments have risen again, and now practically factor in a further hike in the meeting of 18 May, a view that we share. In fact, we consider that in order to anchor expectations and minimise the prospect of second-order effects, the Bank of Mexico need to continue the tightening cycle, increasing the base rate by 25 bps at its May meeting.

Figure 3.35 Implied inflationary expectations for government fixed income instruments* (%)



*Note: Medium- and long-term expectations were adjusted downward by 40 bps to reflect the compensation for inflationary risk.
Source: BBVA Research based on Bloomberg data

Figure 3.36 Expectations of the official policy rate implicit in the IRS curve (%)



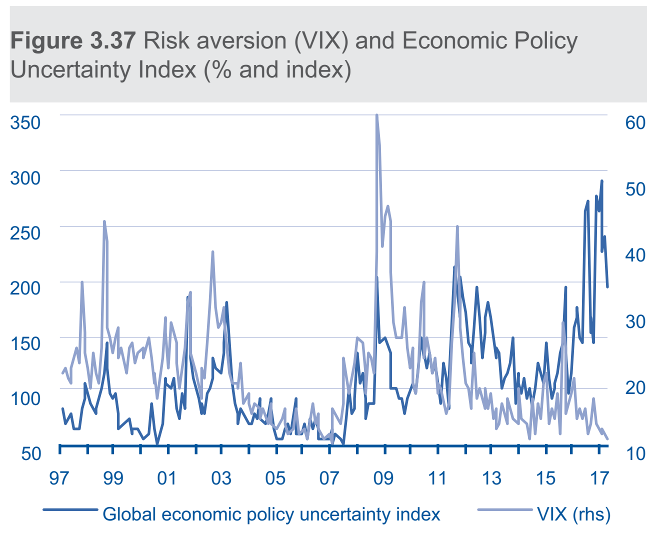
Source: BBVA Research based on Bloomberg data

Looking ahead, a change in the inflationary trend towards the end of the summer could be the sign that the tightening cycle has come to an end, similarly to what happened in 2008, the last time that headline inflation persistently exceeded the upper limit of the tolerance range around the inflation target (4.0%). Specifically, we expect two more hikes of 25 bps each in the second quarter of the year before inflation starts to come down. This outlook is based on the assumption that there will be no significant bouts of currency depreciation and that the US Federal Reserve will continue with its process of monetary normalisation, with an additional 50 bps increase in the remainder of the year. If either of these assumptions were not to materialise, Mexico's monetary policy rate would continue on its upward trend.

3.4 The appreciation of the Mexican peso stands out favourably in an environment of greater demand for emerging market assets

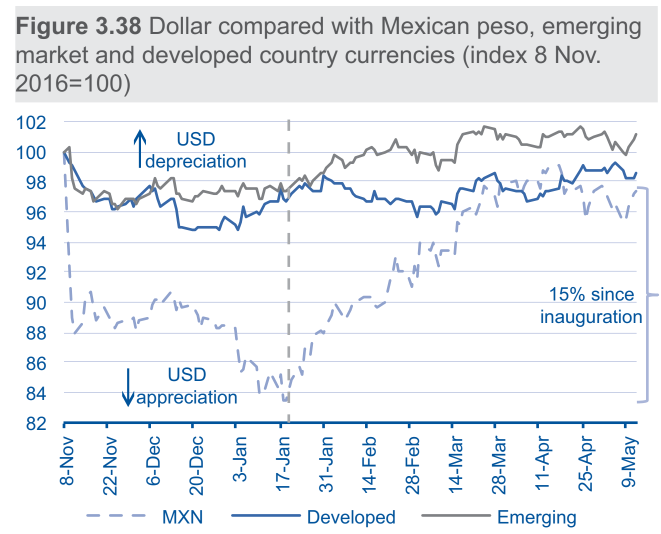
The behaviour of the financial markets in the past few months has been characterised by a greater demand for risk assets, especially those of emerging markets, underpinned by better-than-expected data on the global economy, levels of risk aversion close to all-time lows and expectations of fiscal and regulatory changes in the US. We have seen gains in all the main asset classes, despite uncertainty, geopolitical risks, the bias towards faster monetary normalisation on the part of the US Federal Reserve and renewed doubts about the effectiveness of the OPEC's production cuts in reducing surplus supply in the oil market. The equity markets largely reflect this, although returns have slipped compared to last November. The benchmark for world equity markets, MSCI World, has gained 8.0% so far this year, recently reaching an all-time high, while the S&P500 has risen by 6.3%, underpinned by the outline of the Trump administration's fiscal plan, employment and consumption figures pointing to more solid second-quarter US growth and better-than-expected first-quarter corporate earnings reports.

Figure 3.37 Risk aversion (VIX) and Economic Policy Uncertainty Index (% and index)



Source: BBVA Research based on Bloomberg data

Figure 3.38 Dollar compared with Mexican peso, emerging market and developed country currencies (index 8 Nov. 2016=100)



Source: BBVA Research based on Bloomberg data

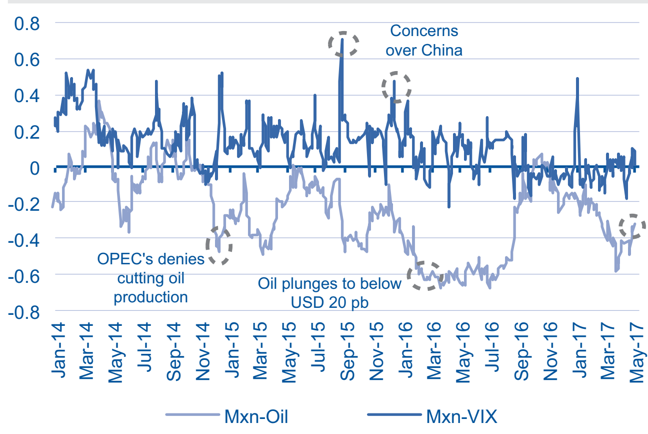
However, in April returns started to show a declining trend amid talk of a possible overvaluation of the equity market based on conventional metrics such as p/e ratios. Growth of emerging equity markets accelerated in April, the MSCI EM benchmark gaining 2.0%, giving a YTD return of nearly 17.0%. Within this category, Mexico's IPyC stock exchange index reached a new all-time high in May and has returned 7.6% so far this year. This particularly positive performance of equity markets depended largely on the low levels of risk aversion. The VIX, which is a proxy for global risk aversion, is currently below 10.0%, a level not seen since the 1990s, and well below the 19.5% average of the past 27 years. This low volatility contrasts with the high level of political uncertainty globally, as reflected in the Global Economic Policy Uncertainty Index, and constitutes a source of risk for the future.

In the currency markets, the dollar lost ground to emerging market currencies, not least the Mexican peso. Statements by several officials in the Trump administration in favour of a mutually beneficial renegotiation of NAFTA, and the reduced likelihood of the US fiscal reform's including a "border adjustment tax" led to the adverse scenario factored in by the markets becoming less and less likely. So, after trading at as much as 22.0 pesos to the dollar before Trump's inauguration, the peso appreciated until in mid-April it was at 18.5 to the dollar, a level not seen since before the US presidential election. This appreciation of 12.0% from the end of 2016 to 17 April made the Mexican peso the currency that had appreciated most, by some distance. (The emerging market currency with the second biggest appreciation in period in question was the Russian rouble, with 9.0%).

Although the gloomy scenario envisaged at the beginning of the year seems less and less likely, Trump's repeated threat at the end of April to leave NAFTA shows that this unfavourable scenario cannot yet be ruled out entirely, particularly as the US government has not even sent Congress the formal request to start the process of renegotiating NAFTA. Rumours that Trump had sent Congress an executive order to quit NAFTA took the dollar back up above 19.2 pesos. Apart from this, in the past few weeks the exchange rate again showed some volatility in reaction to movements in oil prices. Indeed, doubts as to whether OPEC's current cuts can reduce the over-supply of crude in the market have led to new falls in the price of oil. In these circumstances, the correlation between daily movements in the oil price and changes in the exchange rate has increased to levels not seen since the end of 2015, pointing to its persisting at least until 25 May, when OPEC meets to decide whether to maintain or increase the production cuts.

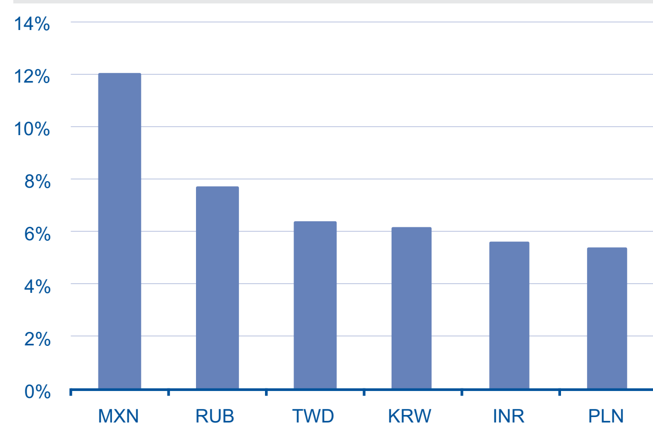
To the extent that the positive performance of risk assets has been underpinned by expectations regarding US economic policy and low risk aversion, going forward we will have to be attentive to the debate about fiscal reform in the US, the possible measures to deregulate the financial sector and the infrastructure plan. We shall also have to follow closely the development of geopolitical stresses and data from China's economy, which could bring an end to the period of low risk aversion that we have seen so far this year. In particular, as regards the exchange rate, we consider that until the US's NAFTA renegotiation objectives have been formally made known, the main risk for the Mexican peso remains, and for this reason we are holding to our forecast of 20.5 pesos to the dollar for year-end. We should point out that if the statements in favour of a mutually beneficial renegotiation are formalised, there would be scope for an appreciation to levels of around 19.5 pesos to the dollar.

Figure 3.39 Correlation between daily movements in exchange rate and oil and risk aversion (VIX)



Source: BBVA Research based on Bloomberg data

Figure 3.40 Appreciation of emerging market currencies between year-end 2016 and 17 April 2017 (%)



Note: RUB: Russian rouble, TWD: Taiwan dollar, KRW: Korean won; INR: Indian rupee; PLN: Polish zloty
Source: BBVA Research based on Bloomberg data

4. Indicators and forecasts

Table 4.1 Macroeconomic forecasts: Gross Domestic Product

(YoY growth rate)	2014	2015	2016	2017	2018
United States	2.4	2.6	1.6	2.3	2.4
EMU	1.2	1.9	1.7	1.7	1.7
Germany	1.6	1.5	1.8	1.7	1.6
France	0.7	1.2	1.1	1.4	1.5
Italy	0.2	0.6	1.0	1.0	1.2
Spain	1.4	3.2	3.2	3.0	2.7
UK	3.1	2.2	1.8	1.7	1.3
Latin America *	0.8	-0.3	-1.5	1.1	1.8
Mexico	2.3	2.6	2.1	1.6	2.0
Brazil	0.5	-3.8	-3.6	0.9	1.8
EAGLES **	5.4	4.7	4.8	4.9	5.0
Turkey	5.2	6.1	2.9	3.0	4.5
Asia-Pacific	5.6	5.6	5.5	5.2	5.1
Japan	0.2	1.2	1.0	0.8	0.9
China	7.3	6.9	6.7	6.3	5.8
Asia (exc. China)	4.2	4.5	4.5	4.2	4.5
World	3.5	3.3	3.1	3.3	3.4

* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
** Saudi Arabia, Bangladesh, Brazil, China, Philippines, India, Indonesia, Irak, Mexico, Nigeria, Pakistan, Russia, Thailand and Turkey.
Forecast closing date: 12 April 2017.
Source: BBVA Research & FMI

Table 4.2 United States indicators and forecasts

	2015	2016	2017	2018	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17
Macroeconomic Indicators												
GDP (real % change)	2.6	1.6	2.3	2.4	0.8	1.4	3.5	2.1	0.7	4.0	2.4	2.2
Personal consumption (real % change)	3.2	2.7	2.1	2.1	1.6	4.3	3.0	3.5	0.3	2.0	2.0	1.8
Gov. consumption (real % change)	1.8	0.8	1.3	1.5	1.6	-1.7	0.8	0.2	-1.7	9.1	0.5	0.6
Gross fixed investment (real % change)	5.0	-1.6	3.0	3.0	-3.3	-7.9	3.0	9.4	4.3	-1.8	4.7	3.0
Construction	11.7	4.9	5.6	2.9	7.8	-7.8	-4.1	9.6	13.7	3.8	5.1	3.2
Industrial prod. (real annual % change)	-0.7	-1.2	1.3	2.2	-1.3	-0.6	0.6	0.9	1.3	1.3	2.6	2.4
Current account balance (% of GDP)	-2.5	-2.6	-2.4	-2.2	-2.9	-2.6	-2.5	-2.4	-2.7	-2.4	-2.4	-2.2
Final annual inflation	0.7	2.0	2.0	2.1	-3.3	-1.8	-2.8	-2.3	-1.5	-2.2	-2.0	-1.8
Average annual inflation	0.1	1.3	2.3	2.0	-2.5	-1.6	-3.2	-2.4	-1.6	-2.0	-2.1	-1.9
Primary fiscal balance (% of GDP)	-2.6	-3.1	-3.7	-2.4				-3.1				-3.7

Note: **Bold** figures are forecast
Source: BBVA Research

Table 4.3 Mexico Indicators and Forecasts

	2014	2015	2016	2017	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17
Economic Activity												
GDP (seasonally-adjusted series)												
Real annual % change	2.3	2.6	2.1	1.6	2.3	1.6	2.0	2.4	2.2	2.2	1.3	0.8
Per inhabitant (US dollars)	10,783	9,443	8,536	8,541	8,502	8,733	8,457	8,454	8,402	8,719	8,599	8,443
US$ billions	1,291	1,143	1,044	1,055	1,040	1,068	1,034	1,034	1,038	1,077	1,062	1,043
Inflation (average, %)												
Headline	4.02	2.72	2.82	5.66	2.69	2.56	2.78	3.24	4.98	5.94	6.02	5.71
Core	3.18	2.36	2.97	4.64	2.69	2.91	3.00	3.28	4.19	4.73	4.86	4.79
Financial Markets (average, %)												
Interest rates												
Bank funding	3.00	3.02	4.29	6.73	3.58	3.92	4.42	5.25	6.17	6.75	7.00	7.00
28-day Cetes	3.00	3.25	4.33	6.77	3.61	3.88	4.27	5.18	6.11	6.81	7.04	6.99
28-day TIIE	3.35	3.44	4.58	7.06	3.89	4.09	4.60	5.44	6.13	7.08	7.33	7.33
10-year Bond (%, average)	6.01	5.94	6.20	7.47	6.12	5.99	5.93	6.81	7.40	7.46	7.62	7.52
Exchange rate (average)												
Pesos per dollar	13.37	15.97	18.71	19.70	17.84	17.97	18.97	20.05	20.29	19.10	19.60	20.20
Public Finances												
*FRPS (% of GDP)	-4.6	-4.1	-2.9	-2.9	-	-	-	-2.9				-2.9
External Sector[3]												
Trade balance (US$ billions)	-3.1	-14.6	-10.0	-14.7	-4.0	-3.1	-5.3	-0.7	-2.8	-3.4	-4.6	-3.9
Current account (US$ billions)	-26.2	-33.3	-27.9	-29.7	-8.9	-8.0	-7.6	-3.4	-7.1	-7.4	-8.0	-7.2
Current account (% of GDP)	-2.0	-2.9	-2.7	-2.8	-3.4	-3.0	-3.0	-1.3	-2.7	-2.8	-3.0	-2.8
Employment												
Formal Private (annual % change)	3.5	4.3	3.8	3.5	3.7	3.7	3.8	4.1	3.8	3.6	3.4	3.3
Open Unemployment Rate (% active pop.)	4.8	4.3	3.9	3.6	4.0	3.9	4.0	3.5	3.4	3.6	3.7	3.8

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Mexico Indicators and Forecasts

	2014	2015	2016	2017	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17
Aggregate Demand[4] (annual % change, seasonally-adjusted)												
Total	3.1	4.1	1.6	**1.5**	2.2	0.9	1.5	1.9	**2.1**	**2.0**	**0.9**	**1.0**
Domestic Demand	2.0	2.1	1.8	**0.5**	1.8	1.6	1.8	1.8	**1.6**	**0.4**	**-0.1**	**-0.1**
Consumption	1.8	2.3	2.3	**2.0**	2.0	1.8	2.7	2.6	**2.7**	**2.4**	**1.5**	**1.4**
Private	1.8	2.2	2.5	**1.9**	2.4	1.8	3.0	2.8	**2.6**	**2.5**	**1.4**	**1.2**
Public	2.1	2.4	1.1	**2.5**	-0.0	1.7	1.4	1.2	**3.4**	**2.0**	**1.7**	**2.8**
Investment	2.9	4.3	0.4	**-0.6**	1.4	-0.2	-0.9	1.2	**-0.6**	**-0.5**	**-0.7**	**-0.7**
Private	4.9	8.1	2.2	**0.6**	3.9	1.4	1.1	2.5	**1.2**	**1.0**	**-0.3**	**0.5**
Public	-4.7	-11.7	-9.4	**-7.9**	-10.8	-8.4	-11.6	-6.4	**-10.9**	**-9.5**	**-3.2**	**-7.7**
External Demand	6.9	10.4	1.2	**4.5**	3.2	-1.0	0.8	2.0	**3.4**	**6.6**	**3.8**	**4.2**
Imports	5.9	8.7	0.4	**1.1**	1.8	-0.8	0.1	0.4	**1.8**	**1.4**	**-0.2**	**1.6**
GDP by sectors (annual % change, seasonally-adjusted)												
Primary	4.5	1.6	4.0	**1.9**	-0.7	3.9	6.4	6.6	**4.8**	**3.4**	**-0.1**	**-0.2**
Secondary	2.7	1.0	0.0	**-0.2**	1.4	-0.5	-0.9	0.0	**-0.2**	**-0.5**	**0.0**	**-0.1**
Mining	-1.3	-4.4	-6.4	**-8.4**	-3.8	-4.6	-7.6	-9.8	**-10.7**	**-9.8**	**-8.0**	**-4.7**
Electricity	8.2	2.3	3.3	**1.4**	1.1	5.8	3.7	2.8	**0.0**	**2.4**	**1.7**	**1.3**
Construction	1.9	2.6	1.8	**1.4**	2.9	1.3	-0.1	3.1	**1.1**	**0.5**	**2.5**	**1.6**
Manufacturing	4.1	2.4	1.0	**1.9**	1.0	0.4	0.6	1.9	**3.3**	**2.3**	**1.5**	**0.6**
Tertiary	1.8	3.5	3.2	**2.6**	3.3	2.6	3.3	3.3	**3.3**	**3.6**	**2.1**	**1.4**
Retail	3.1	4.7	1.9	**1.5**	2.5	1.5	1.2	2.5	**1.9**	**3.0**	**1.0**	**0.1**
Transportation, mail and warehouse	3.1	4.3	2.5	**2.9**	1.8	2.3	2.7	3.1	**3.8**	**3.7**	**2.2**	**1.8**
Massive media information	0.2	7.7	10.1	**9.6**	8.9	9.7	13.4	8.4	**11.5**	**11.7**	**8.5**	**7.0**
Financial and insurance	-0.8	4.3	7.7	**7.0**	7.9	7.7	7.8	7.3	**7.7**	**8.0**	**7.1**	**5.1**
Real-estate and rent	2.1	2.5	1.8	**1.5**	2.1	1.6	1.8	1.9	**1.5**	**2.8**	**1.0**	**0.6**
Prof., scientific and technical servs.	1.4	4.5	7.7	**1.3**	6.9	6.8	11.3	5.9	**3.4**	**1.2**	**0.3**	**0.5**
Company and corporate management	7.1	3.3	4.7	**0.2**	6.0	5.0	5.5	2.4	**2.1**	**0.6**	**-1.8**	**0.1**
Business support services	-0.1	1.2	4.0	**2.5**	3.3	3.5	2.8	6.3	**3.3**	**3.7**	**2.7**	**0.4**
Education	0.1	0.0	1.1	**-0.2**	0.8	1.5	1.4	0.5	**0.4**	**-0.4**	**-0.6**	**-0.1**
Health and social security	-0.6	-2.3	1.3	**1.2**	-1.0	1.8	2.3	2.0	**2.3**	**0.5**	**1.4**	**0.5**
Cultural and sport	-1.4	3.9	5.2	**1.0**	2.0	4.2	9.5	5.0	**5.0**	**1.8**	**-2.7**	**0.1**
Temporary stay	2.9	5.8	4.1	**4.0**	6.0	3.2	3.0	4.4	**5.2**	**5.1**	**4.0**	**1.7**
Other services, except govnt. activities	1.6	2.7	5.8	**1.9**	5.3	6.2	6.1	5.7	**3.5**	**2.3**	**1.5**	**0.3**
Government activities	1.9	2.7	0.0	**2.2**	-3.1	-0.6	1.7	2.3	**3.1**	**2.3**	**1.7**	**1.9**

1: Residential investment
2: Fiscal balance (% GDP)
3: Accumulated, last 12 months
4: Base 1993=100; GDP by sector base 2003=100. The observed data of the primary sector, secondary and tertiary seasonally-adjusted by INEGI, the rest own seasonally-adjusted
bd: billions of dollars
dpb: dollars per barrel
*FRPS: Financial Requirements of the Public Sector
na: not available
Note: Bold figures are forecast
Source: BBVA Research with Census Bureau, Federal Reserve, Bureau of Labor Statistics, Banco de México, INEGI and SHCP data

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