BBVA Research

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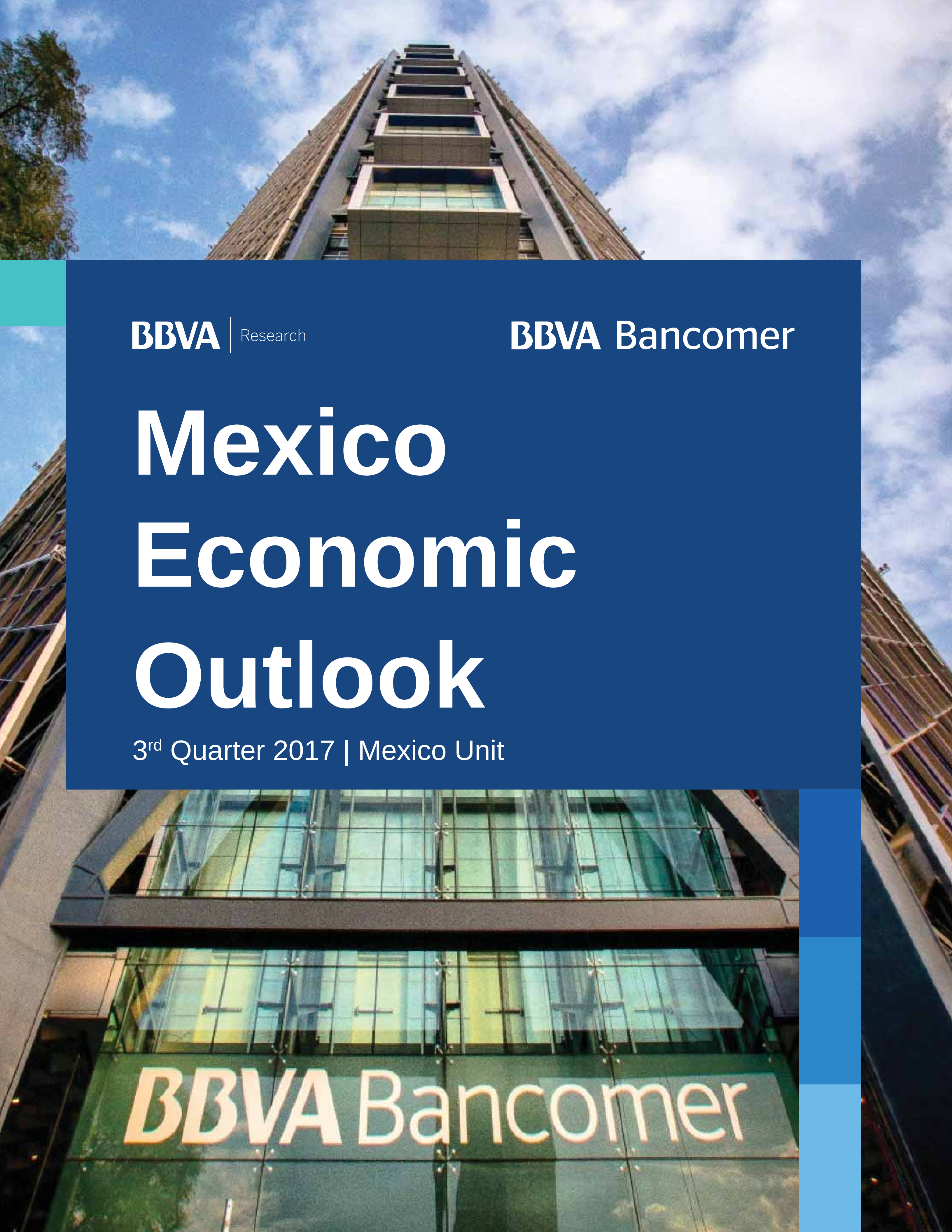
Mexico Economic Outlook

3rd Quarter 2017 | Mexico Unit



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Closing date: **22 August 2017**

1. In summary

After an upturn in global growth in 1Q17, economic expansion has stabilised. As a result, we expect global growth to remain at 3.3% for 2017 and 3.4% for 2018, based on an upward revision for both China (in both years) and Europe (in 2017) and a modest downward revision in the United States. In Latin America, deteriorating commodity prices and greater uncertainty in several countries have delayed the end of the recession. However, forecasts indicate that over the coming quarters, emerging economies should regain lost ground against the advanced countries and China, which have led the recent upturn.

With slight variations, the factors supporting the recent upturn will remain: the accommodative monetary policy will decline as the normalisation process unfolds, while oil prices will continue their upward trajectory, albeit with greater volatility. The accumulation of geopolitical events could affect economic confidence and markets, although these head winds are expected to moderate throughout the year.

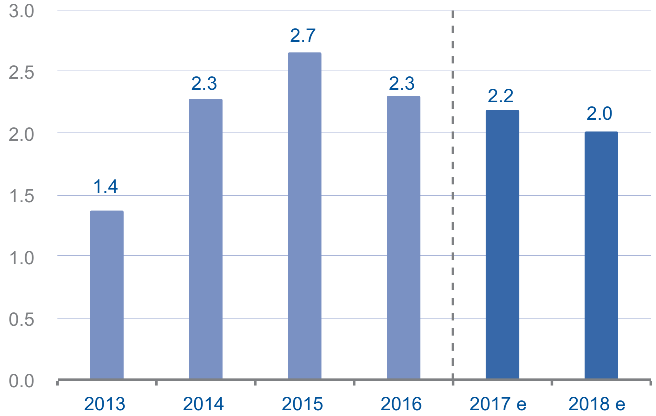
In this environment, the mood in the financial markets has been optimistic, with volatility at all-time lows in spite of the persistent economic, political and geopolitical uncertainty, as well as the correction of expectations of fiscal stimulus in the US. As a result, long-term interest rates have remained low, while pressures on the dollar have to some extent moderated. This financial climate of low volatility and low interest rates, combined with a weaker dollar and better economic conditions, has boosted stock markets, especially those in emerging markets. European assets, including the euro, have also become more attractive after the French elections and better economic performance in Europe, attracting capital inflows into the eurozone.

In the case of Mexico, these favourable global conditions and the better prospects for a successful renegotiation of NAFTA (the North American Free Trade Agreement) suggest that most macroeconomic variables are highly likely to continue their reversion to levels which are more consistent with economic fundamentals. The most obvious case has been the exchange rate. After reaching historical lows at the beginning of the year, the Mexican peso is currently appreciating at 17% in 2017, after the moderation shown by the US regarding their position in the NAFTA renegotiation. Even the levels below 18 pesos, at which the dollar is quoted today, are lower than what was observed before the US presidential election. The appreciation of the peso in recent months will favour the behaviour of inflation more clearly towards the end of the year. Growth in consumer prices is already very close to its highest 2017 level, supported by signs of stabilisation in underlying inflation. We expect that inflation will begin to decline in the fourth quarter, given the moderation in the transfer of the depreciation in the exchange rate to prices, and that the rate will end the year at around 5.9%.

Expectations of better inflationary behaviour in the coming months led the Bank of Mexico (Banxico) to clearly point out that the monetary tightening cycle had come to an end with a benchmark rate at a level of 7%, just as we had been anticipating for several months. Even though the reduction in inflation will be clearer during the first months of next year, we expect it to remain above 4% until the first quarter of 2018, which is why we expect Banxico will not rush to start with a cycle of reductions in the benchmark rate. In fact, in our baseline scenario, we expect Banxico to cut the benchmark rate by 50 basis points until after the July elections next year.

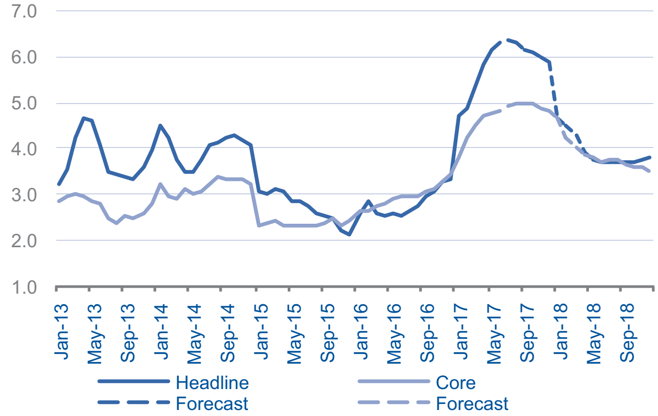
The aforementioned movements in the macroeconomic variables, although transitory, will affect the performance of the drivers of domestic demand during the second half of the year. The increase in inflation will lead to a reduction in the purchasing power of households, while the purchasing power of remittances in pesos will be affected mainly towards the fourth quarter of the year, which is why the latter will no longer support consumption unlike in previous years. To these elements, we must add the weakness in investment that we expect to continue over the rest of the year, mainly due to cuts in public investment spending. However, even with the slowdown in the growth of domestic market expected for the second half of the year, we consider that the better than expected data for the first half and the momentum of external demand, observed at the time, are sufficient to upwardly revise our growth forecast for this year to 2.2%. By 2018, we anticipate GDP growth of 2%, supported by a favourable renegotiation of NAFTA. It should be noted, however, that the risks in this respect have not completely dissipated, since there is still a certain probability that the renegotiation will be postponed until 2019 or that, in an unlikely scenario, the agreement will be broken.

Figure 1.1 GDP growth (% YoY)



Source: BBVA Research based on information from INEGI

Figure 1.2 Headline and core inflation rates (% YoY)



Source: BBVA Research based on information from INEGI

2. The positive global environment is showing a stabilising trend

Robust and steadier global growth, with something of a restoration of balance among the major areas

The world economy has been picking up in recent quarters and has approached growth rates of 1% QoQ, although it is trending towards stabilisation. In global terms the confidence figures are clearly positive, above all in the advanced economies, and have moved into readings at the high end. World trade has recovered swiftly from very meagre levels midway through last year and its swelling only seems to have abated slightly in April and May. All of this has also led to a rekindling of industrial activity and investment globally.

This positive dynamic is attributable to the prime factor behind expansion of late, namely the spurs provided by economic policy in China, which have driven growth in its economy and led to a knock-on affect among other Asian countries as well as the rest of the world economy. Other mainstays of the encouraging global cyclical pattern, such as a raft of extremely accommodative monetary policies in most of the advanced nations, a set of fiscal policies that have recently generally been neutral or expansionary, and relatively moderate commodity prices, have helped global recovery along, while financial markets have also been calm and have not suffered without let-up from sources of political tension, the latest of these being the presidential elections in France.

The brighter situation, which for the most part affects the advanced economies, is being accompanied by a certain shift in the balance away from the United States and towards Europe, both in terms of activity (unwelcome surprises in the United States in the opening months of the year and positive ones in the eurozone) and on the political scene (problems in pushing through measures for the new US administration compared to the overcoming of electoral hurdles in Europe which had threatened to cast doubt over the euro project). On the other hand the emerging economies have performed less promisingly, with a slower than expected exit from the recession in LatAm which was also more mixed, the contrast hinging on levels of dependence on commodity revenues.

This environment of positive growth is currently being partnered by only modest inflation levels. Whereas deflation risks appear to have been overcome, the glut of liquidity in markets as a result of very expansionary monetary policies has not morphed into an acceleration of inflation, since the overhang of unused resources (above all labour) seems to be heading off any substantial pick-up in wages and core inflation, while the delay and, to some extent, reversal of oil prices in recent months (figures) has dampened headline inflation expectations and rates.

Auspicious situation in financial markets and normalisation of monetary policies

The tone in financial markets has been upbeat, with volatility at historic lows in spite of the persistent economic, political and geo-political uncertainty, as well as the correction to expectations of a fiscal boost in the United States. This has meant that long term interest rates have remained anchored and corrected a portion of the rises in previous quarters, while the dollar has broken off from its firming course. This financial climate of low volatility and interest rates, and less dollar strength combined with a bright economic environment has brought cheer to equities and is good news for the emerging markets. On the other hand European assets, including the euro, have also become more appealing. Following the French elections and a context in which growth in the developed world is proving kinder to Europe, capital flows into the eurozone have taken an about-turn.

The big question is whether the markets are being too lenient, particularly bearing in mind that the major central banks are making inroads in the normalisation process. Even though the tone of monetary policy is still accommodative, in the last quarter steps have been taken to ready the market for a gradual withdrawal of stimuli in tandem with the improvement in the economy.

The US Federal Reserve (Fed) has hiked interest rates twice in 2017, making a total of 50 basis points overall, and has announced and outlined a plan to gradually pare down its balance sheet. From now until yearend the Fed intends to make one more 25bp hike, probably in December, and embark on a “passive” (i.e. by not renewing assets falling due) and steady scaling down of the balance sheet, which is likely to be from October onwards. Even so, in the absence of robust growth and with very restrained price and wage inflation, market expectations are out of kilter with those of the Fed (they are more bearish).

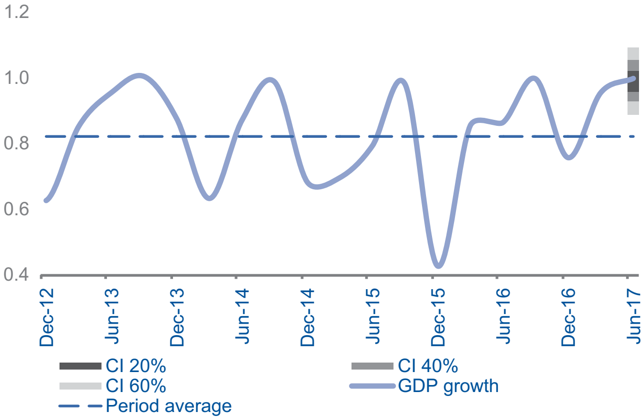
The European Central Bank (ECB) is holding interest rates unchanged (the refi rate at 0% and deposit rate at a negative level of -0.40%) and sticking to the asset purchasing programme (currently at 60bn euros a month). Nonetheless, it was more confident about the strength of growth and considers that the risk of deflation has disappeared, which has given rise to the first changes in its forward guidance. In June the ECB removed its downward bias as regards rates, which is seen as a first step on the long road of normalisation. It is foreseeable that at its September meeting the ECB could take a further step by announcing a down-scaling in its purchasing of assets (i.e. tapering), which would be implemented from January 2018 onwards. Assuming that the central bank does not change the script in its exit process, interest rate rises ought not to take place until late 2018. Here, a good communications strategy is key to avoiding jitters on financial markets, especially since they have been somewhat sceptical about any imminent normalisation.

We are standing by our forecast of stable growth in 2017-18, with risks still on the downside

Our new forecasts imply global growth staying at 3.3% for 2017 and 3.4% for 2018, with an upward revision for both China (in both years) and Europe (in 2017) due to a better than anticipated first half, whereas our estimate for the United States is being revised downwards a shade on a poorer than expected showing in the first quarter, as well as bigger problems in having expansionary fiscal measures passed and undertaking reforms. In LatAm, ebbing commodity prices this year and heightened domestic uncertainty in several countries have meant that emerging from recession is taking longer than had been foreseen. These forecasts indicate that in the coming quarters emerging economies should make up ground on the advanced countries and China, which have spearheaded the recent upturn.

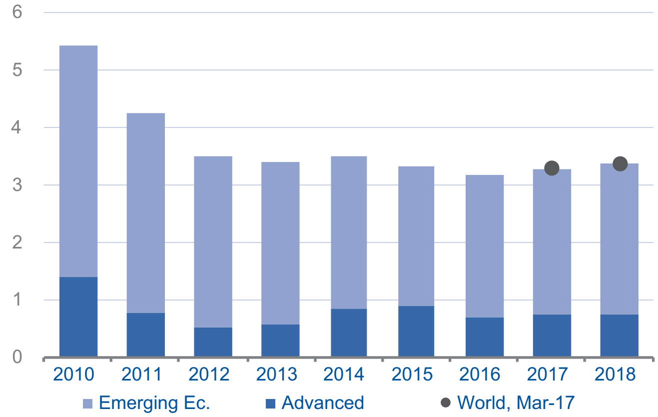
The drivers behind the recent pick-up will remain in place, albeit with the slight variations: Monetary policies will by and by kick into a process of normalisation, while fiscal policies will remain relatively neutral or expansionary; oil prices, which have been sluggish in edging towards long term equilibrium levels (USD60/bbl), this being more than anything due to the rise in supply (from producer countries such as Libya, Nigeria and the United States), are set to continue to chart their rising course; the flurry of politically-related events (elections in Germany and Italy, Brexit negotiations, initiatives geared towards closer integration in the European Union, the political calendar in the United States, and the electoral cycle in LatAm in 2018) could influence economic confidence and the situation in markets, although these do seem to be having less of a long-lasting impact.

Figure 2.1 Regional GDP forecasts (YoY, %)



Source: IMF and BBVA Research

Figure 2.2 World GDP growth (QoQ, %) Forecasts based on BBVA-GAIN



Source: BBVA Research

United States: growth in 2017-18 is being revised downwards owing to a lower likelihood of stimuli

The US economy's performance in the first quarter of the year was rather worse than expected, even though the key growth drivers have not changed in any substantial way. The political scene over the last few months has proved that any ambitious economic stimulus measures are unlikely to be implemented short term. Forecast GDP growth is 2.1% in 2017 and 2.2% in 2018, which is two tenths lower than predicted in our last estimate. The improvement in the global setting, expectations of slightly firmer oil prices and the buoyancy of residential construction could encourage an upturn in investment, which should make up for the expected slowdown in private consumption from a more gradual upswing in the labour market and higher inflation compared to recent years. In spite of this, price-rises have slackened a bit in the last few months, partly due to transitory factors, and clear signs of inflation pressure over the forecast horizon are still not discernible. We therefore expect the Fed to continue to press ahead gently with its monetary policy normalisation process, as has been mentioned. Uncertainty over the scenario remains high. Risks associated with more protectionist policy have eased off, but implementing the economic policies that have been announced still has something of a question mark against it. An already lengthy spell of cyclical expansion which has started to see increased borrowing in certain sectors, as well as the lack of elbow room for demand-side policies, both promote weakness, which might unleash a recession in the medium term.

China: the effect of the economic measures is serving to underpin target growth

After the growth rally that was witnessed early on in the year, the latest figures point to a more gradual slowdown in China's economy than had been expected. Behind this performance lies the support from a prudent monetary policy and fiscal stimuli, which have boosted credit and investment, although there has also been the improvement in the climate outside and the weaker real effective exchange rate. In this context the authorities are still trying to hit on a happy medium between keeping up growth, deleveraging in orderly fashion and fending off financial weaknesses. They are thus combining tougher real estate market and shadow banking regulation with monetary policy that is geared towards a tightening, yet with liquidity being provided to limit turbulence on financial markets.

Owing to the better performance of late, we have revised forecast GDP growth upwards by around 0.2pp in 2017-18, which would mean the authorities achieving their target of 6.5% in 2017, although we still predict a slowdown to 6% in 2018. Inflation is still modest, while industrial product prices, which had rocketed at the start of the year, are losing steam. This, together with low food prices and a tougher regulatory stance, mean that we are also revising our inflation forecast downwards to 1.7% in 2017 and 2% in 2018. Despite the ongoing macroprudential measures, risks are still mounting in the medium term, to the extent that financial frailties stemming from a recovery based on rising debt among players and encouragement of shadow banking are still piling up, while the process of adjustment in the growth pattern is still moving at a very slow pace.

The eurozone: clear improvements, but still with limitations

Economic growth has continued to pick up momentum in the first half of the year, with slightly better than expected progress for GDP, which has come in at over an annualised 2%. Moreover, the improvement has been across the board among both the various different components in demand and the different member states. Stronger global demand has underpinned the rebound in exports which, together with improved confidence, is spurring investment and employment, while private consumption remains sound. This evident cyclical progress for the economy and the disappearance of deflation risks are causing the ECB to start to weigh up already-discussed tapering measures, whereas fiscal policy will be mildly expansionary over the forecast horizon. For this reason we have revised forecasts upwards in 2017 by three tenths to 2%, which represents above-potential growth for the third year on the spin. This, together with a slackening as regards some of the mainstays of growth, such as a stronger euro, higher oil prices and the stabilisation of world growth, ought to justify our projection of a certain deceleration for 2018, down to 1.7%.

Inflation eased off in the second quarter on account of energy price base effects, while core inflation rose by two tenths and is holding at around 1%. The smaller oil price rise, in tandem with a stronger euro, lead us to revise our forecast slightly downwards for headline inflation by circa two tenths to 1.6% in 2017 and 1.4% in 2018, although our prediction of a steady rise in core to an annual average of 1.1% this year and 1.4% in 2018 is unchanged.

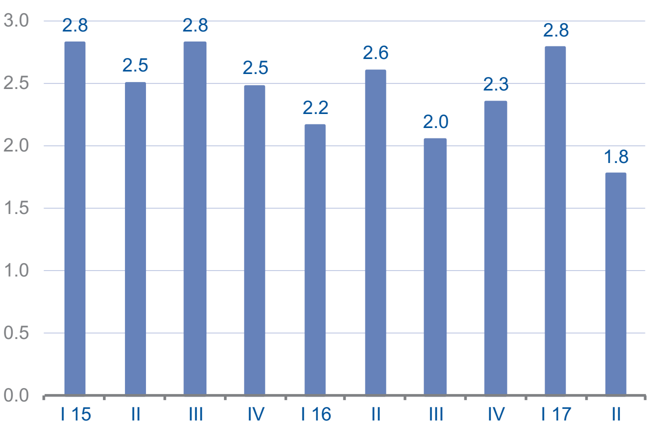
Domestic risks are still biased to the downside, but they have diminished, particularly those of a political nature. That said, the Brexit negotiations, the handling of certain banking problems and the popularity of anti-euro election options in countries like Italy (with elections in early 2018) are sources of risk.

3. We expect GDP growth in 2017 to be 2.2%, supported by the favourable performance shown in the first half of the year

3.1 Continuing the dynamism of the export sector, which is emerging as one of the main sources of GDP growth in 2017

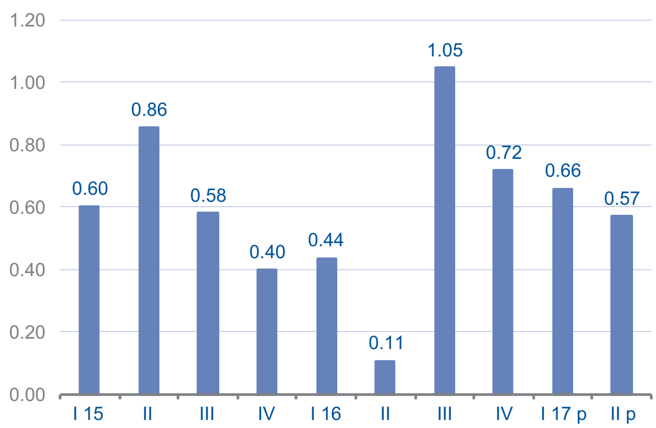
The macroeconomic environment at the beginning of 2017 was adverse; however, the annual GDP growth observed in the first half of the year, according to figures published by INEGI, was positive and at a rate of 2.3%. All of the unfavourable factors indicated at the beginning of the year the possibility that the GDP growth rate for 2017 would be lower than that of 2016, which was 2.3%. As mentioned, this has not happened, at least as far as the first half of the year is concerned, as the annual GDP growth for the first half of 2017 was the same as for all of 2016.

Figure 3.1 Quarterly GDP: annual growth
(Annual % change, original figures)



Source: BBVA Research based on information from INEGI

Figure 3.2 Quarterly GDP: quarterly growth
(Quarterly % change, SA)



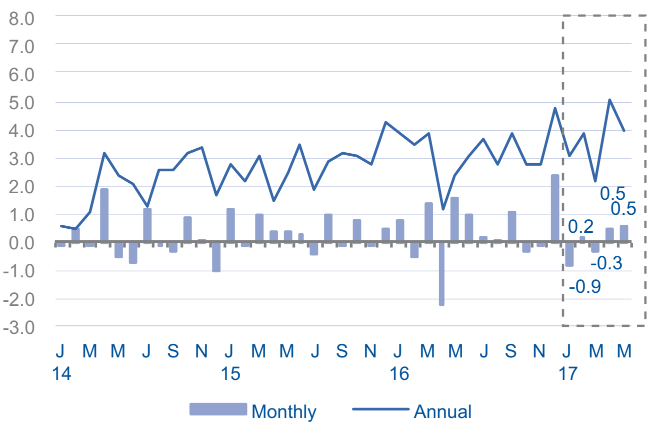
SA = seasonally adjusted
Source: BBVA Research based on information from INEGI.

However, when analysing the behaviour of GDP growth in the first half of 2017, the annual growth rate of GDP in the first quarter of the year was 2.8% and for the second quarter it decelerated to 1.8% (Figure 3.1). The deceleration of the GDP growth rate in the second quarter of 2017 is also observed when considering the quarterly growth rates of its seasonally adjusted series (Figure 3.2). If the data for 2016 is considered, we can also see that since the fourth quarter of 2016, the quarterly GDP is already presenting a slowdown in its growth rate. It should be noted that the deceleration of annual GDP growth in the second quarter is largely due to the less favourable performance of the main macroeconomic variables on the component side of demand, such as private consumption and gross fixed investment. These are topics that are discussed below.

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

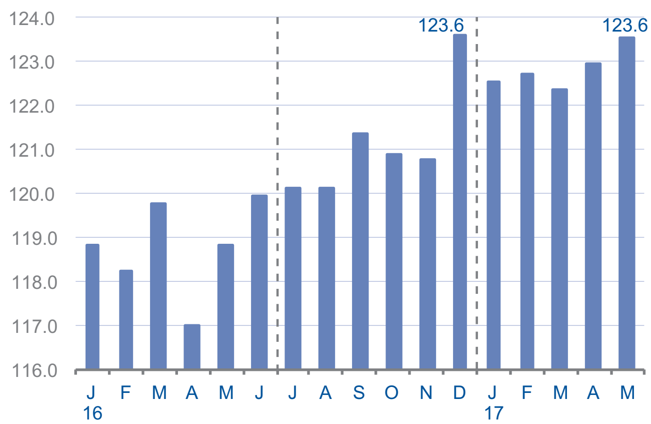
Private consumption is the main component of GDP. As a yearly average, this macroeconomic variable contributed 67% to GDP from 2010 to 2016. This means that its evolution and dynamism have a high impact on the expansion of economic activity. For example, in 2015 and 2016 the GDP growth rate was 2.6% and 2.3%, respectively, and the contribution to the growth of private consumption in those years was 1.6% and 1.8% respectively. The previous point means that if in 2016 the GDP growth rate was 2.3%, private consumption contributed 1.6% of that growth, or 70% of what growth there was in that year.

Figure 3.3 Index of Private Consumption
(Change % MoM, YoY, SA)



MoM = "month-on-month"; YoY = "year-on-year"; SA = seasonally adjusted.
Source: BBVA Research based on information from INEGI

Figure 3.4 Index of Private Consumption
(Level, SA)

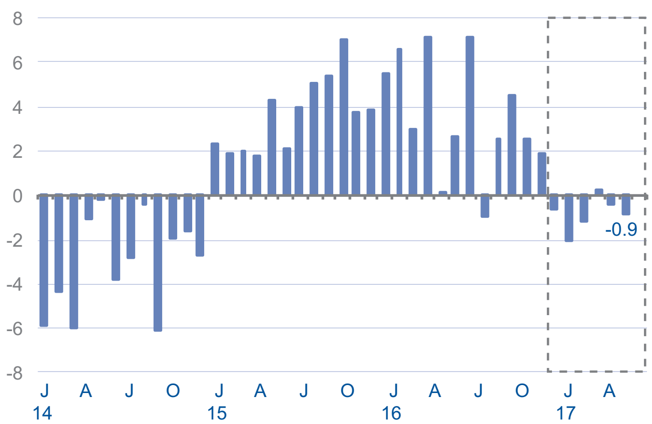


SA = seasonally adjusted
Source: BBVA Research based on information from INEGI

According to the available private consumption index data, one finds that in the first three months of 2017 the performance of this indicator was rather unfavourable in terms of its monthly growth rate although its annual growth rate continues to indicate a positive performance (Figure 3.3). In April and May 2017, private consumption recorded positive monthly growth rates that allowed the level registered in May 2017 to equal that of December 2016 (Figure 3.4). If the indicator of private consumption in monthly terms registers an unfavourable behaviour or moderate growth in the coming months, this will be reflected gradually towards the end of the year in lower annual growth rates. However, if the growth of private consumption continues with a monthly dynamism similar to that registered in April and May, this macroeconomic variable will report relatively high annual growth rates in the coming months and rates similar to those of May 2017.

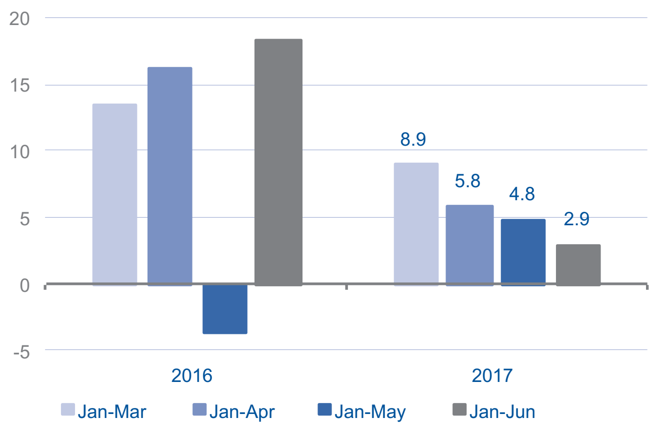
It should also be remembered that until now, INEGI has only published data on the private consumption index until May 2017, there are other indicators which were published in May and June that refer to the behaviour of consumption in June which indicate that it is possible that some momentum was lost or will be lost in the coming months. For example, the INEGI Retail Sales Index recorded a growth rate of 4% for the accumulated period from January to May 2017, while during the same months of 2016 this rate was higher and at 8%. In other words, this index registered a significant slowdown during the year compared to the same period of 2016. If this slowdown continues in the coming months, then it will eventually be reflected in the future private consumption index. Another relevant indicator that also refers to the behaviour of private consumption is the Retail Sales Index of the National Association of Self-Service and Department Stores (ANTAD). According to this index, in May and June this indicator registered negative annual growth rates, which indicates that the weakness of private consumption has spread throughout the second two months of the year (Figure 3.5).

Figure 3.5 ANTAD same-store sales index (Real annual % change)



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

Figure 3.6 Accumulated sales of cars in the domestic market (YoY % change)



SA = seasonally adjusted.
Source: BBVA Research based on AMIA information

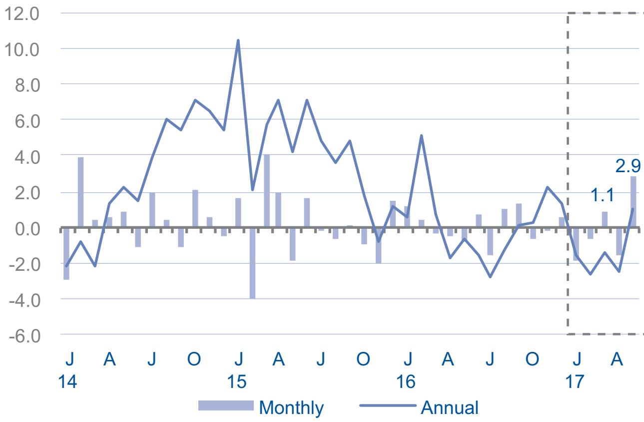
In addition, cumulative domestic car sales have also slowed significantly (Figure 3.6). In fact, from January to March 2017, cumulative car sales recorded an annual growth rate of 8.9% compared to 2016, while for the period from January to June this rate slowed down to 2.9%. In sum, there are several indicators that indicate a less favourable performance of private consumption in this year compared to 2016.

Finally, it should be noted that one important reason that also helps us to foresee a less dynamic rate of private consumption over the rest of 2017 is the contraction of the average daily wage of workers registered in the Mexican Social Security Institute (IMSS) in real terms. For example, in January 2017 the annual real growth rate of the IMSS's average salary was negative and –0.6% and has continued to deteriorate. In June 2017, the negative growth was already -1.4%. These figures indicate that lower revenues in real terms from average wages mean less possibilities of consumption of a given basket of goods and services. This, in turn, may end up affecting the growth rate of private consumption.

3.1.2 Index of gross fixed capital formation: during the first four months of 2017, its behaviour has been unfavourable

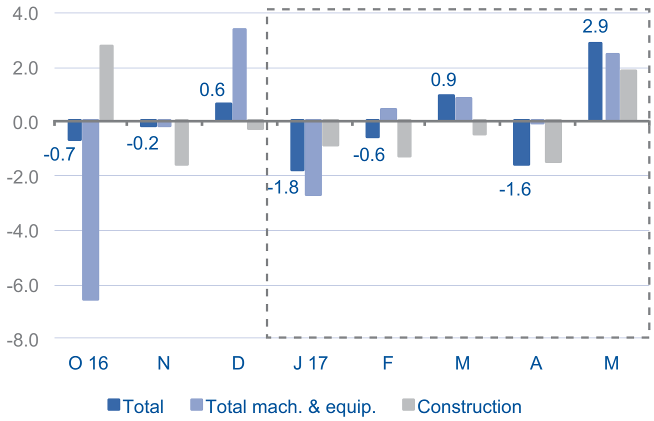
On the other hand, the average annual growth rate of the monthly index of gross fixed investment (which represents the behaviour of the aggregate GDP demand component denominated gross fixed capital formation) of 2016 in relation to the average recorded in 2015 was 0.2%. This indicator's poor performance was observed in the first four months of 2017 and, on the other hand, by the fifth month the behaviour had changed. Annual growth rates were negative during the first four months of 2017 and in the fifth it was already positive. The results for monthly growth rates are similar in the case of annual rates (Figure 3.7). This dynamic of investment during 2017 is largely explained by the weakness of its components (Figure 3.8).

Figure 3.7 Gross fixed investment (Change % MoM, YoY, SA)



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

Figure 3.8 Gross fixed investment by components (change % MoM, SA)



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

One of the factors behind the unfavourable performance of gross fixed investment is the contraction of public sector investment. In accordance with the National Accounts System, in 2016 this component of final demand contracted 9.2% with respect to 2015. National Accounts data for the first quarter of 2017 also indicates that the deterioration of gross fixed capital formation continued and that in that quarter registered a negative annual growth rate of -3.7%. Inasmuch as a continuing contraction of public investment is expected, elements exist that mean the index of gross fixed investment will continue to show poor performance given the deterioration expected for the rest of the year.

The other institutional component of gross fixed capital formation is the private fixed gross investment of the private sector. The real annual growth rate of this aggregate in 2016, in accordance with the National System of National Accounts, was positive at 1.9%. In addition, the first quarter of 2017 also recorded a negative annual growth rate of -0.5%. This corroborates the poor performance of private gross fixed investment until 1Q17. Worth mentioning is the possibility that one factor affecting private sector investment is the uncertainty associated with the renegotiation of NAFTA, with the formal process for the three countries involved starting in the middle of August this year. To the extent that the renegotiation of NAFTA implies risks and uncertainties for companies and future trade flows, it is possible for companies to opt to postpone their new investments until the entire NAFTA renegotiation process is completed and the uncertainty that the latter caused has dissipated. If this is the case, then it is to be expected that private sector fixed gross investment prospects will improve when the NAFTA renegotiation ends successfully.

3.1.3 External Sector: in the first half of 2017, the non-oil trade balance recorded a surplus of almost $5.3 billion, while the oil balance deficit was higher at $8.2 billion

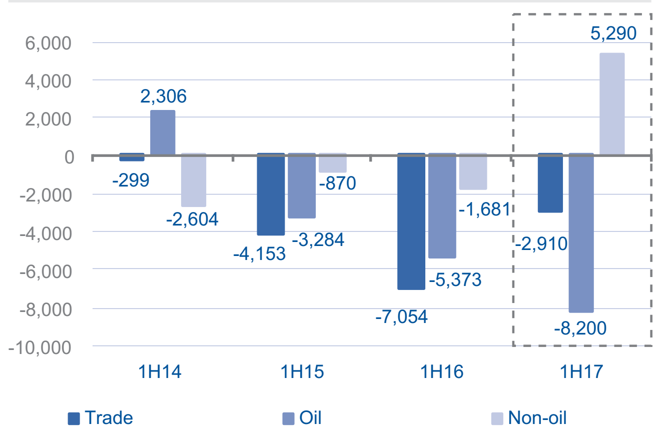
The balance of the country's total trade balance during the first half of 2017 was a deficit of $2.9 billion. Although this is an account deficit, it reflects the positive performance of the external sector in 2017 compared to 2016, as in the same months of last year, the deficit of this account with the exterior was $7 billion. It should be mentioned that in February, April and June the monthly trade balance was positive, contrasting favourably with the figures for the same months of 2016 (Figure 3.9).

From the perspective of the trade balance of non-oil goods, the balance recorded in the first six months of 2017 was positive at almost $5.3 billion. This figure contrasts with the oil trade balance of the first half of 2017, which recorded a deficit of $8.2 billion. This semi-annual deficit in the oil balance is the largest since the international price of a barrel of crude oil declined substantially from 2014 (Figure 3.10).

Figure 3.9 Monthly balance of the Trade Balance ($ billion)

Source: BBVA Research based on information from INEGI

Figure 3.10 Semi-annual balance of the Trade, Oil and Non-Oil balances ($ billion)



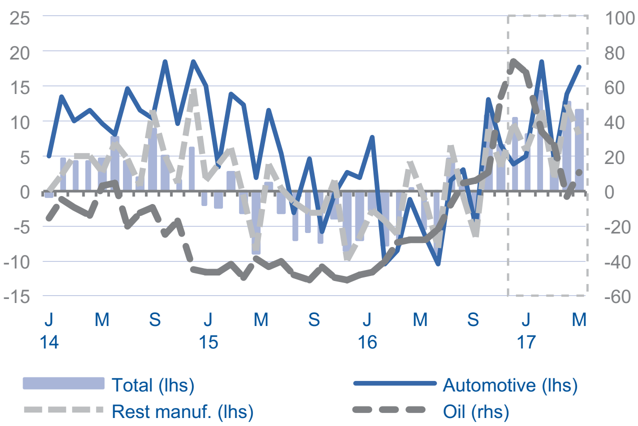
Source: BBVA Research based on information from INEGI

The largest deterioration in the oil balance recorded during the first half of 2017 is due, on the one hand, to the fact that the country imported 16% more oil products in terms of volume compared to its imports of these products in 2016. Another factor that has also influenced the deterioration of the country's trade balance is the increase in the price of gasoline. For example, the average gallon of regular gasoline in the United States was $2.07 in the first half of 2016, while for 2017 it increased 14% to $2.37. That is to say, the combined increase of larger quantities of imported petroleum products together with the increase in their prices was what influenced the deficit in the oil balance in the first half of 2016, which was almost $5.4 billion and which increased for the same months in 2017 to $8.2 billion.

3.1.3.1 Exports of goods by type: the favourable performance of manufacturing exports persists and the deterioration of the oil balance increases

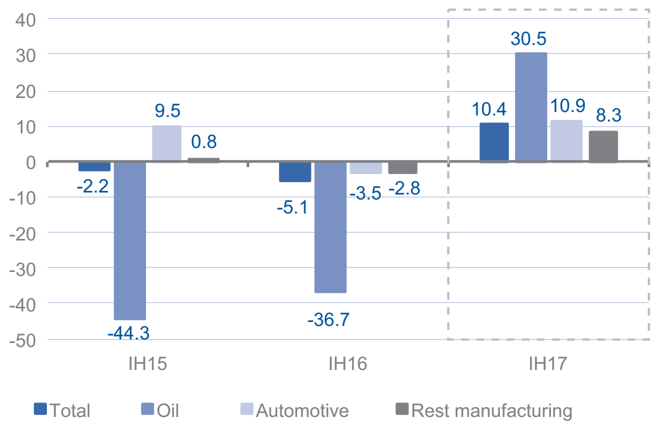
Since the last three months of 2016, the performance of merchandise exports has improved (Figure 3.11) and this has been maintained over the first six months of 2017. From the perspective of the first half of 2017, the performance of the different categories of exports has been favourable. For example, the annual growth rate of total accumulated exports from January to June 2017 was 10.4%, which contrasts with the negative rate of -5.1% recorded in the same period of 2016. In addition to highlighting the behaviour of total merchandise exports, it is important to note that all categories of exports showed positive growth rates – automotive exports (10.9%) and other manufacturing (8.3%) – in contrast to those registered in the same period in previous years.

Figure 3.11 Monthly exports of goods by type (YoY % change)



Source: BBVA Research based on information from INEGI

Figure 3.12 Semi-annual exports of goods by type (YoY % change)

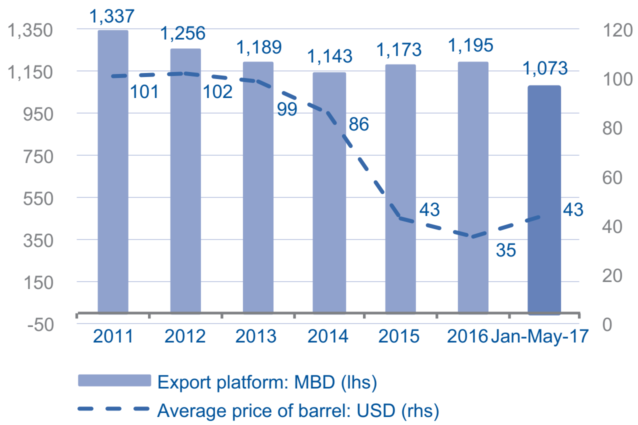


Non-petroleum exports include manufactured, agricultural and fisheries goods and non-petroleum Extractive products.
Source: BBVA Research based on information from INEGI

To the extent that growth in manufacturing exports is sustained at rates similar to those recorded in the first half of 2017, such exports will become one of the main sources of GDP growth in the country this year. It should be kept in mind that by the second half of the year the exchange rate is expected to remain below the high levels recorded particularly during the first quarter of 2017. This could mean that exports of manufactured goods grow more moderately.

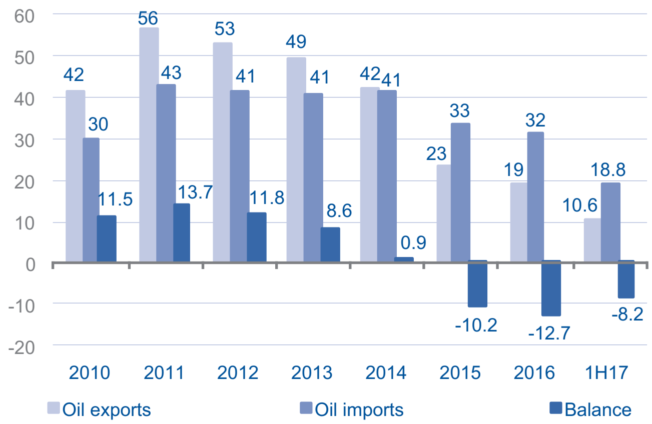
Finally, it should be noted that the value of oil exports during the first half of 2017 grew significantly due to the increase in the barrel price that the country exports. From January to June 2016 the average price per barrel of the country's export mix was $31.2, while for the same period of 2017 it increased by 39.2% to $43.3 (Figure 3.13). However, the increase in the price of a barrel of crude oil exports more than compensates for the decrease in the crude oil export platform. In the first half of 2016 this was 1,134.2 tbd (thousand barrels per day) and for the same period of 2017 it decreased 5.4% to 1072.3 tbd.

Figure 3.13 Oil exports (figures in $ billion and thousands of barrels a day (MBD))



Source: BBVA Research based on information from INEGI

Figure 3.14 Figure 3.14 Oil trade balance: oil exports – oil imports ($ billion)



Source: BBVA Research based on information from INEGI

Once the energy reform materialises with higher levels of crude oil extraction, it will be feasible to think that the country's crude oil export platform will increase. In this sense, if in the future the country's crude oil export prices stabilise at around 43 dollars per barrel, then oil exports will not increase and the dynamism of total merchandise exports will fall mainly on the export of manufactured goods, which in 2016 accounted for 90% of total merchandise exported.

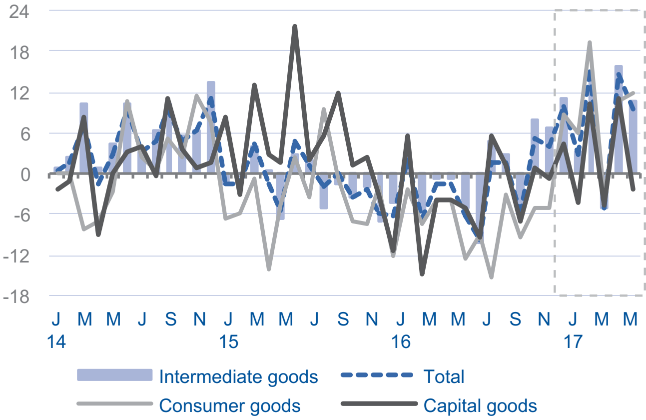
3.1.3.2 Imports of goods by type: growing at a similar rate to exports of manufactured goods

During the first half of 2017, total merchandise imports recorded an annual growth rate of 7.2%. This rate is lower than the 10.4% rate at which total merchandise exports grew in the same period. It should be noted that the expansion of manufacturing exports boosts the growth of imports of intermediate goods, and from the moment the former are reactivated, the latter are likewise rapidly reactivated (Figure 3.15). This behaviour is a consequence of the vertical integration that some productive sectors present, as is the case of the automotive sector and the export maquiladora or in-bond industry.

In the case of the dynamism of imports of goods by type, it is noteworthy that imports of capital goods are those that in the first half of 2017 had a low annual growth rate of 2.3% (Figure 3.16). The reduced dynamism of imports of capital goods may also be due to the behaviour that gross fixed investment has registered throughout the year, as commented on in the respective section. In this sense, GDP growth at a higher rate, which is accompanied by a larger share of gross fixed formation, will also be reflected in a higher growth rate of imports of machinery and equipment.

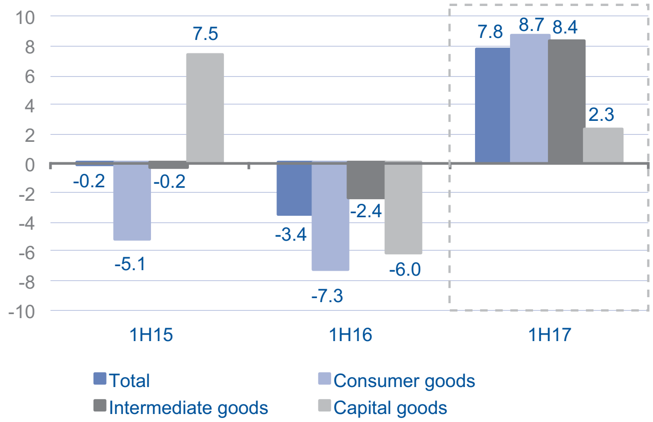
In 2016, the percentage structure of imports of goods was as follows: imports of consumer goods accounted for 13.4% of total imports of goods (3% oil + 10.4% non-oil), intermediate goods 76.2% (5.1% oil + 71.1% non-oil), capital goods 10.4%.

Figure 3.15 Monthly imports of goods by type (YoY % change)



Source: BBVA Research based on information from INEGI

Figure 3.16 Semi-annual imports of goods by type (YoY % change)



Source: BBVA Research based on information from INEGI

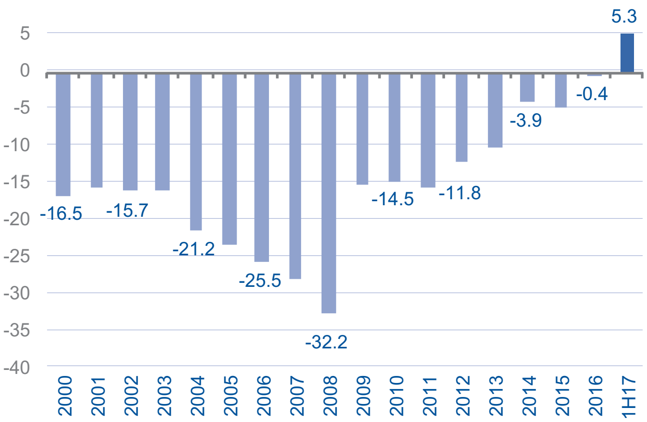
3.1.3.3 Balance of trade: the deficit in the petroleum trade balance is the current source of external imbalances

The first part of this section referred to the behaviour of the trade balance and of the oil and non-oil balances from the perspective of the first half of 2017. The non-oil trade balance is now viewed from an annual perspective based on a long-term horizon covering 2000 to 2016 and the first half of 2017 (Figure 3.17). According to this approach, with the surplus balance that this balance showed in the first half of the year, if the monthly behaviour reported from January to June (Figure 3.18) were to be reported on a continual basis, it would cause this annual surplus to rise to $10.6 billion.

If this possible scenario in 2017 of the annual surplus of the non-oil trade balance were to be realised, even by a smaller amount than the $10.6 billion mentioned, this would be the first surplus balance of this balance from 2000 to 2017 (Figure 3.17). This in essence would be reflecting a fundamental transformation of the country's export sector. This transformation means that the deficit of the non-oil balance has gradually been reduced first to a deficit of reduced amounts (2014 and 2015), then to a position of near equilibrium (2016) and finally a surplus in 2017.

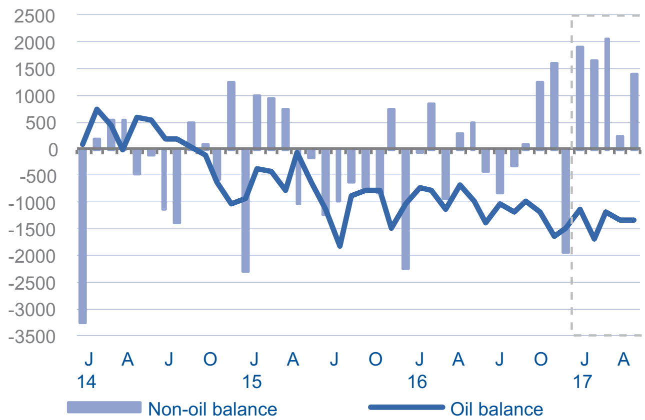
To the extent that the export sector consolidates a surplus position of the non-oil trade balance and at the same time shows progress in reducing the deficit of the oil balance, the external sector of the country will be strengthened and, therefore, one of the drivers of economic growth in the country.

Figure 3.17 Annual balance of trade in non-petroleum goods ($ billion)



Source: BBVA Research based on information from INEGI

Figure 3.18 Monthly balance of trade in petroleum and non-petroleum goods ($ billion)

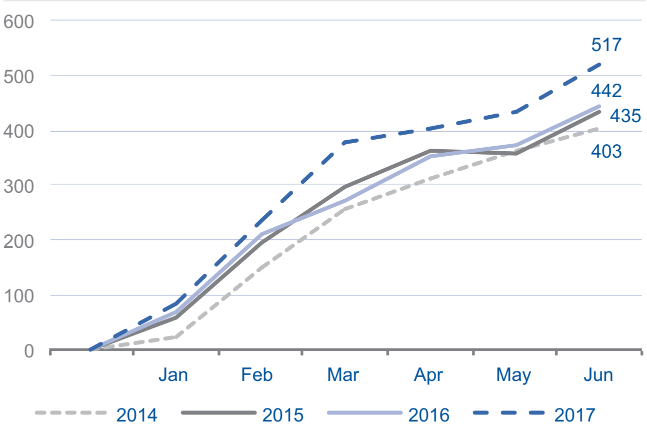


Source: BBVA Research based on information from INEGI

3.1.4 Evolution of formal employment of private sector workers (IMSS) and contributions from average real wages: the contraction of real wages continues to become more significant

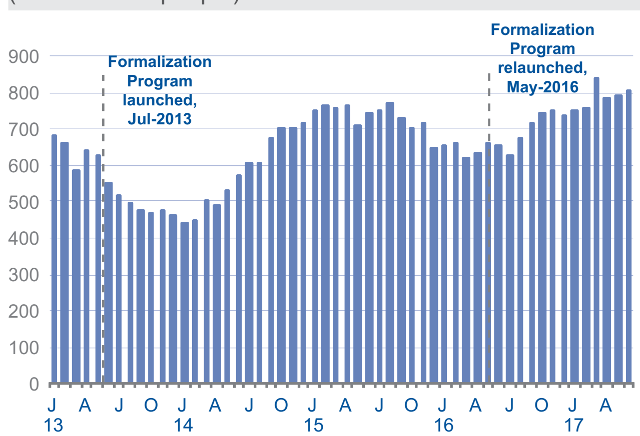
The number of workers registered at the IMSS(Mexican Social Security Institute) has increased over the year, from 18.6 million in December 2016 to just over 19.1 million in June 2017. Thus, in the first half of 2017 the number of these workers increased by 517,000. This increase is higher compared to the growth of formal IMSS employment registered in the same period of 2015 and 2016. In those years, the increase in the number of workers registered with this Institute was 435 and 442 thousand people, respectively. In other words, the performance of this indicator, which shows formal IMSS employment, was more favourable in the first half of 2017 than it was in previous years (Figure 3.19).

Figure 3.19 Increase in the total number of workers registered with the IMSS over the course of the year (Thousands of people)



Source: BBVA Research based on information from INEGI

Figure 3.20 Increase in the total number of workers registered with the IMSS in 12 months (thousands of people)



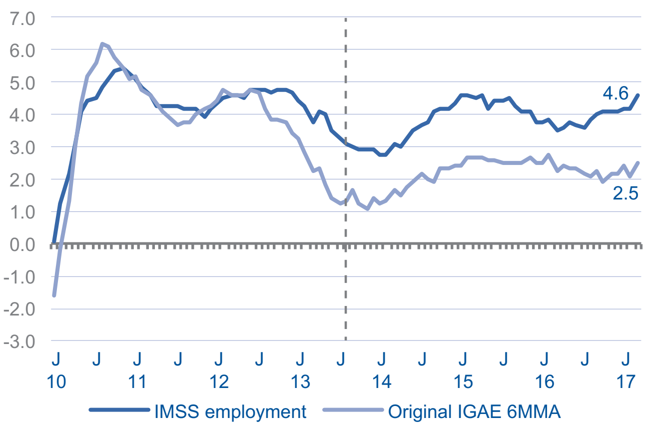
Source: BBVA Research with data from INEGI and STPS (Office of Employment and Social Welfare)

It is worth mentioning that possibly a part of this favourable performance in the increase of IMSS registered workers is due to the fact that in May 2016 the labour authorities relaunched the Employment Formalisation Program (EFP). The EFP began operating in July 2013 with the intention that those workers who had a job and lacked social security and, therefore, were not registered with the IMSS, would register with that Institute (Figure 3.20). In this way, these workers would have social security and would no longer be considered informal according to the definition of an informal worker being one who lacks social security.

Thanks to the EFP, the increase in formal IMSS employment has gone up significantly despite the fact that since 2013 to date, the growth rate of the global economic activity index (IGAE) has been lower than those that existed in previous years (Figure 3.21). This has been largely due to the presence and impact of the EFP. The EFP has permitted IMSS employment to grow at relatively high annual rates while the IGAE has done so at lower rates. As long as the auditing of jobs considered to be part of the EFP continues to bear fruit, the growth rate of IMSS employment will be higher than that of the IGAE.

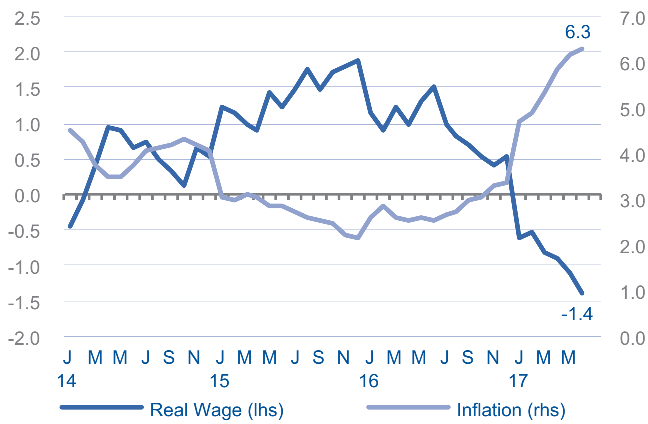
Nevertheless, an issue arising from the data associated with the workers registered with the IMSS is that relating to the average base wage for perceived contribution. The average base wage for IMSS contribution purposes in real terms is an indicator of changes over time in purchasing power of organised sector workers. If the average real salary for IMSS contribution increases therefore, so does the purchasing power of the workers in that sector. This greater purchasing power in turn will be reflected in greater private consumption of goods and services. Likewise, the expansion of private consumption is a factor that drives GDP growth, since private consumption is one of the main components of GDP on the aggregate demand side.

Figure 3.21 Annual growth rate of formal employment IMSS and IGAE, 6-month moving average (YoY % change)



Source: BBVA Research based on information from INEGI

Figure 3.22 Inflation and average IMSS wages (YoY % change)



Source: BBVA Research with data from INEGI and STPS

The average contribution salary of workers registered with the IMSS increased in real terms in 2015 and 2016 as a consequence of the decrease in inflation that occurred in those years. On the other hand, as of January 2017 this wage began to contract due to the increase in inflation (Figure 3.22). Thus, to the extent that inflation has continued to increase, the negative effect of inflation on real wages has also continued to decline in real terms. What has basically happened is that the average wage increase for workers registered with the IMSS has been around 4.5% in nominal terms, while annual inflation has been above 6%. As long as inflation continues at a higher level than the nominal increase in the average wage of workers registered with the IMSS, the deterioration of this average wage increase in real terms will continue. The previous point signals that it is to be expected that when inflation returns to levels of 4% or less, the average real wage of IMSS-affiliated workers will stop declining and possibly experience an upturn.

Finally, it should be remembered that the fall in the real wage reduces the employee's possibilities of purchasing goods and services. This in turn means that private sector consumption has to stop counting on one factor which drives its growth in real terms, a factor which will re-emerge when real salaries start growing again.

3.1.5 Public finances: non-tax revenues sustained the increase in total budget revenue for the public sector in the first half of 2017, while cuts to programmable spending contracted total expenditure

Total public sector budget revenue showed real annual growth of 7.6% in the first half of 2017. Importantly, this year-on-year comparison includes the amount of 321.7 billion pesos from the Bank of Mexico operating surplus. If we exclude this component from budget revenue for the first half of 2017, the real annual rate would have fallen 5.4%.

If we break down total budgetary revenues into components, non-tax income (including the federal government's petroleum revenues) showed real annual growth of 30.8% in the first quarter of 2017. Excluding the central bank's operating surplus would imply an increase of 33.3% in this component in real annual terms. Tax revenues meanwhile showed a real annual variation of 0.1% in the first half of 2017. Although this figure alludes to a stagnation in the annual growth of tax revenues, a recovery of such revenues was observed, with this income falling by 3.5% in real annual terms since the first quarter of 2017.

VAT is an important component of tax revenues due to its weight in the structure of the latter (a 27.2% share in the first half of 2017). It showed a real annual variation of 1.3% in the first half of 2017, which compares unfavourably to the 2.1% real annual growth observed in the first quarter of 2017.

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

	2016	2017	Real % change	% struct.
Total	**2,338.9**	**2,655.6**	**7.6**	**100.0**
Federal Government	1,868.2	2,128.4	7.9	80.1
Tax	1,393.1	1,472.3	0.1	55.4
Income Tax	762.8	834.1	3.6	31.4
VAT	374.3	400.0	1.3	15.1
Non-tax	475.1	656.1	30.8	24.7
Agencies & companies	160.3	174.9	3.3	6.6
Gvmnt. productive co.	310.4	352.4	7.6	13.3
Pemex	172.8	182.0	-0.2	6.9
CFE	137.6	170.5	17.4	6.4
Total	**2,338.9**	**2,655.6**	**7.6**	**100.0**
Oil revenue	315.0	413.8	24.5	15.6
Non-oil revenue	2,024.0	2,241.9	5.0	84.4

Source: BBVA Research with Finance Ministry (SHCP) data

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

	2016	2017	Real % change	% struct.
Total	**2,465.0**	**2,531.2**	**-2.7**	**100.0**
Projected expenditure	1,844.1	1,816.4	-6.7	71.8
Current expenditure	1,381.4	1,436.1	-1.5	56.7
Capital expenditure	462.7	380.3	-22.1	15.0
Non-projected expen.	620.9	714.8	9.1	28.2
Investments in states	355.1	411.0	9.7	16.2
Borrowing cost	237.6	279.6	11.5	11.0
Adefas* and other	28.3	24.2	-18.9	1.0

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

Public sector oil revenues accounted for 15.6% of total budget revenues in the first half of 2017 (the corresponding figure was 13.9% in the first quarter of 2017). It is important to note that this revenue item increased in annual terms, with a real growth rate of 24.5% in the first half of 2017.

As far as net public sector spending in the first half of 2017 is concerned, it registered a real annual decrease of 2.7%. This was mainly due to programmable spending (accounting for 71.8% of total net public sector spending in that half-year), with a real annual contraction of 6.7% in the first half of 2017. Within the area of programmable expenditure, CapEx showed a real annual decline of 22.1%. Current expenditure meanwhile recorded a reduction of 1.5% in real annual terms in that half-year.

It is important to acknowledge that federal payments, public pensions, and the financial cost of public debt continued to pressure public finances in the first half of 2017. Our own calculations show that without financial investment and federal payments, other spending was kept in check to a greater extent, with a real YoY reduction of 3.9% over the six-month period. If we also omit public sector pensions and the financial cost of public debt, the containment of this more limited concept of expenditure, is even greater as it has fallen 8.2% in real annual terms during the first half of 2017.

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 continue these efforts to rein in spending during the second half of 2017 to reach the targets of a primary surplus of 0.5% and a debt stock of 49.5% of GDP for the public sector's financial requirements.

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

	2016	2017		
	Nominal	Nominal	Real	Real % change
Total net expenditures	**2,465.0**	**2,531.2**	**2,398.4**	**-2.7**
Without financial investment	2,350.6	2,435.8	2,308.0	-1.8
Without financial investment and participations	1,995.5	2,024.8	1,918.6	-3.9
Without financial investment, participations and pensions	1,680.1	1,677.8	1,589.8	-5.4
Without financial investment, participations, pensions and financial cost	1,442.5	1,398.2	1,324.8	-8.2

Source: BBVA Research with Finance Ministry data

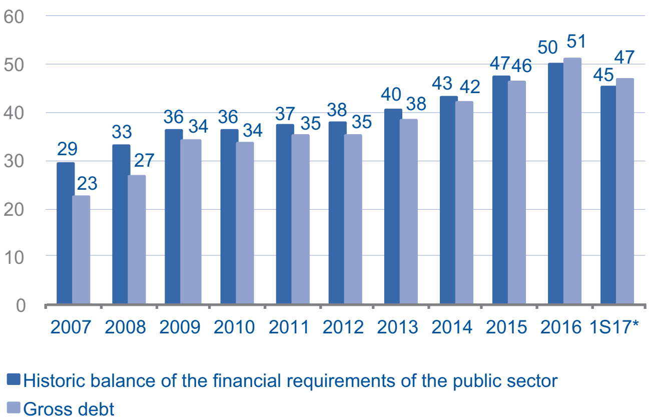
Table 3.4 Financial situation of the public sector January to June (Billions of pesos)

	2016	2017	Real % chge.
Public Balance	-116.6	141.9	n.s.
Pub. Bal. w/o Prod. Investment	133.7	318.4	125.6
Budget Balance	-126.1	124.4	n.s.
Budget Revenue	2,338.9	2,655.6	7.6
Net Budget Expenditure	2,465.0	2,531.2	-2.7
Federal Govnmt. Balance	-95.5	105.0	n.s.
Agencies & Co. Balance	-30.6	19.5	n.s.
Primary Balance	126.0	416.7	213.3
Budget Balance	111.5	404.0	243.4
Federal Government	93.6	319.5	223.6
Agencies & Companies	17.9	84.5	346.7
Pemex	-74.2	-18.3	-76.7
Other institutions	92.1	102.8	5.7
Indirectly-controlled institutions	14.5	12.6	-17.6

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

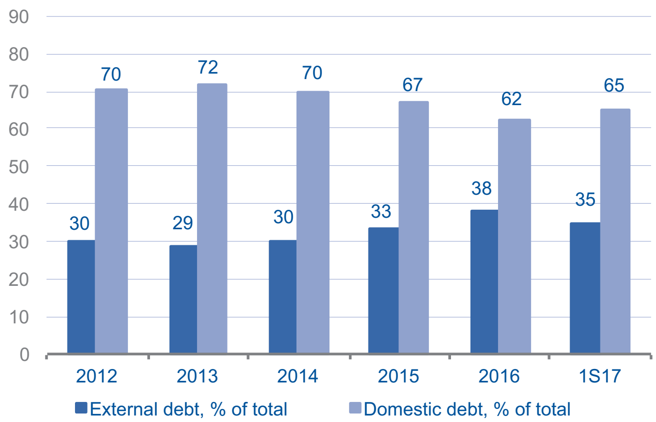
The primary public sector balance showed significant improvement in the first half of 2017, coming in at 416.7 billion pesos as against 126 billion pesos over the same period in 2016. The increase in the primary surplus was largely due to the federal government balance and, to a lesser extent, the Pemex balance. If this disciplined management of the finances of the federal government and state productive enterprises continues during the second half of 2017, the likelihood of compliance with the 0.5% GDP target for the entire public sector primary surplus in 2017 will increase substantially.

Figure 3.23 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 second quarter and a GDP deflator of 6.1%.
Source: BBVA Research based on Ministry of Finance and INEGI data

Figure 3.24 Percentage structure of internal and external public sector debt (% of the total debt)



Source: BBVA Research based on Ministry of Finance data

As for the issue of public debt, the balance of gross debt stood at 46.9% of GDP at the end of the first half of 2017. The debt level is 3.9 percentage points lower than the ratio of public debt to GDP seen at the close of 2016. As regards the breakdown of this debt into domestic and external components, external debt went from 37.8% in 2016 to 34.8% at the end of the first half of 2017. The appreciation of the Mexican peso against the dollar during the period was clearly a prime factor in both the reduced proportion of gross external debt and the lower ratio of gross debt to GDP.

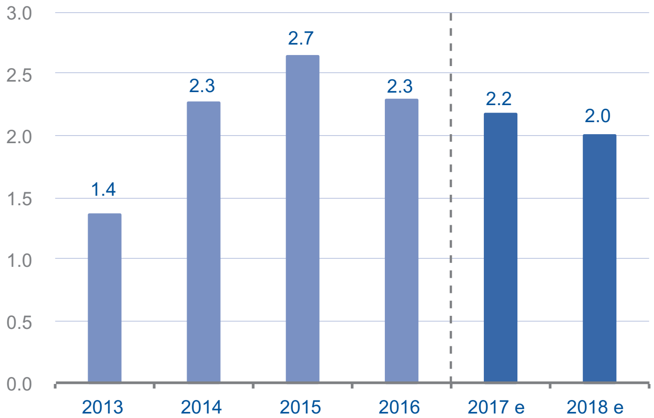
Over the first six months of 2017, total public sector financing requirement was 16% of GDP higher than in 2007. As far as 2017 is concerned, SHCP (the Ministry of Finance and Public Credit expects that the balance will be reduced to 48% of GDP from 50.1% of GDP in 2016 with the support of the Bank of Mexico's operating surplus. To reach this balance, it should be remembered that the annual deficit in the public sector financing requirement would have to reach a level of 1.4% of GDP by 2017 (after 4.1% and 2.9% of GDP in 2015 and 2016, respectively).

3.1.6 2017 and 2018 GDP Outlook

Given the positive performance of economic activity in the first half of the year, as discussed at the beginning of this section, we forecast that the 2017 GDP growth rate will be 2.2% (Figure 3.25). This growth is due to the fact that in the second part of the year we expect GDP to register growth rates that are slightly lower than those it showed in the first half of 2017. This will happen because important macroeconomic variables that may influence the behaviour of economic activity in the rest of the year, such as the contraction of real wages, will continue to be present.

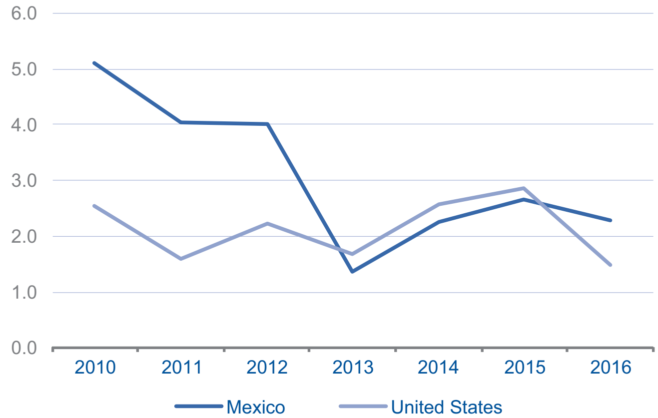
By 2018, we consider GDP growth will be at 2%, slightly lower than our estimate for 2017. This is largely due to the fact that US GDP growth in 2018 will be similar to 2017 (2.1%), with the average exchange rate of 2018 slightly lower than in 2017. The latter will allow for a greater growth of imported goods, which could push down net exports, and therefore lower the momentum of GDP. To the extent that the reform of the oil sector is bearing fruit and the US economy is showing higher growth rates than it has in recent years (Figure 3.26), among other factors, we can expect Mexico's GDP to be higher than forecast for 2017 and 2018.

Figure 3.25 Annual GDP Mexico: observed and estimated (YoY % change)



Source: BBVA Research based on information from INEGI

Figure 3.26 Annual GDP of Mexico and the US (YoY % change)



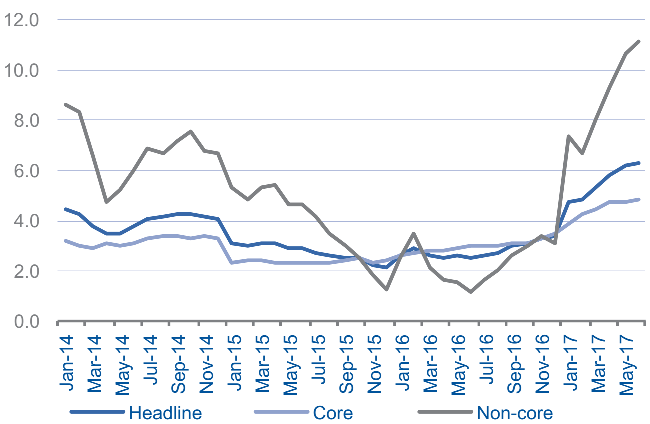
Source: BBVA Research with data from INEGI and BEA (Bureau of Economic Analysis)

3.2 Inflation is reaching its maximum level…

Until July, inflation had an upward trend for 13 consecutive months after having remained low and relatively stable during the last two years (2015-16), averaging 2.8% during that period (2.7% in 2015 and 2.8% in 2016), remaining remain below the target for 17 months in a row (between May 2015 and September 2016), and being slightly above 3% for only two quarters in those two years (1Q15 when it averaged 3.1% and 4Q16 when it averaged 3.2%). The upward trend was mainly due to two simultaneous unexpected developments: 1) the considerable further depreciation of the peso as a result of the outcome of the US election, which caused a quickening in the pass-through rate of goods and 2) the sharp increase in energy prices in January of this year as a result of their liberalisation. The second factor has also recently had indirect effects (mainly increases in transport tariffs)The two developments have been accompanied by considerable increases in agricultural output which have increased during the last four months (and considerably between March and May).

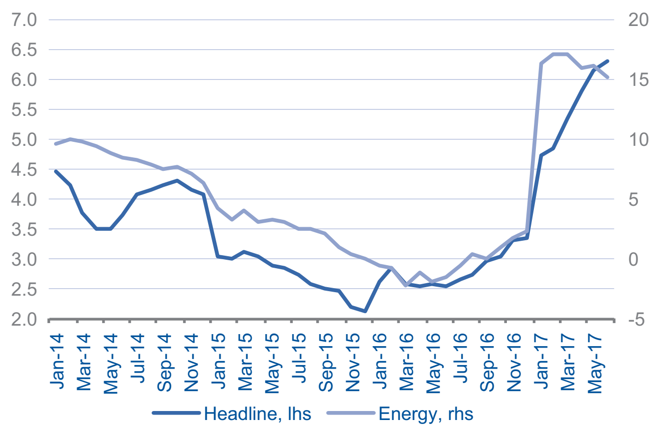
In January, there was an upturn in inflation of 1.36%, with the annual rate increasing from 3.36% in December 2016 to 4.72%. The annual rate has continued to climb to 6.44% in July, well above the central bank's 3% target and even above the 4% upper limit of the range of tolerance (see Figure 3.27). The sharp increase registered by headline inflation in January this year is explained in part by the 12.7% increase in the energy price component (see Figure 3.28), which had a monthly incidence on headline inflation of 1.2pp, and is explained by a fiscal policy of liberalising the prices of certain energy items, particularly gasoline and LPG. Likewise, the upward trend has also responded to the higher pass-through pace of commodity prices (see Figure 3.29).

Figure 3.27 Headline Inflation and components
(YoY % change)



Source: BBVA Research based on INEGI data

Figure 3.28 Headline inflation and energy prices
(YoY % change)



Source: BBVA Research and INEGI

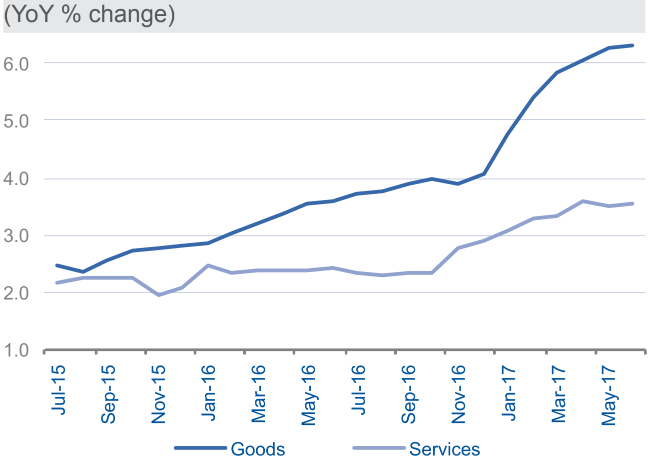
As a result of the foregoing, annual headline inflation went from an average 3.24% in 4Q16 to an average 4.98% in the first quarter of 2017 and to 6.1% in the second quarter. At the close of 2Q17, it stood at 6.31%. Meanwhile, average annual core inflation went from 3.28% in 4Q16 to 4.19% in 1Q17 and 4.78% in 2Q17. At the close of 2Q17, it stood at 4.83%. Within core inflation, the goods index increased by 2.3% between December 2016 and June 2017 (from 4.05% to 6.33%). Both sub-indices of this component showed significant increases in the same period, rising from 4.4% to 6.9% in the case of food and from 3.76% to 5.86% in that of non-food goods. The services index also increased, albeit at a lower rate, going from 2.92% to 3.56% between December and June.

The sharp increase in inflation largely reflects a change in relative prices as a consequence of the transitory nature of the shocks on inflation. As was to be expected, the impact on inflation of the shocks led to a considerable increase in short-term inflation forecasts (which tend to move in line with inflation), but did not translate into increases in long-term expectations. These remained stable due to the monetary policy of the Bank of Mexico (Banxico), which bolstered the prospect that the increase in inflation would be temporary and avoided an unleashing of inflation expectations that would cause second-order effects in the price formation process. Even in the absence of second-order effects, 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 the two shocks mentioned above, the effect of the second, the pass-through, is more important to the inflationary trend. As shown in Figure 3.3, the increased slope in the food trend up to April and non-food goods up to May suggests that, as we anticipated, the pass-through pace increased at the start of this 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 forecasted that it would be difficult to keep absorbing the increase in costs through lower margins.

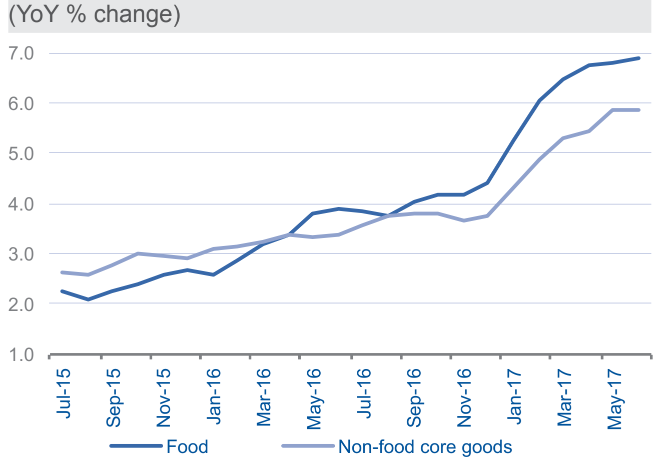
In ***Mexico Economic Outlook*** 2Q17, we pointed out that there is still some way to go in the process of passing on the effects of the currency depreciation to the price of goods, but also that the risks ahead have reduced thanks to the peso's significant appreciation (approximately 18%) since bottoming out in January this year. As we pointed out in the April edition, when the exchange rate was above 18.5 pesos to the dollar, it was expected that the peso would continue to strengthen. If our outlook were confirmed, the annual depreciation rate would tend to decrease rapidly in the second half of the year and would even show a negative variation towards year-end and particularly from January 2018. This should bring about a lower rate of pass-through in the following months. These trends seem to be confirmed and both food and non-food inflation has stabilised. Risks have continued to decline, with the likelihood that the effect on inflation of this transfer of accumulated depreciation to commodities will be temporary continuing to increase.

Figure 3.29 Components of core inflation (YoY % change)



Source: BBVA Research, INEGI and Bloomberg

Figure 3.30 Components of the underlying goods index (YoY % change)



Source: BBVA Research and INEGI

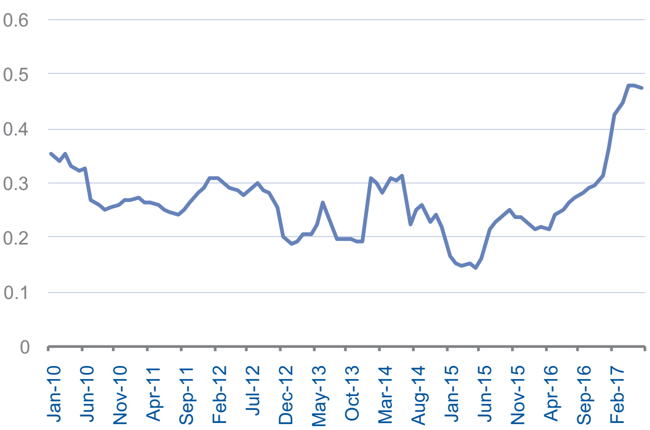
The environment that still allows for the absence of generalised second-order effects is also supported by the credibility of Banxico's monetary policy (i.e. the increase in the monetary rate from 3% to 7% between December 2015 and June 2017), with the rigidity of nominal wages resulting in contractions of real wages avoiding generalised pressures on prices. 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, while for the goods component of core inflation we continue to see changes in relative prices with a much greater upward tendency. Meanwhile, the pass-through to headline inflation is much lower, mainly due to the aforementioned absence of second-order effects.

... and we forecast that it will start to decline in September and that the downward trend will increase from January 2018

We expect to see inflation remain at 6.4% during July and August, but that the annual rate will begin to show signs of moderation from September. As can be seen in Figure 3.31, the trend in seasonally-adjusted monthly core inflation reveals that, once the seasonal effects are discounted, the trend began to show signs of stabilisation in 2Q17 and even showed an inflection in June. It is foreseeable that annual inflation will stop rising and start a downward trend after the summer.

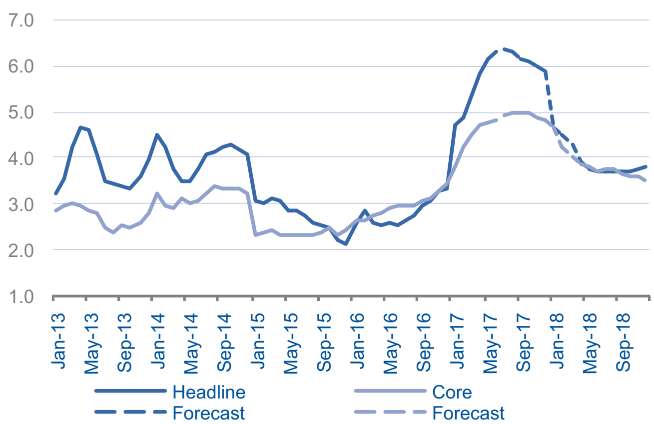
We anticipate that the annual headline inflation will remain at 6.4% during July-August and above 6% until October (averaging 6.3% between July and October), before showing a significant decline in the last two months of the year, in which we expect it to average 6%. By the end of 2017, our forecast is 5.9%. In January 2018, a very favourable comparison base effect will permit a decrease of 1.3pp to 4.6% and we predict that the downward trend will continue in the subsequent months for inflation to close 2018 below 4% (at 3.7%), within the Central Bank's target range.

Figure 3.31 Seasonally adjusted core inflation
6-month moving average (YoY % change)



Source: BBVA Research, INEGI and Bloomberg

Figure 3.32 BBVA Bancomer inflation outlook
(YoY % change)



Source: BBVA Research and INEGI

Our forecasts are subject to both upside and downside risk. The main downside risks are a 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 continue to be associated with the probability of our seeing second-order effects (although now much smaller), and a possible new slide in the peso if it seems NAFTA renegotiations will lead to substantial changes in trading relations between Mexico and the US.

3.3 Monetary pause during the rest of the year

The monetary tightening cycle came to an end last June after a 0.5% increase that pushed the benchmark rate to 7%, its highest level since 2008. The central bank was unusually explicit in this regard in its statement and based its decision on three arguments. Firstly, the risks of second-order effects have been reduced. Inflation figures for July show that the monthly increase in prices for services has stabilised after a significant increase during the first few months of the year reached 0.5%. This, coupled with the appreciation of the exchange rate observed during the first half of the year, means that a scenario with second-round effects derived from the transfer of the exchange rate to headline inflation has been reduced. Secondly, the turning point for inflation is near. Inter-annual inflation is expected to peak in August and then begin a downward trend that will intensify during the first few months of next year. It should be noted that the last time inflation exceeded 4% in 2008, Banxico ended the tightening cycle once inflation hit its highest point. Thirdly, inflation expectations are anchored. After a considerable rise at the beginning of the year, both fixed income and analysts' expectations are at levels similar to those observed before the US presidential election (Figure 33).

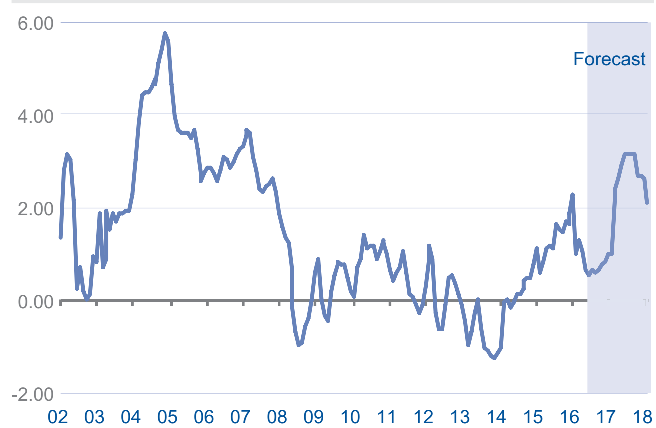
Given the scenario of a gradual reduction in inflation, Banxico is expected to maintain the level of monetary tightening until a convergence towards its 3% target is clear. We believe that it will be difficult to see inflation coming close to the inflation target before the second quarter of the year. We therefore expect the monetary pause to remain in place at least until this point. Subsequently and with inflation levels clearly below 4%, the possibility of reducing the benchmark rate will become increasingly important. Given the reduction of inflation, the real short-term rate will rise again (see Figure 34). This is not entirely consistent with the criterion of efficient convergence (in order to reach the inflation target at the lowest cost in terms of economic activity), which Banxico has emphasized in its communication. This is a relevant argument in favour of a reduction of the benchmark rate towards the middle of next year, however, the fact that the electoral process in Mexico may generate volatility in the financial markets during those dates introduces a high degree of uncertainty regarding the decision.

In sum and based on the arguments put forward, we believe that in the most likely scenario Banxico will maintain a monetary pause until the third quarter of 2018, when it will begin to reduce the benchmark rate to achieve a reduction of around 10% throughout next year.

Figure 3.33 Implied inflationary expectations for government fixed income instruments* (%)

*Note: Medium- and long-term expectations were adjusted downward by 4% to reflect the compensation for inflationary risk.
Source: BBVA Research based on Bloomberg data

Figure 3.34 Real benchmark rate (%)

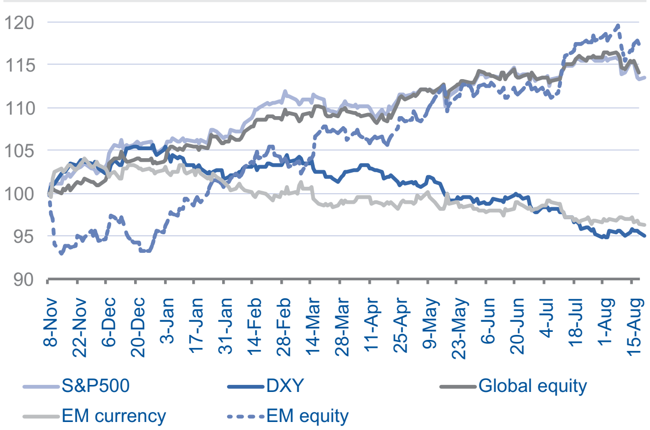


Note: The forecast is based on our own monetary policy rate and inflation forecasts.
Source: BBVA Research

3.4 A favourable global environment is maintained regarding demand for risky assets, particularly in emerging markets

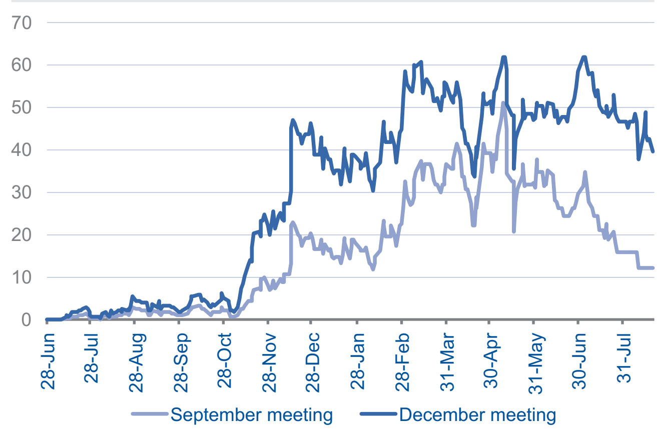
Asset prices in financial markets have continued to be influenced in recent months by an environment that has combined the revival of growth around the world, low levels of risk aversion and expectations that monetary stimuli will be maintained or will be very gradually removed. This environment has been particularly favourable to the growth in demand for emerging market assets, particularly in stock markets (Figure 35). The underlying benchmark for emerging countries (MSCI EM) has recorded gains of 8.3% in the last almost four months (from 28 April to 18 August) and 23% so far this year. Figures well above the 2.8% and 10.2% that the global stock market benchmark (MSCI ACWI) has increased in the past almost four months and so far this year, respectively. It is also important to note that after an uncertain end to 2016 after the change of administration in the US, the uptick in growth and world trade figures have benefited these nations. Mexico is a good example of this, where the stock index (IPyC) fell 5% between the day of the US presidential election and the end of 2016 to post a recovery of 12% so far in 2017, after reaching new all-time highs. This appetite for risk has not been limited to emerging markets. The major stock indexes in the US have maintained their own pace of gains, supported mainly by high-tech companies, corporate reports above expectations and, to a certain extent, expectations stemming from the growth policies promised by President Trump. The S&P500 has recorded an increase of 8.3% so far this year, 13.4% since the US presidential election.

Figure 3.35 Performance of stock and currency markets vs. the US dollar (Index 8 November 2016 = 100)



Source: BBVA Research based on Bloomberg data

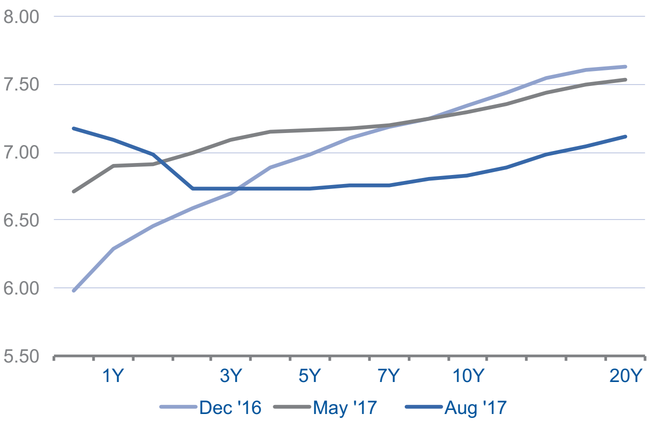
Figure 3.36 Implicit probability of an increase in the Federal Funds Rate in the Futures Market (%)



Source: BBVA Research based on Bloomberg data

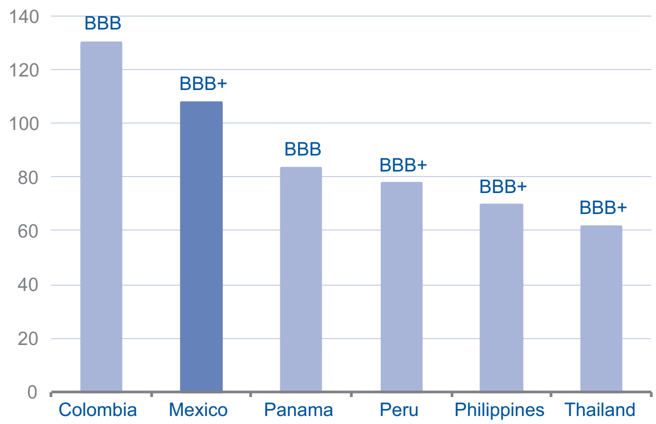
In the foreign exchange and fixed income markets, notification from central banks in developed countries and forecasts regarding their monetary policy have predominated over the other mentioned factors, causing behaviour differs from that seen in the stock markets. Long-term rates in the US have continued at low levels after their significant rise at the end of 2016 due to the prospect that the Fed's monetary normalisation would be more gradual than forecasts from members of the Open Market Committee (FOMC) (Figure 36). While the most recent figures indicate that the US economy is close to full employment, wages are not showing marked upward movement as expected, with inflation remaining more than half a point below the Fed's 2% target. In fact, it is these expectations of a more gradual normalisation and lower inflation than expected which are maintaining the 10-year yield on the Treasury bond at close to 2.2%, having reached levels of up to 2.6% during the first quarter. For its part, the short part of the US curve has continued its rise given the rise in the federal funds rate in March and June, which has led to a further flattening of the yield curve. In Mexico, the curve has gone beyond flattening and is currently reversed (Figure 37). In addition to the influence of lower long-term rates in the US, recent monetary policy movements are behind this unusual behaviour. Indeed, the end of the cycle of monetary tightening and the more relaxed tone of the central bank took the market and most analysts by surprise, leading not only to discarding additional increases, but to incorporating price cuts in the benchmark rate for next year. The component of the expected monetary rate included in the long-term rate was significantly reduced. If we add the reduction of Mexico's sovereign risk following the recent change of perspective by the rating agencies[1], as well as the perception in the markets that liquidity conditions will remain in place longer, we can see a combination of factors that explains the inverted shape of the yield curve to a great extent.

Figure 3.37 Government yield curve (%)



Source: BBVA Research based on Bloomberg data

Figure 3.38 Sovereign risk. CDS spread 5-year level by rating level (basis points)



Source: BBVA Research based on Bloomberg data

Concerning exchange rate matters, the main characteristic of recent months has been the generalised depreciation of the dollar. Influenced by the aforementioned lower expectations of interest rate hikes by the Fed; a marginal reduction in US growth expectations, higher expectations of economic activity in other regions (such as the eurozone) and President Trump's comments in favour of a weak dollar, the dollar is currently at its lowest level since May last year, leaving behind the gains it obtained after the presidential election. This generalised fall in the dollar has influenced the recovery of the Mexican peso, but it is undoubtedly the better prospects for a successful renegotiation of NAFTA that have led the Mexican currency to rank as the most appreciated currency globally so far this year. The letter sent to Congress by the Trump administration to give a formal start to the renegotiation process, as well as the specific objectives presented by the American trade representative, outline a more sensible and moderate position than that set out by the presidential address at the beginning of the year.[2] It will be necessary to add the result of the Mexican state elections to this positive trend, which seems to have been interpreted by those in the market as reducing the probability of a victory for left-wing

1: The Fitch Ratings and S&P agencies reviewed Mexico's sovereign debt perspective, moving it from a negative to a stable outlook in recent weeks, which led the 5-year CDS spread down to around 100 basis points, a level not seen since the end of 2014.
2: See flash "USA seeks to maintain the essence of NAFTA, but the negotiations will be complicated" (https://www.bbvaresearch.com/publicaciones/mexico-eeuu-busca-mantener-la-esencia-del-tlcanpero-las-negociaciones-seran-complicadas/)

parties in next year’s elections. The Mexican peso has appreciated 15% so far in 2017 and 18% since the inauguration of the new US president. Finally, it is important to note that the relative stability in the oil price has been a key factor in this positive shift. Although there have been periods of volatility in this market, we can see that the general correlation of daily exchange rate movements with those of the price of energy has decreased in recent months.

Going forward, attention will have to be focused on any event that could interrupt the conditions that currently favour the demand for assets with higher yields, particularly the low levels of global risk aversion. In the case of Mexican assets and particularly the peso, the renegotiation of NAFTA will be the main event to follow. The declarations of the players after each round of negotiations do not preclude episodes of volatility, but it is expected that by the end of the year there will already be considerable progress in the process that signals a possible final agreement towards the beginning of 2018. In this scenario, and leaving aside major disruptions at the international level, we think that the exchange rate will show some depreciation in the coming months and will close the year around 18.7 pesos per dollar.

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	**2.1**	**2.2**
EMU	1.3	1.9	1.7	**2.0**	**1.7**
Germany	1.6	1.5	1.8	**1.9**	**1.8**
France	1.0	1.0	1.1	**1.5**	**1.5**
Italy	0.2	0.7	1.0	**1.3**	**1.2**
Spain	1.4	3.2	3.2	**3.3**	**2.8**
UK	3.1	2.2	1.8	**1.5**	**1.1**
Latin America *	0.8	-0.4	-1.3	**0.8**	**1.6**
Mexico	2.3	2.7	2.0	**1.6**	**2.0**
Brazil	0.5	-3.8	-3.6	**0.6**	**1.5**
EAGLES **	5.4	4.7	5.0	**5.0**	**5.1**
Turkey	5.2	6.1	2.9	**5.0**	**4.5**
Asia-Pacific	5.6	5.6	5.6	**5.2**	**5.2**
Japan	0.2	1.1	1.0	**0.8**	**0.9**
China	7.3	6.9	6.7	**6.5**	**6.0**
Asia (exc. China)	4.2	4.5	4.6	**4.1**	**4.4**
World	3.5	3.3	3.2	**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: 8 July 2017.
Source: BBVA Research & IMF

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)	2.9	1.5	**2.1**	**2.2**	0.6	2.2	2.8	1.8	1.2	2.6	**2.6**	**2.5**
Personal consumption (real % change)	3.6	2.7	**2.5**	**2.1**	1.8	3.8	2.8	2.9	1.9	2.8	**2.0**	**2.0**
Gov. consumption (real % change)	1.4	0.8	**0.1**	**0.6**	1.8	-0.9	0.5	0.2	-0.6	0.7	**0.4**	**0.7**
Gross fixed investment (real % change)	5.2	-1.6	**2.2**	**3.0**	-4.0	-2.7	2.4	8.5	-1.2	2.0	**1.8**	**3.8**
Construction	10.2	5.5	**2.3**	**1.1**	13.4	-4.8	-4.5	7.1	11.1	-6.8	**4.0**	**0.7**
Industrial prod. (real annual % change)	-0.7	-1.2	**1.9**	**2.2**	-1.3	-0.6	0.6	0.8	1.4	4.8	**2.6**	**1.4**
Current account balance (% of GDP)	-2.5	-2.5	**-2.5**	**-2.6**	-2.9	-2.6	-2.5	-2.4	-2.6	-2.6	**-2.6**	**-2.5**
Final annual inflation	0.7	2.1	**1.5**	**1.9**	-4.7	-0.7	0.0	-3.9	-1.9	-1.1	**1.1**	**-4.3**
Average annual inflation	0.1	1.3	**2.0**	**1.7**	-4.6	-1.3	-0.9	-3.1	-2.2	-1.1	**0.2**	**-2.0**
Primary fiscal balance (% of GDP)	-2.4	-3.1	**-3.7**	**-2.8**	-2.5	-3.2	-3.7	-3.1	-3.9	-4.3	**-3.4**	**-3.5**

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

Table 4.3 Mexico Indicators and Forecasts

	2015	2016	2017	2018	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17
Economic Activity												
GDP (seasonally-adjusted series)												
Real annual % change	2.6	2.0	2.2	2.0	2.3	1.5	2.0	2.3	2.6	3.1	2.0	1.3
Per inhabitant (US dollars)	9,443	8,536	8,593	9,083	8,502	8,733	8,457	8,454	8,434	8,789	8,660	8,488
US$ billions	1,143	1,044	1,061	1,133	1,040	1,068	1,034	1,034	1,042	1,086	1,070	1,048
Inflation (average, %)												
Headline	2.72	2.82	5.86	3.85	2.69	2.56	2.78	3.24	4.98	6.10	6.36	6.02
Core	2.36	2.97	4.69	3.74	2.69	2.91	3.00	3.28	4.19	4.78	4.94	4.85
Financial Markets (average, %)												
Interest rates												
Bank funding	3.02	4.29	6.73	6.80	3.58	3.92	4.42	5.25	6.17	6.75	7.00	7.00
28-day Cetes	3.25	4.33	6.77	6.78	3.61	3.88	4.27	5.18	6.20	6.75	7.04	6.99
28-day TIIE	3.44	4.58	7.06	7.10	3.89	4.09	4.75	5.60	6.53	7.13	7.33	7.33
10-year Bond (%, average)	5.94	6.22	7.15	7.37	6.02	5.96	5.94	6.98	7.26	7.11	7.02	7.23
Exchange rate (average)												
Pesos per dollar	15.97	18.71	18.90	18.30	17.84	17.97	18.97	20.05	19.90	18.57	18.39	18.78
Public Finances												
*FRPS (% of GDP)	-4.1	-2.9	-2.9	-2.5				-2.9				-2.9
External Sector[3]												
Trade balance (US$ billions)	-14.7	-13.1	-14.7	-15.3	-4.0	-3.1	-5.2	-0.8	-2.8	-3.4	-4.6	-3.9
Current account (US$ billions)	-28.2	-22.4	-29.5	-30.9	-7.3	-6.2	-6.5	-2.4	-6.9	-7.4	-8.0	-7.2
Current account (% of GDP)	-2.5	-2.1	-2.8	-2.9	-2.8	-2.3	-2.5	-0.9	-2.6	-2.7	-3.0	-2.8
Employment												
Formal Private (annual % change)	4.3	3.8	3.8	3.2	3.7	3.7	3.8	4.1	4.3	4.2	3.7	3.1
Open Unemployment Rate (% active population)	4.3	3.9	3.6	3.7	4.2	3.9	3.8	3.7	3.5	3.6	3.6	3.6

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Mexico Indicators and Forecasts

	2015	2016	2017	2018	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17
Aggregate Demand[4] (annual % change, seasonally-adjusted)												
Total	4.1	1.6	**3.8**	**2.9**	2.2	0.9	1.5	1.9	4.1	**4.4**	**3.5**	**3.2**
Domestic Demand	2.1	1.8	**1.7**	**1.9**	1.8	1.5	1.8	1.9	2.8	**1.8**	**1.2**	**1.0**
Consumption	2.3	2.3	**2.4**	**2.0**	1.8	1.8	2.8	2.6	2.9	**3.2**	**1.9**	**1.4**
Private	2.3	2.4	**2.5**	**1.8**	2.1	1.8	3.0	2.8	3.3	**3.4**	**2.0**	**1.5**
Public	2.3	1.2	**1.4**	**2.9**	0.2	1.6	1.4	1.6	1.0	**1.8**	**1.7**	**1.3**
Investment	4.4	0.1	**-0.8**	**3.4**	2.1	-1.2	-1.4	1.0	-2.2	**-0.7**	**-0.5**	**0.1**
Private	8.1	1.9	**0.7**	**5.2**	4.4	0.6	0.4	2.3	-0.5	**1.3**	**0.6**	**1.4**
Public	-11.5	-9.2	**-9.7**	**-8.1**	-9.2	-10.2	-11.1	-6.2	-11.6	**-12.3**	**-7.1**	**-7.5**
External Demand	10.5	1.3	**9.6**	**5.6**	3.5	-1.0	0.7	1.8	7.5	**12.0**	**10.0**	**9.1**
Imports	8.7	0.5	**8.3**	**5.5**	2.1	-1.0	0.2	0.6	8.4	**8.5**	**7.9**	**8.5**
GDP by sectors (annual % change, seasonally-adjusted)												
Primary	1.7	3.5	**1.7**	**1.4**	-1.1	4.2	5.1	5.6	6.0	0.9	**-0.6**	**0.6**
Secondary	1.0	0.0	**-0.2**	**1.7**	1.4	-0.5	-0.9	0.0	-1.0	0.5	**0.0**	**-0.4**
Mining	-4.5	-6.5	**-9.2**	**-0.7**	-3.6	-4.7	-7.7	-10.0	-11.3	-8.5	**-9.0**	**-7.7**
Electricity	2.3	3.3	**-0.3**	**2.1**	1.3	5.8	3.7	2.6	-0.2	-1.8	**0.4**	**0.5**
Construction	2.6	1.8	**1.0**	**3.0**	2.9	1.4	-0.1	3.1	-0.5	0.4	**2.5**	**1.6**
Manufacturing	2.4	1.0	**3.0**	**1.9**	0.8	0.4	0.6	2.2	4.5	4.0	**2.2**	**1.3**
Tertiary	3.5	3.2	**3.3**	**2.1**	3.3	2.6	3.3	3.4	3.8	4.1	**2.6**	**2.6**
Retail	4.8	1.9	**3.2**	**1.2**	2.5	1.6	1.2	2.4	3.9	4.4	**2.6**	**2.1**
Transportation, mail and warehouse	4.3	2.5	**3.9**	**2.7**	1.8	2.3	2.7	3.1	4.7	4.6	**3.0**	**3.5**
Massive media information	7.6	10.1	**5.3**	**5.1**	9.3	9.9	13.2	8.1	5.8	7.3	**3.2**	**4.8**
Financial and insurance	4.3	7.7	**8.4**	**7.1**	7.7	7.7	7.8	7.5	9.1	10.0	**7.1**	**7.6**
Real-estate and rent	2.5	1.9	**1.9**	**1.9**	2.0	1.6	1.9	1.9	2.3	1.8	**1.6**	**2.0**
Prof., scientific and technical servs.	4.5	7.7	**3.3**	**1.3**	7.0	6.8	11.2	5.9	6.0	4.4	**1.5**	**1.4**
Company and corporate management	3.3	4.7	**2.8**	**3.3**	5.8	5.1	5.5	2.5	5.4	3.3	**0.4**	**2.2**
Business support services	1.2	4.0	**3.0**	**1.4**	3.2	3.6	2.9	6.2	3.8	3.1	**3.5**	**1.4**
Education	0.0	1.1	**0.7**	**0.1**	0.8	1.5	1.4	0.6	1.6	0.9	**0.3**	**0.1**
Health and social security	-2.3	1.3	**1.9**	**1.4**	-0.8	1.5	2.3	2.1	1.7	3.4	**1.2**	**1.2**
Cultural and sport	3.9	5.2	**3.1**	**0.6**	2.2	4.1	9.5	4.9	4.8	4.7	**1.4**	**1.6**
Temporary stay	5.7	4.0	**4.1**	**2.6**	6.5	3.1	2.6	3.8	0.9	6.6	**3.9**	**4.9**
Other services, except govnt. activities	2.5	5.8	**1.2**	**0.3**	5.2	6.3	6.2	5.7	3.4	-0.2	**1.5**	**0.3**
Government activities	2.7	0.0	**0.8**	**0.8**	-3.0	-0.7	1.7	2.1	0.8	0.2	**1.2**	**1.0**

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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