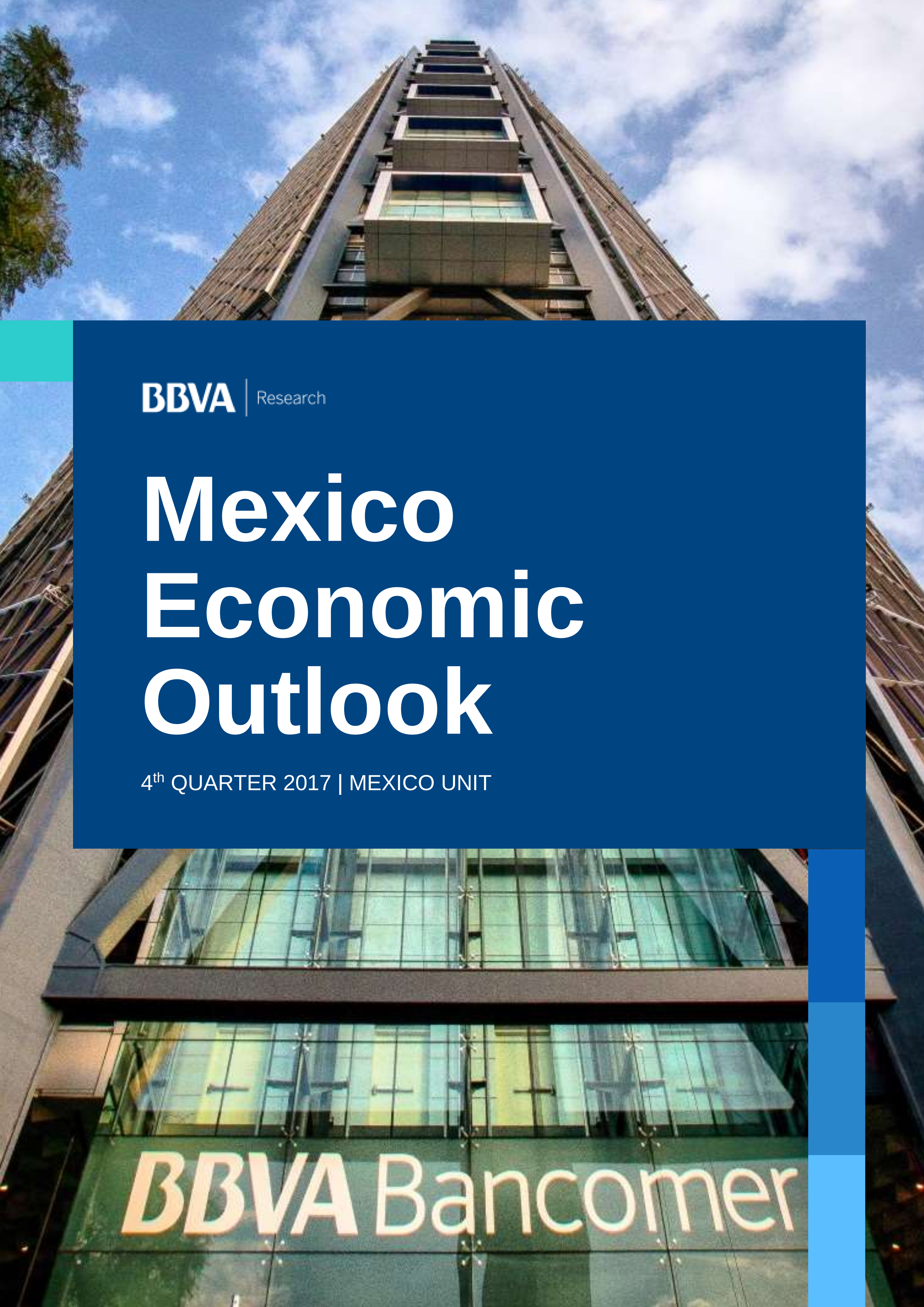



BBVA | Research

# Mexico Economic Outlook

4th QUARTER 2017 | MEXICO UNIT

# Index



Closing date: **9 November 2017**

# 1. Summary

The positive global environment has firmed up in the past few quarters. Our new forecasts suggest that global growth is picking up pace to 3.4% in 2017-18, which implies an upward revision of around 0.2 pp this year and an acceleration from 3.2% last year. This change is due to higher growth forecast now for both China and Europe in 2017, on account of positive surprises in both regions since Q2. For the US we continue to project sustained growth of just over 2% at the forecast horizon. The factors underlying the gathering momentum and stability of world growth will remain present, even though some of them could gradually fade in the coming quarters. The most immediate will be the normalisation of monetary policy by both the US Federal Reserve and the European Central Bank, as it will lead to a gradual reduction in global liquidity and less support for capital flows into the emerging economies. On top of this, there are still a number of political risks that could influence economic confidence and the performance of the markets.

In an environment where growth remains spirited and with no inflation surprises on the downside, the central banks are pressing ahead with the gradual process of withdrawing monetary stimuli. Specifically, the US Federal Reserve has announced the start of the reduction of its balance sheet from October. This will take the form of a passive reduction, by allowing a portion of public and private bonds to simply expire, which has been clearly signalled, so that it has not led to any form of market unrest. Furthermore, the Federal Reserve still expects to implement a series of rate hikes, even though the markets have systematically shown themselves to be more dovish. We expect a 25 bps hike for official rates in December this year and then two further hikes up to 2% in 2018.

Mexico's economy contracted in the third quarter of the year. The preliminary QoQ growth rate, annualised, was negative at 0.8%. This performance was due to reduced momentum in consumption, which in turn was due to the temporary increase in inflation, and to the falls in oil output and construction. Added to this slowdown was the negative impact of September's hurricanes and earthquakes. For the last quarter of the year we anticipate an uptick driven in large part by the recovery of trade and the start of reconstruction work. With the growth data available so far we can already assert with a high degree of certainty that economic growth for 2017 will come in at between 2.1% and 2.2%. For next year, we estimate that the economy will grow at a similar pace to that of 2017. However, there are two risk factors to consider: the possibility of deteriorating trade relations between Mexico and the US, and the uncertainty surrounding the presidential elections in 2018. As for the public finances, we foresee the target primary fiscal surplus of 0.4% of GDP being attained. This, together with the Banco de México operating surplus will mean that debt as a percentage of GDP will fall for the first time in ten years. This substantially reduces the possibilities of a downgrade in Mexico's sovereign rating.

Talks on NAFTA deteriorated in the fourth round, and the path towards "NAFTA 2.0" became much more challenging. The US put forward proposals that were unacceptable to the other parties, as well as once again stressing its intention to reduce its trade deficit. A unilateral withdrawal from NAFTA by the US can no longer be ruled out. In fact, although we continue to assign a probability of more than 50% to a positive outcome of the talks ("NAFTA 2.0"), this is less than the 85% we had been ascribing to it until September. In other words, the probabilities of agreement and breakdown are now more evenly balanced in our opinion. That said, as we have shown in numerous earlier editions of Mexico Economic Outlook, if the US acts in accordance with its economic interests it should keep the agreement in place.

This context has been reflected in the exchange rate. The peso's depreciation since mid-August is due to the risks associated with NAFTA. The peso's poor relative performance started with the first round of talks on NAFTA 2.0, was unaffected by more hawkish comments from the US Federal Reserve, and was accentuated in October with the increased risk of NAFTA breakdown. Looking ahead, any change in trend will continue to be mainly in reaction to shifting prospects for the renegotiation of NAFTA.

We estimate that an end to NAFTA would not have an across-the-board effect on trade flows, since the weighted average import duty faced by Mexico's exports to the US under WTO most favoured nation (MFN) rules would be 3.5%. Nonetheless, it would certainly have a negative effect on investment and on particular sectors such as the production of vehicles for transporting goods (lorries/trucks). This segment accounts for 6.1% of total exports from Mexico to the US, and would face a 25% import duty under the WTO's MFN regime.[1] Thus we envisage that the elimination of the agreement would affect economic growth mainly through a fall in FDI in the heavy automotive (truck) sector and a decline in private domestic gross fixed investment in related sectors. Assuming a fall of 7.4% in FDI and a decline in domestic gross fixed investment of between 2% and 4%, we estimate that the ending of NAFTA would have a negative effect on GDP growth in 2018 of between 0.5 and 0.8 pp.

Another potential risk on the horizon is the proposed tax reform currently being discussed in the US, involving a cut in corporation tax from 35% to 20%. In Mexico this rate is 30%. Two pertinent questions arise in this respect: What effect will it have on US FDI into Mexico? Should the Mexican government respond by cutting its corporation tax rate too? Our analysis indicates that even if this tax cut were to be implemented in the US, Mexico would still have a more competitive manufacturing base. For this reason, we consider that Mexico should not respond by cutting its corporation tax rate. In the event that the Mexican government did decide to cut the rate from 30% to 20%, tax revenues would show an annual contraction of 16.9%, equivalent to 1.2% of GDP.

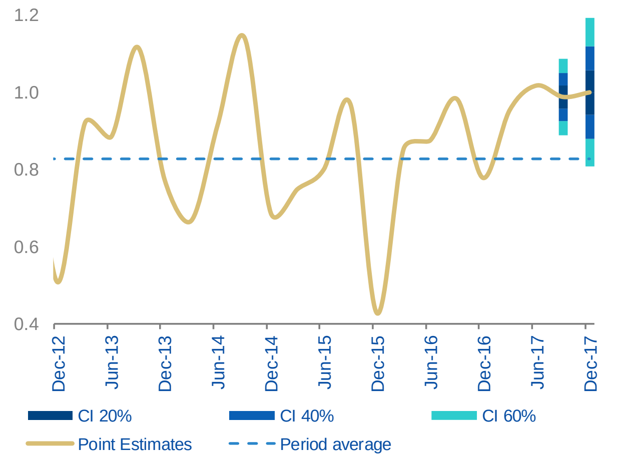
Lastly, inflation is at last declining. Having shown a rising trend for fourteen months in a row, headline inflation peaked in August at 6.7% and reached an inflection point in September (6.35%), as we had been anticipating since the beginning of the year. Thus, while the balance of risks for inflation has deteriorated because of the peso's recent depreciation and the risk of further depreciation, it is increasingly clear that inflation is evolving as anticipated by the central bank and, in our opinion, will quickly approach the target range (3.0% +/- 1 pp) in the first half of 2018. We forecast that inflation will end 2017 at 6.2% and for closing 2018 will be below 4.0% (at 3.7%), within the central bank's target range. The risks for inflation have an upward bias, but are moderate. Although we still expect the next interest rate move to be downwards, the context and the recent communication of Banxico (Banco de México, Mexico's central bank) make it clear that this is still some way off. Therefore we consider that in the most likely scenario Banxico will keep its monetary policy on hold until the third quarter of 2018, when it will start to reduce its key rate.

# 2. The positive global environment is strengthening

## Robust and steady global growth with a more synchronized recovery across areas

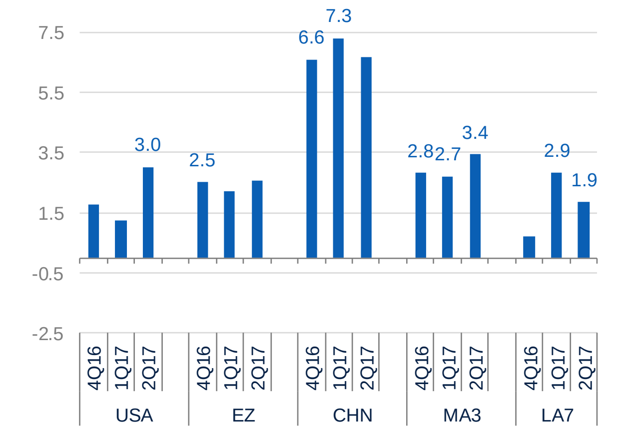
The growth rate of the world economy has stabilised by mid-year at around 1% QoQ, and the available indicators suggest so far that this trend will continue in the second half of the year (Figure 1). Global confidence indicators continue to improve, both in advanced and emerging economies, and anticipate a more positive outlook than the activity indicators, which slowed down at the beginning of the third quarter. Nonetheless, global trade growth remains solid and the recovery of the industrial sector continues apace, underpinning the upturn in investment, while private consumption remains resilient despite weaker tailwinds.

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




Source: BBVA Research

**Figure 2.2** GDP growth by region (Seasonally Adjusted Annual Rate, %)




Source: BBVA Research

This positive dynamic reflects a stronger economic performance in all areas (Figure 2). In the advanced economies, US GDP rebounded in Q2 and dispelled doubts over the persistence of moderate growth in the coming quarters, while a greater strength from domestic factors was behind the positive surprise in Europe. In emerging economies, stable growth in China will continue to support the rest of Asia, which, coupled with favourable financial markets conditions, is also allowing growth in Latam countries to gain traction. In addition, the recovery in Russia and Brazil means that these countries are no longer dragging global growth. Hence, unlike other episodes of growth since the financial crisis (in early 2013 and mid 2014), the current recovery is proving to be more synchronised,[1] according to our index.[2]

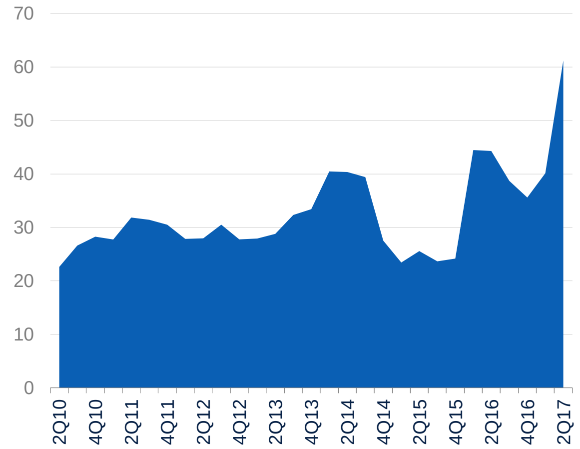
This environment of positive and more synchronised growth has thus far been accompanied by moderate levels of inflation, also generalized by areas, despite the abundance of liquidity in the markets, while there are still no clear signs of accumulation of inflationary pressures. In the case of the emerging markets (EM), the appreciation of their currencies

1: Proof of this can be found in the fact that Harding and Pagan's concordance index for growth in developed and emerging economies has risen 25% since 2016.
2: The synchronisation index given here is the product of inverting the standard deviation of quarterly growth observed across countries. The index therefore associates less (more) growth volatility among countries with a higher (lower) degree of synchronisation worldwide.

due to a weak dollar and a certain increase in commodity prices has helped inflation to continue to abate. Among the developed economies, the reduction in inflation results from the disappearance of the base effect of energy prices (especially in Europe) and certain transitory factors (mainly in the United States), although core inflation remains at low levels and doubts persist on whether the factors underlying this weakness of inflation are temporary or permanent. This context helps central banks in the emerging economies to have greater room for manoeuvre to continue supporting growth, while it allows the monetary authorities in the advanced economies to remain cautious in normalizing their monetary policies.

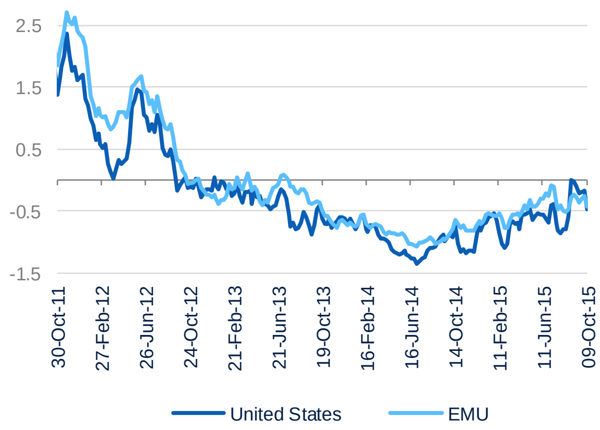
Other drivers behind the global performance, such as fiscal policies, have generally been neutral or expansionary lately, while relatively subdued commodity prices appear to extend over the forecast horizon, and relatively complacent financial markets are not suffering persistently from sources of political stress.

**Figure 2.3** Synchronisation index (based on the time variance of GDP)




Source: BBVA Research

**Figure 2.4** Financial tension index. USA vs. Eurozone (normalised)




Source: BBVA Research

## Favourable environment in financial markets and normalization of monetary policies

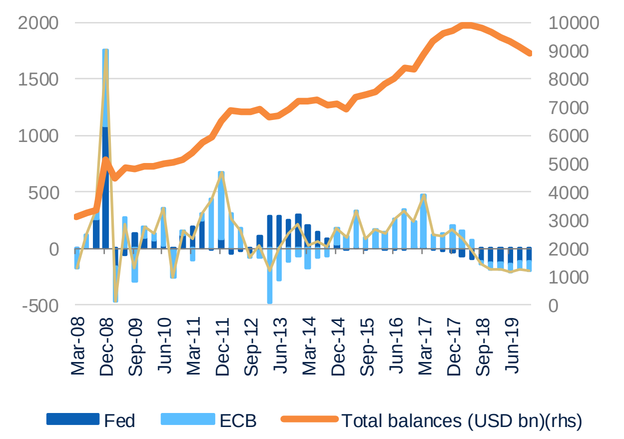
In this quarter market dynamics have been broadly unchanged since the first half of the year in spite of episodes of stress (Figure 4), above all of a political (debt ceiling debate in the United States) and geo-political nature (tensions in North Korea). These events have caused a certain safe-haven effect on debt, which has led long-term interest rates to the lower end of the market range. However, its effect has been only transitory.

In an environment where growth remains dynamic and with no downward surprises on inflation, central banks are pressing ahead with the gradual process of withdrawing monetary stimulus. Specifically, the US Federal Reserve (Fed) has announced it will start reducing its balance sheet as from October. This would take the form of a passive reduction, by allowing a portion of public and private bonds to expire, which has been well communicated, so it has not generated any tensions in markets. Moreover, the Fed, still expects to implement a series of rate hikes, even though the markets have systematically shown themselves to be more bearish. We expect a 25 bp hike for official rates in December this year and then two further hikes up to 2% in 2018. However, uncertainty about these hikes has increased, not only because inflation is still at low levels, but also because of the changes that are going to take place at the Fed following the exit of many of its members.

The European Central Bank (ECB) will announce the tapering of its asset purchase programme in October, which it would start to implement in January next year. The withdrawal of stimulus will be gradual and the ECB will be as flexible as possible, although the precise strategy it will adopt is uncertain as regards how much it will scale back its purchases and for how long the programme will continue. Our scenario contemplates a gradual reduction in purchases until the programme ends in summer 2018. Rate hikes, however, will be delayed until mid 2019, largely due to the ECB's growing concern over euro appreciation and its potential impact on inflation.

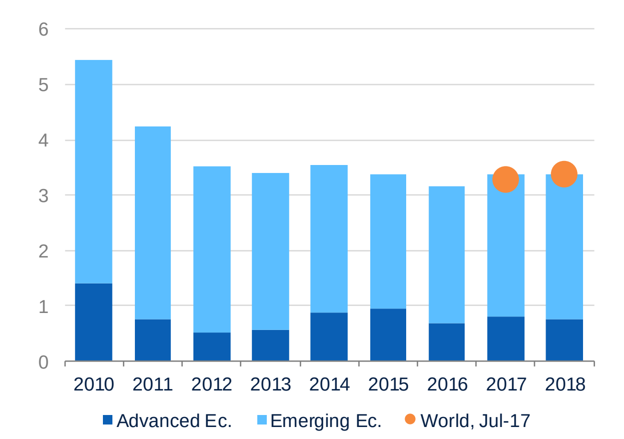
Like in the previous quarter, the combination of low volatility, low rates and dollar weakness have drawn a favourable outlook for EMs. Hunt for yield strategies have led to strong inflows towards EMs, particularly in the bond market, as well as currency strength.

**Figure 2.5** Fed and ECB balance sheets
(level and quarterly changes, in billions of USD)




Source: BBVA Research

**Figure 2.6** World GDP forecast by region
(% YoY)




Source: IMF and BBVA Research

## Higher global growth on the upward revision in Europe and China

Our new forecasts lead global growth to accelerate to 3.4% in 2017-18 (Figure 6), which implies an upward revision of around 0.2pp this year and an acceleration from 3.2% in 2016. This change is due to higher forecasted growth both for China and Europe in 2017 on account of positive surprises in both regions since Q2. For the United States, we are maintaining our estimate of sustained growth of slightly over 2% within the forecast horizon, while the better progress predicted for the Latam economies is being confirmed. In contrast, growth for the rest of the Asian economies will continue to be robust, although it will feel the effect of the expected slowdown in the Chinese economy in the coming quarters.

The underlying factors supporting the acceleration and stability of global growth will remain present, even though some of them could gradually wear off in the coming quarters. The most immediate will be the normalisation of monetary policy by both the Federal Reserve and the European Central Bank (Figure 5), as it will lead to gradual reduction in global liquidity and less support for capital flows into the emerging economies. In addition, there are still multiple political risks that can influence economic confidence and market behaviour.

## The United States: sustained growth in spite of political uncertainty and natural disasters

GDP growth rebounded to 3.1% YoY in Q3, bouncing back from the substantial decline experience din the two previous quarters. Although uncertainty is still high, due to both natural disasters and economic policy, the economic fundamentals remain consistent with sustained growth of around 2% which has been recorded over the past two and a half years. The net economic impact of the hurricanes will be limited at the national level, given that the 0.2pp that we estimate could be subtracted from growth in Q3 should be offset by the reconstruction efforts in the final stretch of the year. Moreover, the agreement between the government and the Democrats has delayed the deadline for approving the budget (guaranteeing government funding until December) and raised the debt ceiling. With respect to economic policy, the government is now focusing on tax reform, but this is still short on essential details and offers only limited options for enhancing efficiency. Even if it is finally approved, the tax cuts are unlikely to give a significant boost to economic growth given the cyclical situation of the economy, which is very close to full employment.

For all these reasons we maintain our GDP growth forecast of 2.1% in 2017 and 2.2% in 2018. The solidity of global growth, dollar depreciation, expectations of sustainable oil prices and the mild improvement in construction should support an upturn in investment. On the contrary, the more gradual improvement in the labor market and higher inflation lead us to continue to forecast a slowing down in private consumption over the forecast horizon. Even so, more sluggish growth in prices in recent months and the absence of any clear signs of inflationary pressures mean that we expect the Fed to continue slowly with its normalisation process for monetary policy. The risks for this scenario are still to the downside owing to the unknowns regarding the implementation of the economic policy measures announced, whereas the long period of cyclical expansion together with lax demand-side policies still work in favour of a build-up of financial vulnerabilities that could trigger a recession in the medium term.

## China: a more promising outlook in the short term

Support from the Chinese authorities, especially with a pro-growth fiscal policy, has led to a somewhat better than expected economic performance in the first half of the year, with GDP growth stabilising at 6.9% YoY. In spite of this, measures have been taken over the year to tackle financial vulnerabilities and encourage an orderly deleveraging process. Particularly, the tightening of regulation on shadow banking and real estate markets are being combined with more prudent monetary policy, less expansionary fiscal policy and the removal of certain controls from the exchange market. The Communist Party Congress in mid October should shed more light on both the commitment on the part of the authorities to taking on the expected structural reforms to adjust the growth pattern and whether priority will be given to financial stability over economic growth.

As a result of the recent improved performance, we have revised up our GDP growth forecast upwards by around 0.2pp to 6.7% in 2017, somewhat higher than the target of 6.5% that the authorities are aiming for, although we maintain our prediction of a slowdown in 2018 to 6%. Since mid-year available indicators were already showing us signs of more moderate economic growth and could be reflecting the impact of more prudent demand-side policies, but with the adverse effect on activity of regulatory tightening, the removal of over-capacity from companies and currency appreciation. Inflation remains subdued, especially in food, although industrial product prices have risen again due to supply-side disruptions. In contrast, the regulatory toughening and a stronger currency should continue to contain price developments, and thus we are keeping our inflation forecast at 1.7% in 2017 and 2% in 2018.

The authorities' strategy and the more gradual slowdown in growth have diminished the risks over the forecast horizon, although they are still rising over the medium term given that debt remains on the rise with some debt service indicators at high levels, while the adjustments by state-owned companies is still being delayed.

## Eurozone: increased growth due to strong domestic demand

The European economy has advanced at a quarterly rate of around 0.6% since the end of last year. More sustained global demand continues to support exports, while the impact of a stronger euro has been limited. The strength of the euro partly reflects the best cyclical momentum of the European economy, driven by the solidity of domestic fundamentals (improvement in the labor market and increased confidence), which have encouraged a better performance by both consumption and investment. Although economic performance has been somewhat better than expected so far this year, the weakness of core inflation is keeping the ECB wary. Therefore, even if it will begin to reduce the bond purchasing programme at the beginning of next year,, monetary policy will still underpin growth through the maintenance of very low interest rates beyond the forecast horizon. Fiscal policy will also be mildly expansionary in 2017-18, being favoured by the positive impact of the cyclical recovery, which provides more room for the Member States to maintain a degree of fiscal support without compromising the achievement of targets. For all these reasons we have revised forecast GDP upwards by 0.2pp in 2017 to 2.2%, which represents above-potential growth for the third year in a row. This makes it hard to imagine a significantly higher acceleration in the short term. In addition, certain tailwinds from the past are faltering somewhat or starting to blow in the opposite direction (euro appreciation, rising oil prices and the stabilisation of world growth) and are behind the expected slowdown to 1.8% in 2018.

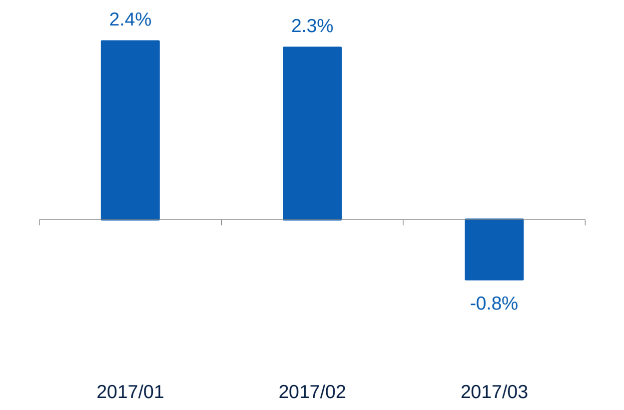
Headline inflation has held relatively stable in the third quarter, with lower energy and food prices being offset by a rise of around 0.1pp in core inflation (to 1.3%). Beyond the volatility and seasonality of certain components of inflation, the strength of domestic demand, the improvement in the labor market and the incipient rise in wages should start to push prices upwards in the coming quarters, although the impact of recent euro appreciation on import prices leads us to revise our forecast for headline inflation downwards by around 0.1pp in 2017 to 1.5% and 0.2pp in 2018 to 1.2%, while we are keeping an unchanged forecast of a gradual increase in core inflation (1.1% this year and 1.4% in 2018).

Domestic risks for the eurozone as a whole still have a downward bias but are moderate. And most of them are political, such as the obstacles in the Brexit negotiations, despite some recent rapprochement of the positions, the unresolved banking problems in certain countries, as well as the political tensions in certain Member States and the possible lack of support for moving ahead with the European project after the results of the German elections.

# 3. Temporary weakness in 3Q17 deriving from the negative impact of natural phenomena

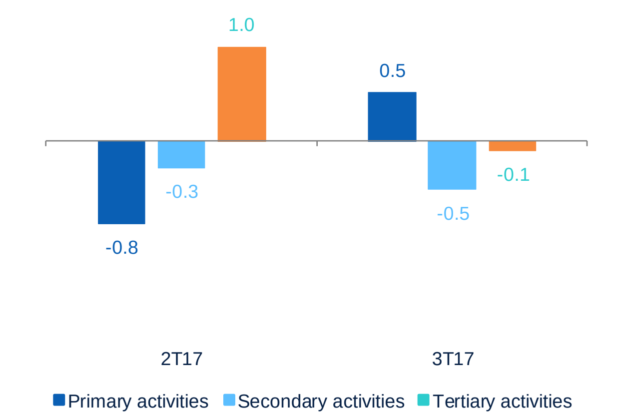
In the third quarter of the year the country's economy contracted by 0.2% relative to the previous quarter (0.8% annualised, SWDA) as a result of declines in the manufacturing, trade and services sectors. In particular, economic activity suffered the effects of the earthquakes and hurricanes that hit the coasts of the Gulf of Mexico on both the Mexican and US sides. In 3Q17 secondary activities declined by 0.5%, tertiary activities by 0.1%, while primary activities increased by 0.5%. We expect the lack of dynamism of GDP in 3Q17 to be short-lived, and economic activity in 4Q17 to be boosted by consumption of goods and services resulting from purchases to assist victims, and going forward improved performance of construction as a result of the rebuilding work made necessary by the September earthquakes.

**Figure 3.1** GDP. Growth rate (QoQ, SA)




Source: BBVA Research based on information from INEGI (National Statistics and Geographical Institute)

**Figure 3.2** GDP by major sector of economic activity. Growth rate (QoQ, SA)




Source: BBVA Research based on information from INEGI

Within industrial activities (30% of GDP) the biggest fall was in the mining sector (5% of GDP), including oil, which according to the Total Economic Activity Index (IGAE in the Spanish initials) declined by -1.5% MoM in July and -2% MoM in August. In September, crude oil output fell by 10.4% MoM, a fall 7.6 pp larger than that seen in August and the largest posted in the past few years, as a result of the negative impact of Hurricane Harvey on US demand for Mexican oil, to which was added the effect of the hurricanes that hit Mexico, which also had negative effects on output.

Like mining, the construction sector (7% of GDP) also had two consecutive months of declines (1.5% and 0.1% in July and August respectively (IGAE, MoM). Also, primary activities (3% of GDP) posted falls of 2.2% and 1.5% in the same months (IGAE, MoM), although their small contribution to GDP limits the negative effects of this on the overall performance of the economy.

Within the tertiary sector (63% of GDP), trade (17% of GDP) showed mixed performances over the course of 3Q17. Retail trade (9% of GDP) posted a fall of 4.6% in July and an increase of 0.9% in August (IGAE, MoM), while wholesale trade (8% of GDP) saw a fall of 0.4% and an increase of 4.2% in those same months. For its part, the retail sales indicator showed moderate but positive growth in July and August (0.2%, IGAE, MoM). We estimate that the figures for September will show weakening of this sector as a result of the earthquakes, which led to the closure of shops and services for several days, with a subsequent uptick in 4Q17 due to purchases to provide assistance to the victims.

Temporary accommodation and food and beverage preparation services (2% of GDP) also showed mixed performances over the course of the quarter, contracting by 0.6% in July and growing by 0.6% in August. We estimate that growth of this sector in September will be affected negatively by the closure of establishments in the last few days of the month following the earthquakes that hit Mexico City, Morelos, Puebla, Oaxaca and, in particular, Chiapas. Confidence indicators for this sector (right time to invest, and business confidence) already show falls in September, of 0.8% and 0.4% respectively (MoM, SA). According to the INEGI, the States with the greatest incidence of temporary suspension of activity were Morelos (55.2% of its establishments), Mexico City (48.9%) and Puebla (47.5%); on average 52 of every 100 establishments that suspended activities in those States did so for more than one day.[3]

Although the loss of human life caused by these natural disasters is an irreversible tragedy, in terms of the country's productive capacity (public and private infrastructure), the damage was not significant, and did not alter the potential growth of the economy. The main effect was the loss of private property, basically homes, and was concentrated locally. As previously mentioned, in the next few quarters we expect an uptick in economic activity as a result of the increase in construction as the lost capital is gradually replaced, and this, together with increased public spending and private donations, the payment of insurance claims and the use of the government's emergency fund for natural disasters (FONDEN) introduces an upward bias to our growth forecasts for the next few months. Commercial business opinion indicators are already showing a recovery in October, with monthly variations of 10.4% (right time to invest, SA) and 0.6% (business confidence, SA).

As for the sectors evolving favourably in 3Q17, the secondary sector, manufacturing (16% of GDP) posted moderate but positive growth in July and August (0.4% and 0.6%, IGAE, MoM) although not enough to offset the reduced dynamism in oil extraction and construction. We expect September figures to continue to show modest but favourable performance for this sector, as pointed to by business opinion indicators for manufacturing (right time to invest and business confidence), which rose by 1.2% and 0.8% respectively in September. Added to this is the increased dynamism shown by the US manufacturing sector at the end of 3Q17, with a monthly percentage change of 0.1% in September, 0.3 pp more than in August and 0.5 pp more than in July.

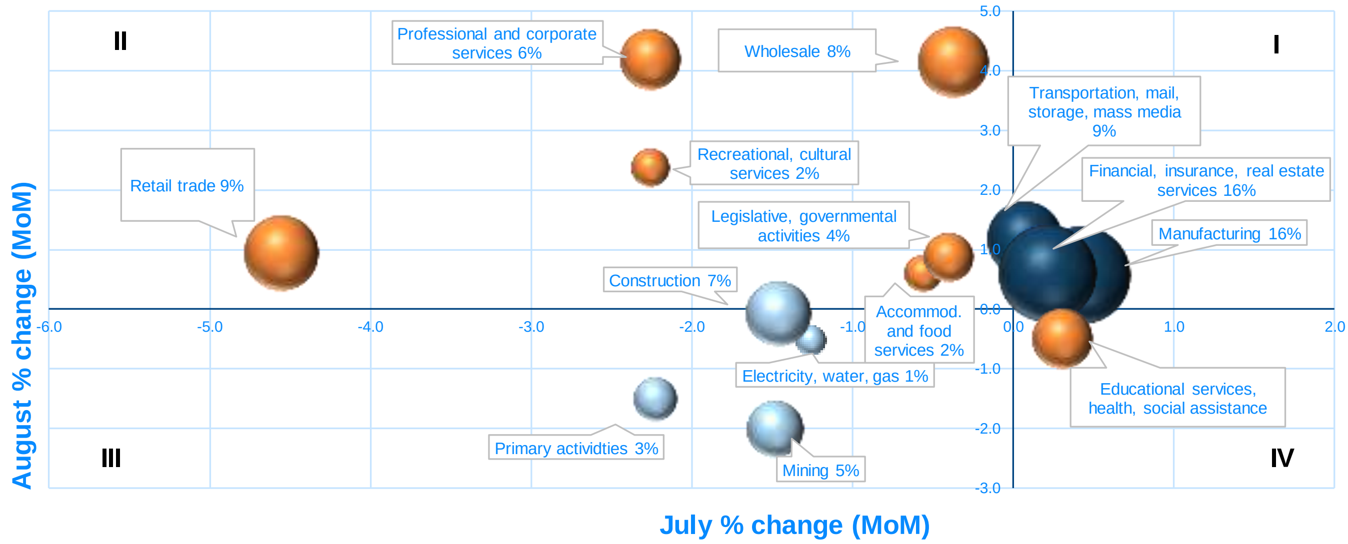
In the tertiary sector, only financial, real estate and rental services (16% of GDP) showed positive growth in July and August (0.2% and 0.6% respectively), after posting falls in the last months of 2Q17.

Figure 3.3 shows the monthly growth of the IGAE (SA) of all the country's economic sectors; the horizontal axis represents the growth of each sector in July and the vertical one that of August. Thus the economics sectors in quadrant I showed positive changes in both months, whereas those in quadrant III showed negative changes in both. The sectors

3: The survey was carried out in the eight States that were most affected by the earthquakes of 7 and 19 September (Chiapas, Mexico City, Guerrero, México, Morelos, Oaxaca, Puebla and Tlaxcala). The sectors covered were service, trading and manufacturing and the sample represented all the economic units of the States and sectors referred to above.

with mixed variations are in quadrants II and IV. The size of the bubbles represents the proportional contribution of each sector to GDP. The economic sectors with negative growth in both months are shown in light blue; those with positive growth in both are in dark blue; and those with mixed performances in orange. Figure 3.3 thus gives us a picture of the performance by the various sectors in 3Q, with information for July and August.

**Figure 3.3** IGAE. IGAE. Monthly growth rate (SA), July and August




Source: BBVA Research based on information from INEGI

## Change of base year from 2008 to 2013 in Mexico's National Accounts System

On 31 October the INEGI announced a change in the base year of the National Accounts System, from 2008 to 2013, which led to differences in observed GDP growth rates relative to those published previously, in particular average growth for the period 2013-2016 went up by 0.5 pp, from 2.1% to 2.6%, while that of the previous period, 2007-2012, went down by 0.4 pp, from 2.1% to 1.7% (Table 1).

One of the main changes relative to 2008 is a variation in the weight of the sectors of the economy with the biggest contributions to GDP: manufacturing and trade. With the change of base year the percentage contribution of manufacturing in gross value added (GVA) falls by 1.1 pp (from 17.6% to 16.5%), while that of trade increases by 1.4 pp (from 16.1% to 17.5%) (Figure 3.4). This change is significant, because trade has shown much greater growth than manufacturing in the past few years (0.9% compared with 2.9% with 2008 as the base and 0.6% as against 2.8% using 2013, average figure 2007-2016). In short, the change of base year gives greater weighting to the trade sector, which has grown more than the other significant sectors of the economy.[4]

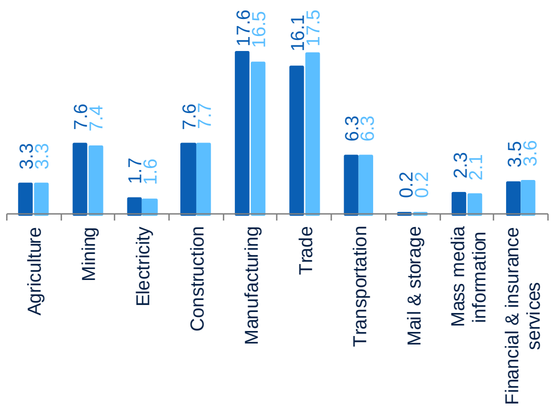
4: GVA 2013. Source: INEGI

**Table 3.1** GDP (YoY 5 change, SA)

| | 1995-2000 | 2001-2006 | 2007-2012 | 2013-2016 |
|---|---|---|---|---|
| Base 1993 | 3.5 | 2.3 | | |
| Base 2003 | 3.5 | 2.1 | 1.9 | |
| Base 2008 | 3.4 | 2.3 | 2.1 | 2.1 |
| Base 2013 | 3.3 | 2 | 1.7 | 2.6 |
| | | | | |
| Difference 2003 vs. 1993 | 0 | -0.2 | | |
| Difference 2008 vs. 2003 | -0.2 | 0.2 | 0.2 | |
| Difference 2013 vs. 2008 | 0 | -0.3 | -0.4 | 0.5 |

Source: BBVA Research based on information from INEGI

**Figure 3.4** Composition of GVA. 2013

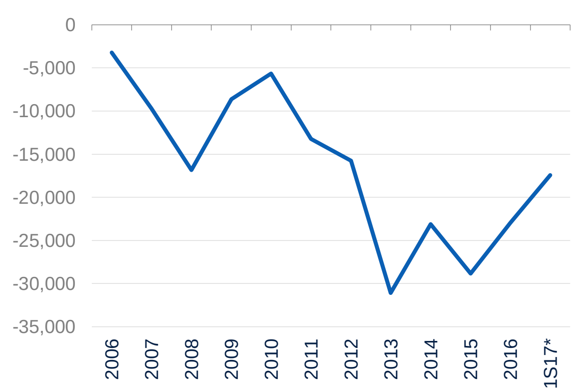



Source: BBVA Research based on information from INEGI

## Current account: the deficit declined significantly in the second quarter of 2017 in response to a more positive balance of non-oil goods and a smaller deficit in primary revenues

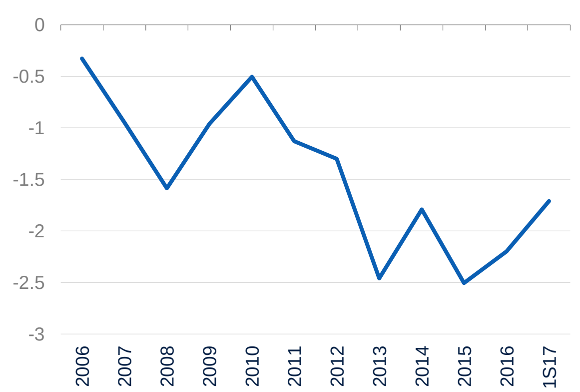
After exceeding US$30 billion in 2013, the current account deficit has gradually shrunk to US$17.4 billion with annualised data in the second half of 2017 (Figure 3.5). In GDP terms, the current account deficit went from 2.5% to 1.7% over the same period (Figure 3.6). Although we are still awaiting the information for the second half of 2017, we expect the current account deficit to come in at 2.4% of GDP for 2017. Our forecast implies that the current account deficit will have increased to 3.0% of GDP in the second half of 2017, partly because of the expected slowdown in exports of manufactured goods. For its part, the forecast for the current account deficit in 2018 is 2.3% of GDP.

**Figure 3.5** Current account (US$ million)




* The current account deficit for the first half of 2017 has been annualized
Source: BBVA Research with information from Banxico

**Figure 3.6** Current account (% of GDP)




Source: BBVA Research with information from Banxico

On analysing the behaviour of the current account deficit in the second quarter of 2017, we see that it declined relative to the first quarter (Table 3.2). This was due mainly to the significant contraction in the deficit in primary revenues and the greater surplus in non-oil goods. This surplus was largely driven by exports of manufactured goods.

When we compare the behaviour of the current account deficit in the first half of 2017 with the same period of last year, we see that the decline of US$5.4 billion was due mainly to the significant reversal of the balance of trade in non-oil goods, which went from a deficit of US$1.7 billion to a surplus of US$5.3 billion. Without doubt this came from increased external demand deriving mainly from the recovery of US manufacturing output in the first half of 2017.

**Table 3.2** Cuenta corriente y sus componentes en los primeros dos trimestres de 2017 (Millones de USD)

| | (A) | (B) | (B-A) |
|---|---|---|---|
| **Current account** | **-8,397.9** | **-321.2** | **8,076.7** |
| Trade bal. goods & services | -4,877.8 | -2,373.8 | 2,504.0 |
| Trade bal. goods | -2,743.5 | -132.8 | 2,610.7 |
| Trade bal. oil products | -4,375.9 | -3,823.6 | 552.3 |
| Trade bal. non-oil goods | 1,600.9 | 3,688.8 | 2,087.9 |
| Bal. of goods acquired in port by carriers | 31.5 | 2.0 | -29.5 |
| Trade bal. services | -2,134.3 | -2,241.0 | -106.7 |
| Bal. of primary revenues | -10,009.7 | -5,140.2 | 4,869.5 |
| Bal. of secondary revenues | 6,489.6 | 7,192.8 | 703.2 |

Bal = Balance
Source: BBVA Research with information from Banxico

**Table 3.3** Cuenta corriente y sus componentes en el primer semestre de 2016 y 2017 (Millones de USD)

| | Ene-Jun 16 (A) | Ene-Jun 17 (B) | Diferencia (B-A) |
|---|---|---|---|
| **Current account** | **-14,128.0** | **-8,720.0** | **5,408.0** |
| Trade bal. goods & services | -10,294.0 | -7,252.0 | 3,042.0 |
| Trade bal. goods | -7,022.0 | -2,876.0 | 4,146.0 |
| Trade bal. oil products | -5,373.0 | -8,200.0 | -2,827.0 |
| Trade bal. non-oil goods | -1,681.0 | 5,290.0 | 6,971.0 |
| Bal. of goods acquired in port by carriers | 31.0 | 33.0 | 2.0 |
| Trade bal. services | -3,272.0 | -4,375.0 | -1,103.0 |
| Bal. of primary revenues | -16,767.0 | -15,150.0 | 1,617.0 |
| Bal. of secondary revenues | 12,933.0 | 13,682.0 | 749.0 |

Bal = Balance
Source: BBVA Research with information from Banxico

## Public finances: non-tax revenues sustained the increase in total budget revenue for the public sector in the first nine months of 2017, while cuts to programmable spending shrank total expenditure

Total public sector budget revenue showed real annual growth of 1.8% in the first nine months of 2017. Importantly, this year-on-year comparison includes the amount of 321.7 billion pesos from the Banco de México operating surplus. If we excluded this component from budget revenue for the period, the real annual rate would have been a negative 6.9%.

If we break down total budgetary revenues into components, non-tax income (including the federal government's petroleum revenues) showed real annual growth of 23.6% in the first three quarters of 2017. Excluding the central bank's operating surplus would imply an increase of 25.8% in this component in real annual terms. There was a 1.0% real annual increase in tax revenues in this period. Although this figure reflects lacklustre annual growth in tax revenues, we have seen a recovery in these revenues, since they had increased by just 0.1% in real annual terms in the first half of 2017.

Income tax is an important component of tax revenues due to its weight in their overall structure (54.5% in the period January to September 2017). It showed a real annual variation of 5.3% in that period, which compares unfavourably with the real annual growth of 11.6% observed in the first three quarters of 2016.

Public sector oil revenues accounted for 15.5% of total budget revenues from January to September 2017 (17.7% during the same period in 2016). It is important to note that this revenue item fell in annual terms, with a negative real growth rate of 11.0% in the first nine months of 2017.

**Table 3.4** Total public sector budgetary revenues from January to September (billions of pesos)

| | 2016 | 2017 | Real % chge. | Struc. % |
|---|---|---|---|---|
| **Total** | **3,501.2** | **3,773.0** | **1.8** | **100.0** |
| Federal Government | 2,655.4 | 2,986.3 | 6.2 | 79.2 |
| Tax | 2,041.5 | 2,182.7 | 1.0 | 57.8 |
| Income tax | 1,066.0 | 1,188.6 | 5.3 | 31.5 |
| VAT | 586.0 | 637.6 | 2.8 | 16.9 |
| Non-tax | 613.9 | 803.6 | 23.6 | 21.3 |
| Agencies & companies budg | 245.4 | 266.7 | 2.6 | 7.1 |
| State enterprise | 600.4 | 520.0 | -18.2 | 13.8 |
| Pemex | 382.6 | 255.1 | -37.0 | 6.8 |
| CFE | 217.8 | 264.9 | 14.9 | 7.0 |
| **Total** | **3,501.2** | **3,773.0** | **1.8** | **100.0** |
| Oil revenues | 621.1 | 584.9 | -11.0 | 15.5 |
| Non-oil revenues | 2,880.2 | 3,188.1 | 4.6 | 84.5 |

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

**Table 3.5** Net expenditure paid by the public sector in January-September ( billions of pesos)

| | 2016 | 2017 | Real % chge. | Struc. % |
|---|---|---|---|---|
| **Total** | **3,764.1** | **3,731.0** | **-6.4** | **100.0** |
| Programmable expenditure | 2,903.0 | 2,744.5 | -10.7 | 73.6 |
| Current expenditure | 2,111.9 | 2,201.9 | -1.5 | 59.0 |
| Capital expenditure | 791.1 | 542.7 | -35.2 | 14.5 |
| Non-programmable | 861.1 | 986.4 | 8.2 | 26.4 |
| Contributions to states | 531.9 | 607.3 | 7.9 | 16.3 |
| Financial costs | 305.1 | 359.3 | 11.2 | 9.6 |
| Adefas* and others | 24.0 | 19.8 | -22.1 | 0.5 |

Adefas: Spanish acronym for 'debit balance from prior fiscal years'.
Source: BBVA Research with Ministry of Finance information

As far as net public sector spending in the first nine months of 2017 is concerned, it registered a real annual decrease of 6.4%. This was mainly due to programmable spending (accounting for 73.6% of total net public sector spending in that period), with a real annual contraction of 10.7% in the period. Within programmable expenditure, capital expenditure showed a real annual decline of 35.2%. Current expenditure meanwhile recorded a reduction of 1.5% in real annual terms in the same period.

It is important to acknowledge that federal payments, public pensions, and the financial cost of public debt continued to pressure public finances in the period January to September 2017. Our own calculations show that without financial investment and the expenditure headings referred to, other spending was kept in check to a greater extent, with a real YoY reduction of 8.5% over the period.

The real annualised reductions in this more limited item of expenditure show the federal government's efforts to maintain some measure of financial discipline in the items more directly under its control. The federal government will have to continue these efforts to rein in spending during the last part of 2017 to reach the targets of a primary surplus of 0.4% and a public sector debt stock of 48.0% of GDP.

**Table 3.6** Indicators of public expenditure in the period January-September ( billions of pesos)

| | 2016 Nominal | 2017 Nominal | 2017 Real | Real % chge. |
|---|---|---|---|---|
| **Total net expenditure** | **3,764.1** | **3,731.0** | **3,524.7** | **-6.4** |
| Without financial investment | 3,509.9 | 3,619.6 | 3,419.4 | -2.6 |
| Without financial investment and state funding | 2,978.0 | 3,012.3 | 2,845.7 | -4.4 |
| Without financial investment, state funding and pensions | 2,507.0 | 2,491.1 | 2,353.3 | -6.1 |
| Without financial investment, state funding, pensions and financial cost | 2,201.9 | 2,131.8 | 2,013.9 | -8.5 |

Source: BBVA Research with Ministry of Finance information

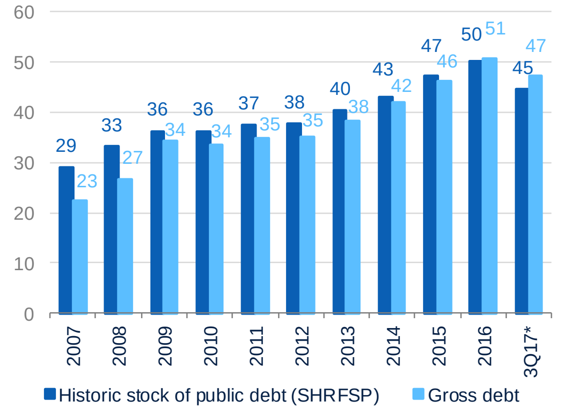
**Table 3.7** Financial situation of the public sector January to September ( billions of pesos)

| | 2016 | 2017 | Real % chge. |
|---|---|---|---|
| Public balance | -251.3 | 63.2 | n.s. |
| Public bal. without prod. invt. | 129.9 | 319.9 | 132.7 |
| Budgetary balance | -262.9 | 42.0 | n.s. |
| Budget revenues | 3,501.2 | 3,773.0 | 1.8 |
| Net expenditure paid | 3,764.1 | 3,731.0 | -6.4 |
| Federal Government Balance | -300.0 | 75.7 | n.s. |
| Bal. agencies & companies | 37.1 | -33.7 | n.s. |
| Primary balance | 59.1 | 416.0 | 564.7 |
| Budgetary balance | 42.2 | 401.3 | 797.9 |
| Federal Government | -79.1 | 336.1 | n.s. |
| Agencies and companies | 121.3 | 65.2 | -49.2 |
| Pemex | 15.0 | -33.9 | n.s. |
| Other entities | 106.4 | 99.1 | -12.0 |
| Entities under indirect control | 16.9 | 14.7 | -18.0 |

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

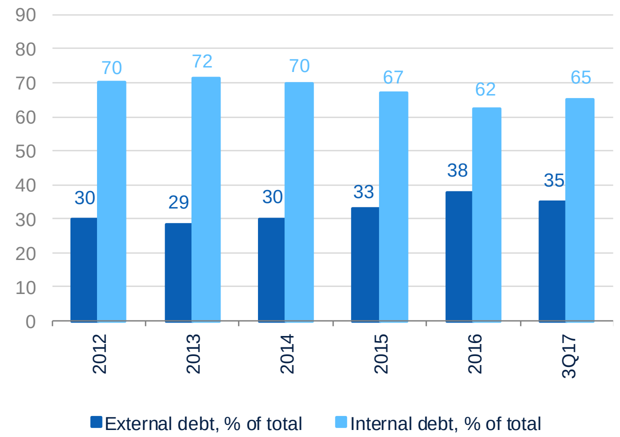
The primary public sector balance showed significant improvement in the first nine months of 2017, coming in at MXN 416.0 billion as against MXN 59.1 billion in the same period of 2016. The increase in the primary surplus was largely due to the federal government balance and, to a lesser extent, those of the IMSS (social security) and the CFE (state-owned electricity utility). If this disciplined management of the finances of the federal government and other state-owned enterprises continues for the rest of 2017, the target of 0.4% of GDP for the entire public sector primary surplus in 2017 will be attained.

**Figure 3.7** Gross debt and public sector financing requirement* (as % of GDP)




* To calculate the SHRFSP (stock of public debt) and public debt we used the Ministry of Finance's nominal GDP forecast for 2017.
Source: BBVA Research based on Ministry of Finance and INEGI data

**Figure 3.8** Percentage structure of internal and external public sector debt (% of the total debt)



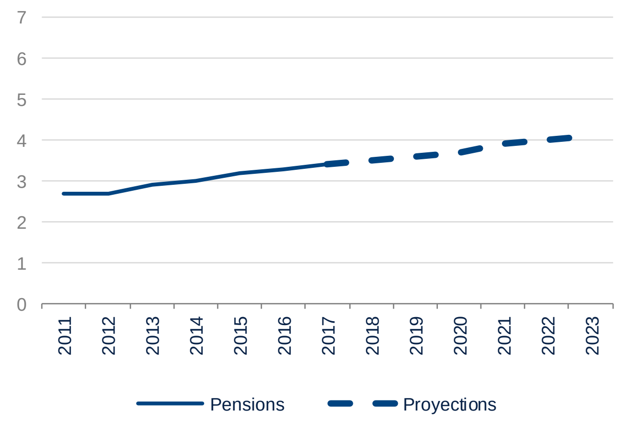

Source: BBVA Research based on Ministry of Finance data

Gross public debt stood at 47.3% of GDP at the end of the third quarter of 2017. The debt level is 3.5 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 34.9% at the end of the third quarter of 2017. The appreciation of the Mexican peso against the dollar so far this year was clearly a prime factor in both the reduced proportion of gross external debt and the lower ratio of gross debt to GDP.

In the third quarter of 2017, the stock of public debt (SHRFSP) was 15.4 pp of GDP higher than its level in 2007. As far as 2017 is concerned, the Ministry of Finance expects the balance to be reduced to 48% of GDP from 50.1% in 2016 with the support of the central bank'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).

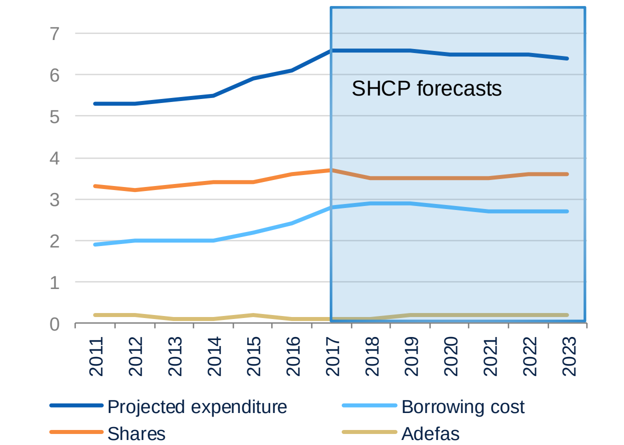
As for the medium-term outlook for the public finances, the Ministry of Finance envisages public sector pensions, federal contributions to the states and the financial cost of the public debt continuing to be a significant source of pressure on the public sector's net spending. This will require the federal government to maintain financial discipline in the expenditure items more directly under its control. It would be desirable for the cuts in current spending to be deeper and for public sector capital expenditure to gradually recover so as to underpin the country's economic growth.

**Figure 3.9** Pensions and retirement benefits paid by the public sector (% of GDP)




Source: BBVA Research with Ministry of Finance information

**Figure 3.10** Non-programmable expenditure and its components (% of GDP)




Source: BBVA Research with Ministry of Finance information

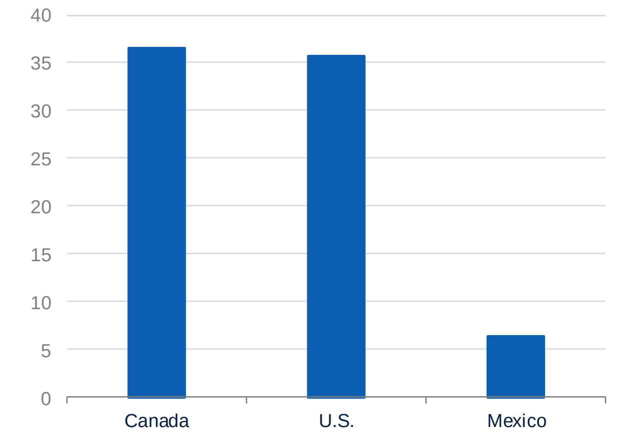
## Mexico would still be more competitive than the US as a manufacturing base, even if the US cut its corporation tax rate from 35% to 20%

The proposed tax reform currently being discussed in the US envisages a cut in the rate of corporation tax from 35% to 20%. In Mexico this rate is 30%. Two pertinent questions arise in this respect: What effect will it have on US FDI into Mexico? Should the Mexican government respond by cutting its corporation tax rate too?

As for the first question, our estimates indicate that even is this tax cut were to be implemented in the US, Mexico would still be a more competitive manufacturing base. Consequently FDI should not be substantially affected. And this for the following reasons:las siguientes razones:

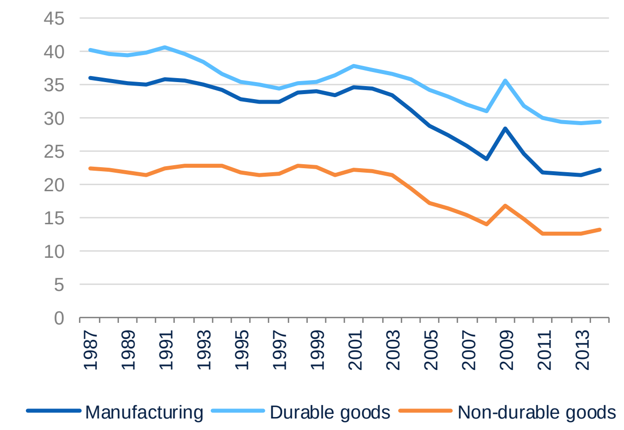
i) Manufacturing labour costs in the US are on average nearly six times higher than in Mexico (Figure 3.11). At the same time in the US manufacturing labour costs as a percentage of total industry revenues in 2014, the latest figures available, were 22.1%. We have carried out a calculation to determine whether this differential would offset the US tax cut and in which country it would be cheaper to produce if the US tax rate were to be cut to 20%, ten pp lower than Mexico's. We find that the difference in labour costs alone is a sufficient factor for Mexico to still be more competitive than the US (Table 3.8). In other words Mexico would lose some of its competitive advantage over the US but would still have a clear advantage.

**Figure 3.11** Labour compensation per hour in manufacturing industry in 2012 (USD)




Source: BBVA Research with information from the BLS

**Figure 3.12** Labour costs as a percentage of nominal revenues in manufacturing industry in the US (% of nominal income)




Source: BBVA Research with information from the BLS

ii) We also have to bear in mind that the peso's depreciation of more than 10% since April 2016 (associated with the Trump risk) would almost offset the US tax cut. This depreciation also means that Mexico would still be more competitive than the US even if the tax cut were to take place.

iii) We must also take into account the fact that the Federal corporation tax is not the only tax faced by US firms; 44 states and Washington D.C. Also have state taxes ranging from 3% to 12%. If in addition to the proposed federal tax of 20% we take account of the average tax of the 50 states and Washington D.C. (6%), Mexico's comparative advantage in terms of post-tax profit widens further (Table 3.8).

Due to these factors, if the US does cut its federal corporate income tax rate to 20%, it will still be cheaper to produce manufactured goods in Mexico - at least 20% more profitable than in the US.

Apart from this, the analysis should consider the tax rates actually paid, not the standard rates laid down in the law. Effective tax rates are usually lower due to deduction, consolidation and other mechanisms. According to the US

Congress Budget Office (CBO), the effective corporate income tax rate in Mexico is 11.9%, whereas in the US it is 18.6%. In other words tax is paid at a significantly lower rate in Mexico. In fact when we look at effective rates, Mexico is not among the countries with the highest rates. This means that when effective rates of corporation tax are taken into account Mexico is more competitive than the US by a bigger margin than an analysis of nominal tax rates would suggest.

For this reason, we consider that Mexico should not respond by cutting its corporation tax rate. In the event that the Mexican government did decide to cut the rate from 30% to 20%, tax revenues would show an annual contraction of 16.9%, equivalent to 1.2% of GDP. Therefore the implementation of this measure in Mexico would put at risk the attainment of the target of 0.9% of GDP for the primary surplus in 2018. Furthermore, it would mean a permanent reduction in tax revenues. This would be irresponsible in the current context in which the government is carrying out a process of fiscal consolidation and above all considering the low historical levels of tax collection seen in Mexico. In short, i) there is no need to react to possible tax changes in the US, since Mexico would still be more competitive, and ii) even if it wanted to react, there is insufficient fiscal room in which to do so.

This does not mean that it is not desirable to achieve a tax reform that reduces taxes on businesses and raises them on consumption. But this is a discussion that needs to be had independently of the tax process in the US and taking care that any change is at least neutral in terms of total revenues.

Box 1

## Impact of tax reform in the US on net income of manufacturing companies

The following is a simplified example of the effect that a reduction in US corporation tax from 35% to 20% would have on the net income of a US manufacturing company. The exercise assumes that non-labour costs are equal in both countries (X% of revenues) and an average state corporation tax rate of 6% in the US. It also takes account of US tax law which requires taxpayers to pay the standard US tax rate regardless of where the income is generated and show proof of tax paid in other countries.

Of every US$100 of revenues of a US manufacturing company based in the US, 20% goes to cover labour costs in the US and X% to cover non-labour costs. Thus the company makes a profit of 100 – 20 - X = 80-X before tax. Of this amount, 35% goes to pay US corporation tax, giving net income of (80 - X)*(0.65) = 52 - 0.65X. If we include the average state corporation tax of 6%, total taxation is 41%, leaving the company (80 - X)*0.59 = 47.2 - 0.59X. With the tax reform in the US the rate would be 20%, so net income would be 59.2-0.74X

If the company is based in Mexico, out of every US$100 of revenues, 3.3% goes to pay labour costs in Mexico (1/6 of the 20% that applies in the US.) and X% goes to pay non-labour costs. Thus the company makes a profit of 100 - 3.3 - X = 96.67 – X before tax. Of this amount, 35% goes to pay US corporation tax which the company is obliged to pay as a US Company (showing proof of the 30% paid in Mexico), so the company's net income is (96.67 - X)*0.65 = 62.84 - 0.65X. With the tax reform, the tax paid in Mexico is at the local rate of 30%, so net income would be 67.69-0.7X. Table 3.6 illustrates all the calculations.

If non-labour costs represent 10% of the firm's revenues (X=10), net profit in Mexico would be 1.4 times that generated in the US under the current US tax regime. If they represent 50% (X=50), net profit in Mexico would be 1.7 times that obtained in the US. With the proposed tax reform, the figures would be 1.2 and 1.5; in other words, producing in Mexico would be at least 20% more profitable than in the US. It is clear that Mexico's competitiveness is maintained even after a cut in the rate of tax on corporate profits from 35% to 20% in the US.

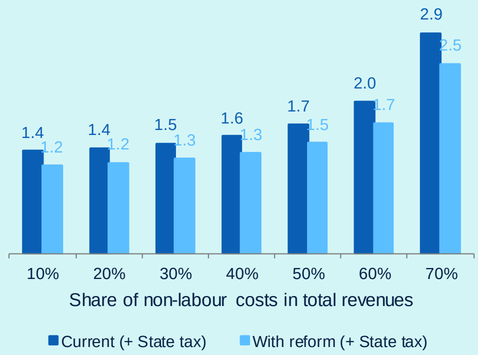
Box 1

**Table 3.8** Post-tax profit: current rate versus proposed rate

| | U.S. company | | | |
|---|---|---|---|---|
| | Current | | With tax reform | |
| | Based in the U.S. | Based in Mexico | Based in the U.S. | Based in Mexico |
| Revenues | 100 | 100 | 100 | 100 |
| Labour costs | 20% | 3.3% | 20% | 3.3% |
| Non-labour costs | X% | X% | X% | X% |
| Federal tax | 35% | 35% | 20% | 30% |
| State tax | 6% | - | 6% | - |
| Profit after Federal tax | (100-20-X)*0.65 = 52-0.65X | (100-3.3-X)*0.65 = 62.84-0.65X | (100-20-X)*0.80 = 64-0.80X | (100-3.3-X)*0.70 = 67.69-0.70X |
| Profit after Federal and State tax | (100-20-X)*0.59 = 47.2-0.59X | - | (100-20-X)*0.74 = 59.2-0.74X | - |

Source: BBVA Research

**Figure 3.13** Post-tax profit in Mexico / Post-tax profit in the US. Ratio




Source: BBVA Research

# 4. The probability of success of NAFTA 2.0 has diminished

## Talks on NAFTA deteriorated in the fourth round, and the path towards “NAFTA 2.0” became much more challenging

Until September, the renegotiation of NAFTA had been moving ahead without major obstacles. The first three rounds took place without major differences, and although the most sensitive aspects of the negotiation had yet to be addressed, the expectation was that a successful renegotiation was not only the most likely but also a very likely scenario. It was thought that the talks would continue to make progress until an agreement was reached and that trade relations among the three countries would be maintained in the years to come with a NAFTA 2.0.

Talks on NAFTA deteriorated in the fourth round, and the path towards “NAFTA 2.0” became much more challenging. The US put forward proposals that were unacceptable to the other parties, as well as once again stressing its intention to reduce its trade deficit.

i. It seeks to include a clause whereby the agreement will expire every five years unless all three countries agree on an extension (the "sunset clause")

   1. This proposal runs counter to the nature of the agreement in introducing an element of uncertainty in firms’ investment decisions

ii. The introduction of specific US content (50%) in automotive production and an increase in North American content to 85% from the current 62.5%

iii. Limits to the scope for the other two countries to bid for US government contracts

Added to the above proposals is the proposal, already known, and reconfirmed in this fourth round, to eliminate chapter 19 on the resolution of disputes by an independent panel.

The question is what does the US really want . There are two possibilities:

- Are the proposals a negotiation tactic aimed at obtaining major concessions from the other two countries, particularly Mexico?
- Is it seeking to make agreement impossible by putting forward unacceptable proposals with a view to later seeking to justify a unilateral withdrawal?

The second possibility seems real, in other words a unilateral withdrawal by the US from NAFTA can no longer be ruled out. In fact, although we continue to assign a probability of more than 50% to a positive outcome of the talks ("NAFTA 2.0"), this is less than the 85% we had been ascribing to it until September. In other words, the probabilities of agreement and breakdown are now more evenly balanced in our opinion. That said, as we have shown in earlier editions of Mexico Economic Outlook, if the US acts in accordance with its economic interests it should keep the agreement in place. The fifth round starts on 17 November and the sixth round will take place in December. The very fact that the talks are continuing is in itself a positive sign within the context of deteriorating expectations following the conclusion of the fourth round. So is the fact that the business sector and certain members of Congress are exerting greater pressure for the preservation of NAFTA.

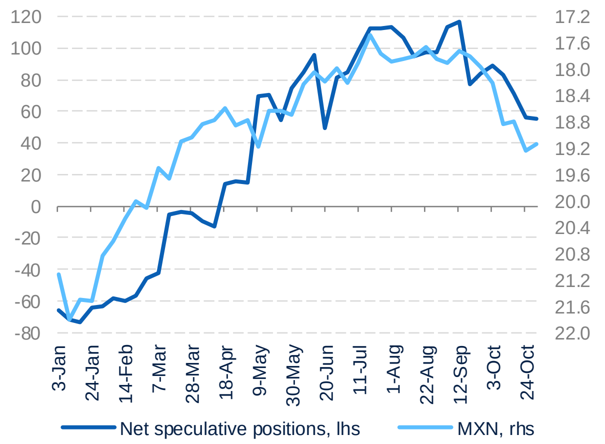
## NAFTA and the exchange rate: the risks return

### From what was likely to go badly to what could go well

During 2016 the risks associated with the US presidential election made the Mexican peso the poorest performer among emerging market currencies. The election result took the MXN to an all-time low of 22.0 pesos to the dollar in January. From then on and until August the outlook changed from excessively negative to positive. Basically the markets' perception of the future of economic relations between Mexico and the US changed, and the exchange rate gradually reflected this change. The MXN was starting to move away from its low point (high point in terms of pesos per dollar) associated with the perception of what was likely to go badly (i.e. a possible break-up of NAFTA and the imposition of higher import duties than those of the WTO's most favoured nation regime), and was gradually returning to levels more consistent with the fundamentals (around 17.0 – 17.5 pesos per dollar) in line with the increasingly widely held view that things might go well in the end and a NAFTA 2.0 could be reached. In fact this is clearly reflected in Figure 4.1, which shows how speculative positions went from betting heavily against the peso at the beginning of the year, to starting to take positions in its favour from April on after gradually winding down their positions against the peso during February and March. This change in the perception of the future of economic relations between Mexico and the US has been the main factor behind the strengthening of the peso during 2017. Indeed, since Trump became a candidate in April 2016 it has been by far the main variable explaining the movements in the peso, both in absolute terms (movement and level of the exchange rate) and in relative terms (comparing movements in the peso to those of other emerging market currencies).

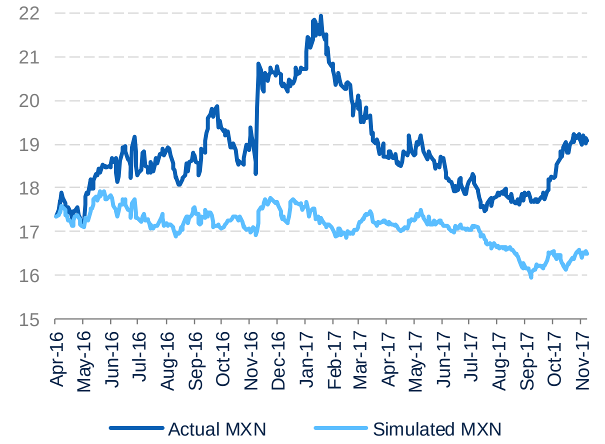
That said, the peso has also benefited from other factors: i) better improved economic prospects thanks to the notable improvement in the US manufacturing sector, ii) the improvement in Mexico's fundamentals, with the current account deficit shrinking and the expectation that public debt, after rising for years (and at a faster rate in the past four years), will at last come down in 2017, and iii) the increase in Mexico's interest rates resulting from monetary policy, which allowed the peso to go from being one of the emerging market currencies with the least risk-adjusted carry trade to being one of those with the most, and what is more in a context in which Mexico's prospects were improving.

**Figure 4.1** MXN and net speculative positions in the peso on the CME, 2017 (pesos per dollar, inverted scale and number of contracts in thousands)




Source: BBVA Research and Bloomberg

**Figure 4.2** Observed exchange rate and simulated exchange rate* (pesos per dollar, replicating the average performance of other emerging market currencies* since 1 April 2016)




* Own calculations based on a new weighting of the JPMorgan Emerging Markets Currency Index after removing the MXN.
Source: BBVA Research and Bloomberg

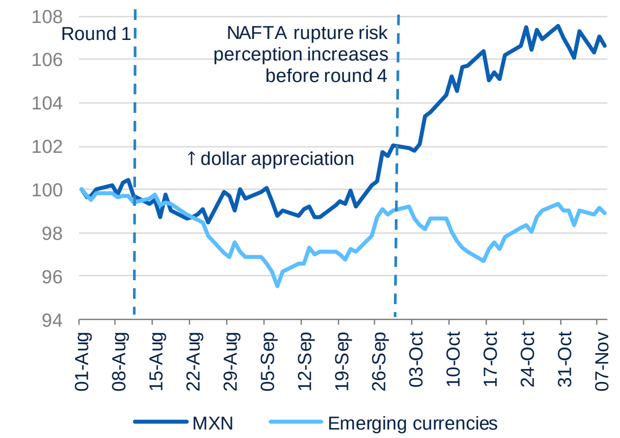
## Until August the peso was recovering the value lost due to its poor relative performance since April 2016

All this, but particularly the expectation that there would be a NAFTA 2.0, explains the strengthening of the peso from February to August 2017 which allowed it to recover its value not just in absolute terms but in relative terms too. Indeed, Figure 4.2 not only illustrates the recovery of the peso but also shows how the markets gradually eliminated the negative differentiation of the peso relative to other emerging market currencies. In order to compare the differentiation of the peso with that of other emerging market currencies, we simulated the trend that the peso would have had since April 2016 (MXN simulated in Figure 4.2). We see clearly how the peso started to deviate from the favourable trend of the emerging market currencies as soon as Trump became a candidate in April 2016. We also see how the peso started to recover the value lost due to this negative differentiation, with the exchange rate going on to reach 17.5 pesos per dollar at the beginning of August. This practically brought the peso back to the value that it would have had if there had been no risks associated with trade relations with the US.

## The peso's negative differentiation returned in mid-August and was accentuated at the beginning of October

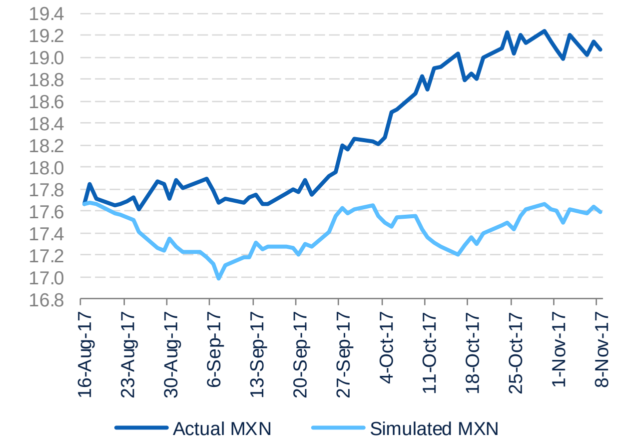
Although the first three rounds of NAFTA negotiations passed without major setbacks, the peso started to be negatively differentiated again from mid-August, precisely when the NAFTA renegotiation process started (see Figure 4.3). As can be seen, following the conclusion of the first round of NAFTA renegotiations which had started on 16 August, the peso started to evolve less favourably than the other major emerging market currencies. Although it was not depreciating, neither was it appreciating as the other emerging market currencies were on average. In the second half of September both the peso and the others weakened against the dollar due to the perception that the Federal Reserve would raise its key federal funds rate in December this year (an expectation which until then had not represented the consensus in the financial markets). Nonetheless, we should highlight the fact that during this period there was no such negative differentiation of the peso as had been observed in August. This differentiation can also be seen clearly in Figure 4.2: without the uncertainty associated with the start of the NAFTA renegotiation, the peso would have continued to strengthen, and would indeed very probably have returned to around 17.0 pesos to the dollar.

**Figure 4.3** Exchange rate (MXN) compared with that of other emerging market currencies*, Aug-Oct (1 Aug 17= 100; +/- for depreciation / appreciation against the dollar)




* Own calculations based on a new weighting of the JPMorgan Emerging Markets Currency Index after removing the MXN.
Source: BBVA Research and Bloomberg

**Figure 4.4** Observed exchange rate and simulated exchange rate* (pesos per dollar, replicating the average performance of other emerging market currencies* since 16 August 2016)




* Own calculations based on a new weighting of the JPMorgan Emerging Markets Currency Index after removing the MXN.
Source: BBVA Research and Bloomberg

At the beginning of October, before the start of the fourth round of the NAFTA renegotiation, the negative differentiation of August returned, but this time with a vengeance. The peso's weakness was accentuated as soon as news leaked of the proposals that the US was going to put forward in this round. The peso weakened from then on and returned to levels of around 19.0 to the dollar, ceding part of the ground it had regained over the course of the year following the change in prospects (see Figure 4.4).

In short, the weakening of the peso since mid-August has been entirely due to the risks associated with NAFTA. The peso's poor relative performance started with the first round of talks on NAFTA 2.0, was unaffected by more hawkish comments from the US Federal Reserve, and was accentuated in October with the increased risk of NAFTA breakdown.

Looking ahead, any change in trend will continue to be mainly in reaction to shifting prospects for the renegotiation of NAFTA. If subsequent rounds evolve more favourably and agreement is reached, the peso should strengthen, with the exchange rate returning to around 17.0 pesos to the dollar. Conversely, if the perceived risk of NAFTA break-up increases and if this risk materialises, the peso would depreciate by a further 5% approximately to around 20.0 pesos per dollar. For the moment, from now to the end of the year uncertainty will remain high and the exchange rate could continue to fluctuate around current levels of 19.0 pesos to the dollar. We are therefore maintaining our forecast of

MXN18.70 per USD at year-end. Added to the risk of the renegotiation process in the first half of 2018 will be the uncertainty typically associated with presidential elections in Mexico. The effects of this uncertainty will be seen mainly in the second quarter, in the months just before the election. Right now it is difficult to anticipate a level for the exchange rate, since we do not know what the starting point is. In other words it will be much lower (fewer pesos per dollar, stronger peso) than now if the prospects for NAFTA 2.0 improve, and even higher than now if the risk of break-up materialises. We could anticipate that, from the starting point at the end of the first quarter of 2018, the exchange rate could increase by about 5.0% and then decrease after the elections, irrespective of the result in our opinion, although at different speeds depending on it.

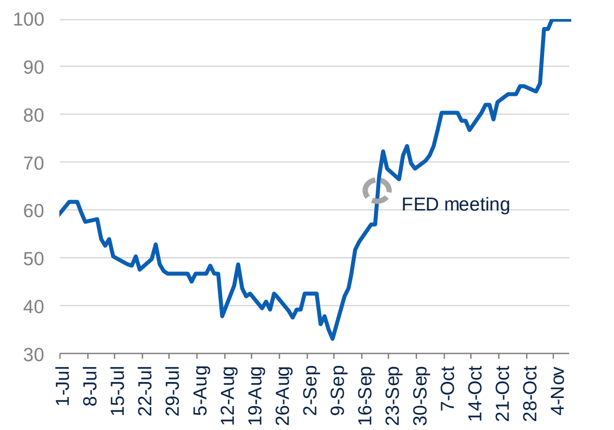
## The incorporation of further US interest rate hikes into market expectations and the renegotiation of NAFTA influence the performance of domestic assets

The economic environment continues to be characterised by the reactivation of growth globally, low levels of risk aversion and expectations that monetary stimulus measures will be withdrawn very gradually. This last feature of the environment was adjusted slightly following the US Federal Reserve's September statement stressing that a further rate hike in December was a real possibility. This reflects the fact that, as in the past few years, investors' expectations regarding the pace of US monetary normalisation differ significantly from those of FOMC members, so much so that investors were assigning a probability of less than 35% to an additional rate hike in December before the meeting referred to.

This change in expectations gave rise to several movements in asset prices. The dollar, which had remained weak since the second quarter of the year, strengthened against all other currencies. Between 20 September when the Federal Reserve meeting took place and 7 November, the dollar gained 2.6% against developed market currencies and 3.7% against those of emerging markets. In the government debt market yield to maturity on ten-year US Treasuries rose by as much as 20 bps to 2.46% at its peak before settling at around 2.3%. On the short section of the yield curve yield to maturity of the one-year bond rose by 21 bps to 1.5%, its highest level since 2008. Thus the curve continues to flatten, influenced by the absence of inflationary pressures in spite of the recovery in the US labour market.

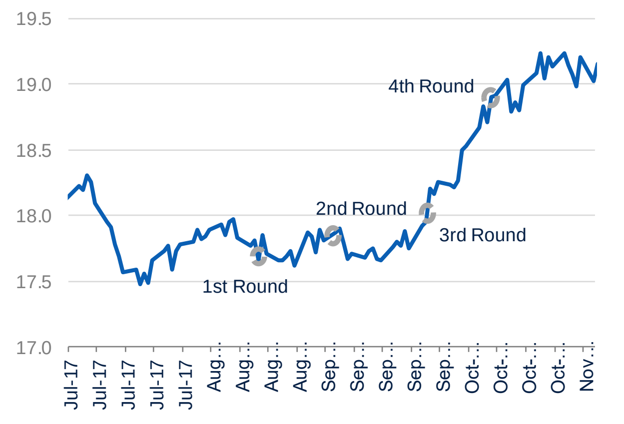
In the equity markets we continue to see significant gains underpinned by better-than-expected economic data globally and good corporate earnings reports. Both the worldwide benchmark for this asset class and the S&P500 are posting new all-time highs following gains of 2.4% and 3.3% respectively. We must mention that in the case of the S&P500 the expectation that November would see approval of the tax reform announced by the Trump administration also played a part. In the case of the emerging markets, growth was slightly less (2.2%), but at a level not seen since 2011.

**Figure 4.5** Implied probability of an increase in the Federal Funds Rate in the Futures Market (%)




Source: BBVA Research based on Bloomberg data

**Figure 4.6** Exchange rate and dates of conclusion of the NAFTA renegotiations (pesos to the dollar)



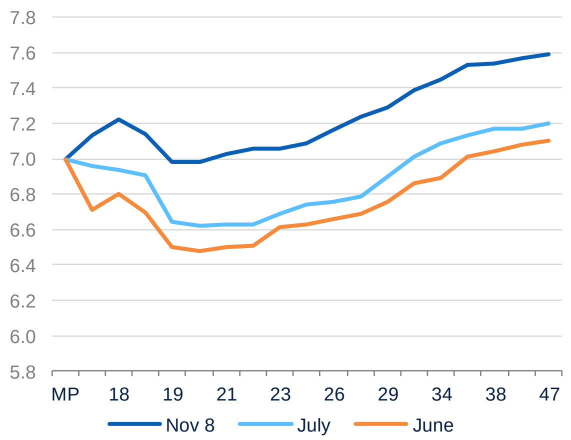

Source: BBVA Research based on Bloomberg data

In the case of Mexican assets, the increased uncertainty about a possible break-up of NAFTA led to negative differentiation. The most notable case is that of the exchange rate, as explained in the previous section. In fact, having been the currency that appreciated most during the first half of the year, the Mexican currency is now, after the Turkish lira, the second most depreciated since the start of the NAFTA renegotiation process on 16 August last. In spite of this significant depreciation, volatility and liquidity have not deteriorated much so far. It is worth highlighting that in response to this depreciation Banxico increased the amount of currency hedging auctions payable in pesos from one to four billion dollars.

Country risk, measured by the spread of the five-year CDS, increased by 15 bps after the US Federal Reserve meeting to 115 bps. This same level was reached again after the fourth round of NAFTA talks before falling slightly to 110 bps. Although this increase was significant, mention must be made of the fact that the level of this indicator is far removed from the long-term mean, which stands at around 130 bps, given the prevailing appetite for risk at the global level.

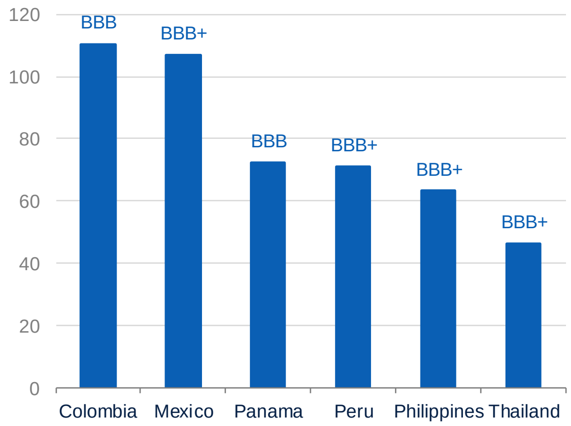
The increase in country risk, together with the Federal Reserve's starting to reduce its balance sheet, which brings the liquidity risk back down to levels more in line with those prior to the crisis, is behind the increase in long-term interest rates. It is worth recalling that since the last increase in the monetary rate, in June last, the curve had been showing a negative slope, so the movements described have reversed this situation. In effect, the yield to maturity of the ten-year government bond has risen by around 40 bps since 20 September to its present level of 7.25%. This situation was also influenced by the change in expectations regarding monetary policy, which have recently been factoring in a further rate hike of 25 bps next year. The higher interest rates have not been correlated with lower inflows of funds from abroad. In fact in the past three months holdings of medium- and long-term bonds have increased by around US$2.7 billion, and the year-to-date increase has been approximately US$6.3 billion. Lastly, negative differentiation was also observed in the Mexican stock market. The IPC stock index fell by 2.7% between 20 September and 7 November, while the emerging markets benchmark gained 2.0%. Nonetheless, so far this year the IPC stock index has gained 7.0%, reflecting the larger gains of higher-risk assets.

**Figure 4.7** Government yield curve (%)




Source: BBVA Research using Valmer data

**Figure 4.8** Sovereign risk. Five-year CDS spread by rating level (basis points)




Data as at 31 October 2017.
Source: BBVA Research based on Bloomberg data

In short, the renegotiation of NAFTA remains the main risk factor for the performance of Mexican assets, although the pace of monetary normalisation in the US continues to influence all emerging economies' assets, including Mexico's. The complex situation in which the NAFTA renegotiation is taking place leads us to think that going forward the conditions of volatility will persist and that market participants will be particularly attentive to any news on this subject. Long-term interest rates will remain at around their current levels providing there are no significant changes in expectations regarding monetary policy and in sovereign risk in the next few months. Specifically, we expect the yield to maturity of 10-year government bonds to end the year at around 7.3%.

## Trade scenario in the event of break-up of NAFTA

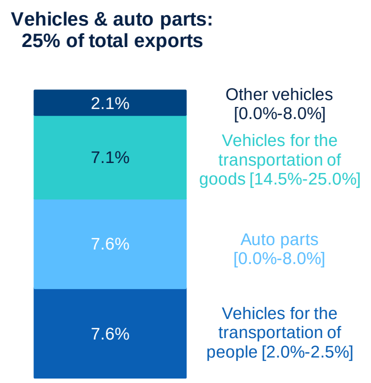
If the US opts to withdraw unilaterally from NAFTA, trade relations between Mexico and the US would continue under the most favoured nation (MFN) tariffs set by the World Trade Organisation (WTO). In this case Mexico's exports to the US would face a weighted average tariff of 3.5%, while US exports to Mexico would pay a weighted average tariff of 4.9%. It is important to note that nearly 50% of Mexico's exports to the US currently pay the MFN tariff due to the fact that the verification of national content required for products to qualify for the benefits of NAFTA (0% tariff) in some cases involve high costs for producers.

We estimate that the break-up of NAFTA would not have an across-the-board effect on trade flows, although it would have a negative effect on investment and on specific sectors such as production of vehicles for the transport of goods. This segment accounts for 6.1% of Mexico's total exports to the US and would face a tariff of 25% under the WTO's MFN regime.[5] The other major segments of the automotive sector,[6] auto parts (7.6% of total exports) and passenger vehicles (7.6% of total exports) would face weighted average tariffs of 1.3% and 2.5% respectively.

5: Except for compression-ignition piston-engine (diesel or semi-diesel) trucks with a total laden weight of more than five but not more than twenty metric tons.
6: Chapter 87 of the Harmonised Commodity Description and Coding System. This sector accounts for 24.3% of Mexico's total exports to the US.

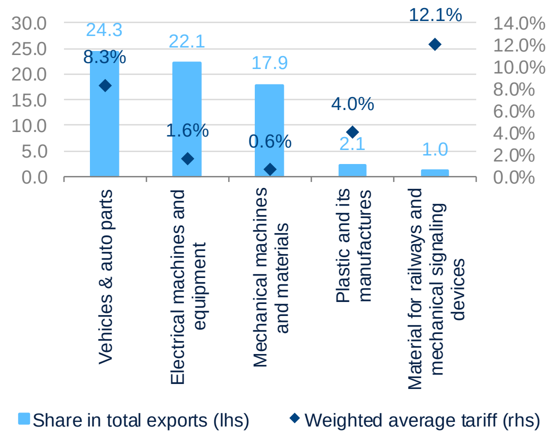
Other sectors with a large share of total exports, such as electrical and mechanical machinery and equipment (22.1% and 17.9% respectively) would face weighted average tariffs of 1.6% and 0.6% respectively. Plastic products (2.1% of total exports) and railway and mechanical signalling equipment (1.0% of total exports) would pay weighted average import duties of 4.0% and 12.2% respectively. These four sectors together, plus the automotive sector, are the five that contribute most (2.7 pp) to the weighted average tariff of 3.5% for total exports of goods.[7]

**Figure 4.9** Exports of vehicles and auto parts. Composition & WTO Tariff




Source: BBVA Research based on data from INEGI & WTO

**Figure 4.10** Weighted average tariff of selected sectors and WTO tariff




Source: BBVA Research based on data from INEGI & WTO

We estimate that the elimination of NAFTA would affect economic growth mainly through investment (FDI and private domestic gross fixed investment). As regards FDI, the segment most affected would be manufacturing, especially the segment of the automotive sector specialising in trucks, which would be faced with import duties of 25% under the MFN regime. Although other sectors could feel the effects, we consider that the expected depreciation of the peso would more than proportionally offset the increase in tariffs on exports.

We consider that the reduced dynamism of export production in the automotive sector, especially the truck segment, would discourage investment in related domestic sectors (auto parts, accessories, etc.), so we would expect to see less growth in private sector domestic gross fixed investment. The biggest fall seen in private sector gross fixed investment in the recent past amounted to 15.5%, in 2009; we would not expect to see a fall of that magnitude in the event of the break-up of NAFTA. We estimate that the fall would be between 2% and 4%.

Assuming a fall of 7.4% in FDI and a decline in domestic gross fixed investment of between 2% and 4%, we estimate that the ending of NAFTA would have a negative effect on GDP growth in 2018 of between 0.5 and 0.8 pp.

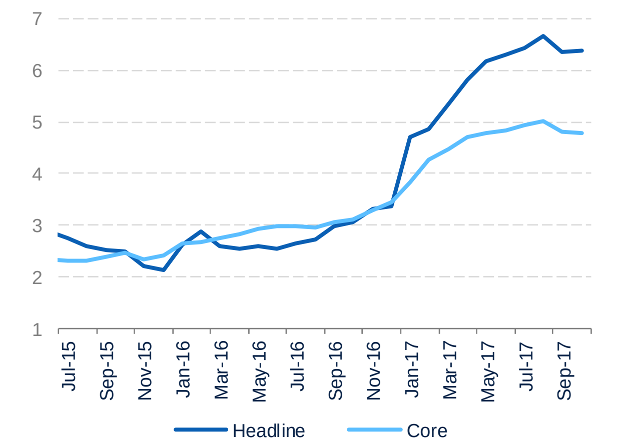
7: The five sectors in question correspond to chapters 87, 85, 86, 84 and 39 of the Harmonised Commodity Description and Coding System.

# 5. Inflation is now coming down as we foresaw

Having shown a rising trend for fourteen months in a row, headline inflation peaked in August at 6.7% and reached an inflection point in September (6.35%), as we predicted at the beginning of the year. Thus annual inflation went from an average of 4.98% in the first quarter of 2017 to an average of 6.10% in the second and 6.48% in the third. In October it increased marginally (to 6.37%), mainly due to a sharp and unexpected increase in LPG prices: 7.4% MoM, with an effect of 0.14 pp on headline inflation. Without this surprise increase, annual inflation would have fallen to 6.2%. In other words, the slight uptick in October does not represent an interruption of the downward trend that started in September.

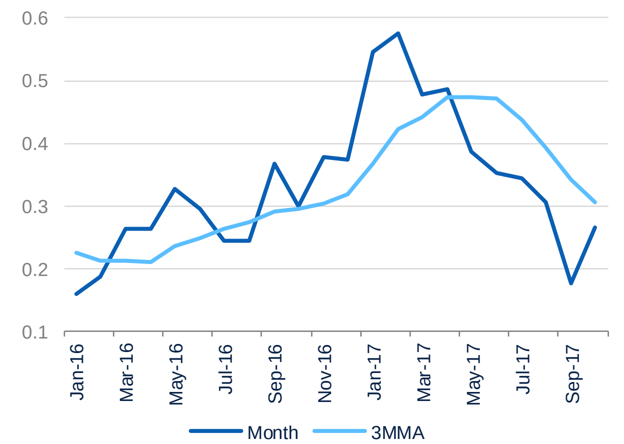
Meanwhile, average annual core inflation went from 4.19% in 1Q17 to 4.78% in 2Q17 and 4.91% in 3Q17. In October it stood at 4.77%. Within core inflation, the goods index increased by 2.5 pp between December 2016 and August 2017 (from 4.05% to 6.51%). Both sub-indices of this component showed significant increases in the same period, rising from 4.4% to 7.57% in the case of food and from 3.76% to 5.63% in that of non-food goods. The services index also increased, albeit at a slower pace, going from 2.92% to 3.72% in the same period. In the last two months (September-October), core inflation has shown a tendency to diminish, moderating its recent high from 5.0% to 4.8%. Within this, goods inflation eased from 6.5% to 6.0% between August and October. Price inflation of non-food goods, the component most subject to the pass-through of the exchange rate to goods, has declined over the past four months to 5.3% in October compared with 5.9% in June. That of food eased from 7.6% to 6.7% between August and October. As for inflation of services, although it shows no moderation, it has fluctuated in a narrow range between 3.6% and 3.7% in the past five months.

**Figure 5.1** Headline and core inflation
YoY % change




Source: BBVA Research and INEGI

**Figure 5.2** Seasonally adjusted core inflation
MoM % change




Source: BBVA Research and INEGI

In short, both headline and core inflation started to moderate in September (see Figure 5.1). The change in trend in inflation is due mainly to the gradual fading of one of the main shocks to which it was exposed, namely the considerable additional depreciation of the peso in reaction to the result of the US elections which led to an increase in the rate of pass-through to goods. In fact both the seasonality of core inflation and the base effects prevent us from appreciating the full extent of the moderation in core inflation. Eliminating seasonality from the core inflation series allows us to see the downward trend of the past few months more clearly (see Figure 5.2). In monthly terms, core inflation reached its highest rate of increase in February, just one month after the exchange rate reached its peak of 22.0 pesos to the dollar and at a time when few foresaw an appreciation of the peso such as the one we ended up seeing. Since then, the seasonally adjusted monthly increase has been moderating and in the past few months has even shown increases of between 0.2% and 0.3%, consistent with core inflation evolving in line with an annualised increase of around 3.0%. Figure 5.3 shows even more clearly the moderating trend in core inflation. As can be seen in Figures 5.2 and 5.3, 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 which have been accentuated in the past few months.

In contrast, headline inflation shows no such moderating trend. The annual rate has remained above 11.0% in the past five months. This trend mainly reflects two shocks: one from farm prices, which showed significant increases (of 1.7% MoM on average) between March and August, and the other from energy prices in the last three months due to an increase in petrol (gasoline) prices and the unexpected increase in the price of LPG in October. All the same, it is important to highlight the change of trend in headline inflation in a context in which these additional shocks have been faced in the past few months.

The notable change of trend in inflation in a context of additional supply shocks to prices has been possible thanks to the stability of medium- and long-term inflationary expectations, which have remained at around 3.5%. This in turn has been possible thanks to the recovery of the peso (which gave rise to the expectation that the rate of pass-through would tend to diminish, an expectation which has materialised, as shown previously), the monetary policy actions of Banco de México (namely the increase in the monetary policy rate from 3.0% to 7.0% between December 2015 and June 2017) which reinforced the prospect of the increase in inflation being temporary and avoided inflationary expectations slipping their anchor and leading to secondary effects on the price formation process, and to the rigidity of nominal wages which translates into contractions of real wages avoiding generalised pressure on prices. Thus, although inflation has continued to face additional shocks over the course of the year, a low rate of pass-through to headline inflation, deriving mainly from the absence of second order effects, and the end of the pass-through to core inflation will continue to be translated into a downward trend in inflation.

## Inflation will continue to show a downward trend, which will be accentuated from January 2018

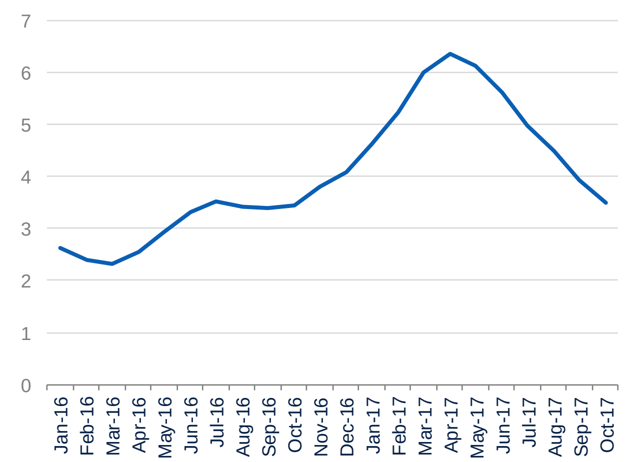
We anticipate that for the rest of 2017 both headline and core inflation will continue to show a falling trend (see Figure 5.4). The greater-than-expected increase in energy prices of a few months ago will lead to a smaller decline in headline than in core inflation towards year-end. For headline inflation we anticipate a level of 6.2% in December (0.2 pp less than in October), while for core inflation we foresee a decline to 4.5% (0.3 pp less than the current level).

In January 2018, a highly favourable base effect, as the fading effect of the increase in energy prices of January 2017 following the liberalisation of petrol (gasoline) and LPG prices will allow headline inflation to decline by 1.3 pp to 4.9%, and we foresee the downward trend continuing in the subsequent months with inflation ending 2018 below 4.0% (at 3.7%), within the central bank's target range.

## The risks for inflation are tilted to the upside, but are moderate

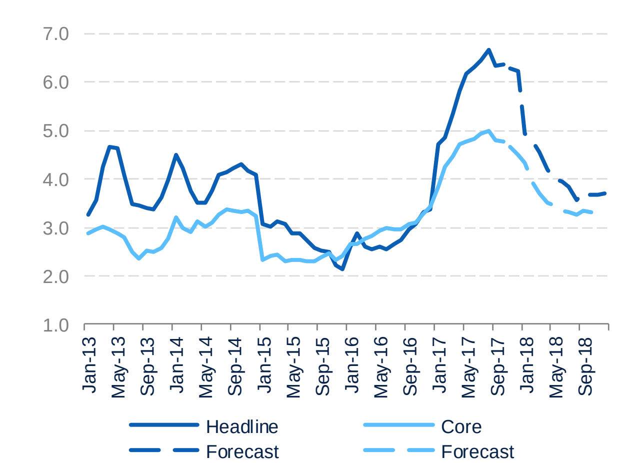
Our forecasts are subject to both upside and downside risks, and recently the balance of risks has deteriorated so that they now seem to have a little more of an upward bias, mainly because of the risk of a break-up of NAFTA which would lead to further depreciation of the peso. Nonetheless, we consider that the current level of the exchange rate (19.0 pesos per dollar) already factors in most of this risk, so that the additional depreciation if it materialised would be moderate (around 5% to 20.0 pesos per dollar). This depreciation should not lead to significant pass-through to goods if we consider that the most intense rate of pass-through was seen when the exchange rate reached 22.0 pesos per dollar and that there was no moderation in prices after the appreciation of the peso observed in the subsequent months. In the 3Q17 edition of Mexico Economic Outlook we pointed out as the main risk the possible return of the peso's weakness if the NAFTA renegotiations were expected to lead to substantial changes in the trade relationship between Mexico and the US, as has been the case since the end of September. The main downside risks are a possible significant strengthening of the peso (to around 17 pesos per dollar) if the NAFTA talks were to have a positive outcome, lower-than-expected momentum in the economy, resulting in a widening of the output gap and the possibility of falls in world energy prices.

**Figure 5.3** Seasonally adjusted core inflation
Change QoQ annualised




Source: BBVA Research, INEGI and Bloomberg

**Figure 5.4** Inflation outlook, BBVA Bancomer
YoY % change




Source: BBVA Research and INEGI

## Banxico will be cautious in the next few months; rate cuts are still a long way off

Since Banxico explicitly called an end to the cycle of rate increases last June, economic conditions have remained largely consistent with the reasons on which it based its decision. Inflation peaked in August and has now started to come down, and will do so much more markedly from January, as commented in the previous section. Both our expectation and that of Banxico is that inflation will still continue to evolve favourably. The risks of second order effects have continued to diminish, while medium-term inflationary expectations remain anchored. Although the recent depreciation of the peso has led to a slight uptick in expectations extracted from the fixed income market, they remain at just over 3.0%. Also deriving from this recent depreciation, the IRS curve is factoring in an additional increase in the central bank's key lending rate of 25 bps for next year. Nonetheless we consider that this change in market expectations could be temporary, since to some extent it factors in a high probability of an adverse outcome of the NAFTA talks, which is not the baseline scenario for now.

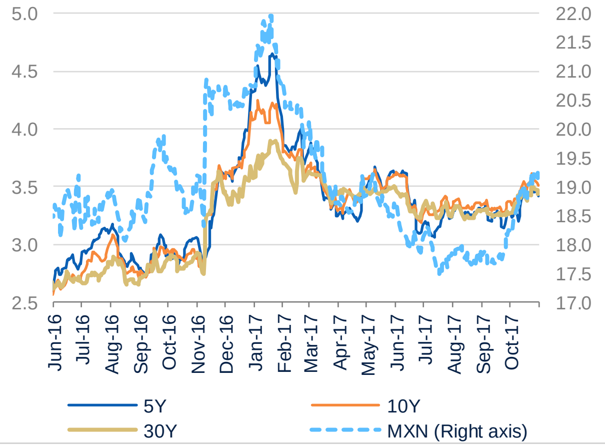
Thus, while the balance of risks for inflation has deteriorated because of the peso's recent depreciation and the risk of further depreciation, it is increasingly clear that inflation is evolving as anticipated by the central bank and, in our opinion, will quickly approach the target range (3.0% +/- 1 pp) in the first half of 2018. With regard to this expectation we should highlight that in average terms despite the levels reached recently by the exchange rate, it is still far removed from the levels reached at the beginning of the year. During the first quarter, the average reached 20.3 pesos, while in the past three months it has been 18.3 pesos. In short, the risks for inflation are tilted upwards, but are moderate in our opinion.

Apart from this, although Banxico has recently toughened its discourse, reflecting the increase in short-term risks, it is maintaining its position to the effect that prospects for inflation in 2018 have not changed. The point is that with inflation falling, as mentioned, real short-term rates will increase substantially in the first half of next year (from current levels of around 0.6 pp to 2.5 pp at the end of the first quarter of 2018 and to 3.0 pp at the end of the second), constraining monetary policy, in a context in which inflation is moving ever closer to the target, without the need for additional increases in the nominal rate. For this reason, the more restrictive tone recently adopted by Banxico in our opinion mainly reflects its intention of keeping inflationary expectations anchored.

### Although we still expect the next interest rate move to be downwards, the environment and Banxico's communication make it clear that this is still some way off

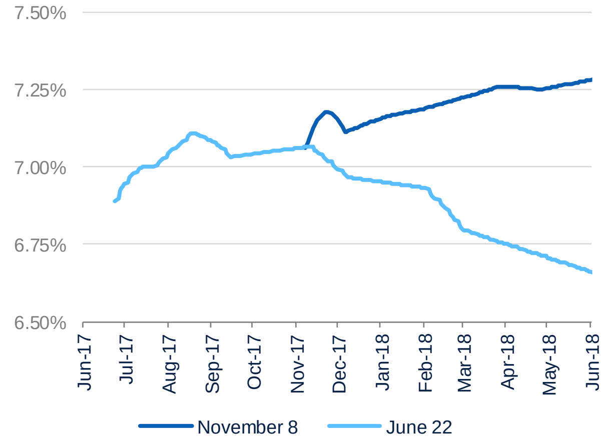
Although the increase in the real rate of interest in the first few months could lead Banxico to consider starting a gradual shift in its rates towards the neutral level of 5.5%, the risks suggest that it will prefer to be cautious and extend the monetary pause for longer, until the currency risks dissipate. Moreover, the change of command at Banxico also counsels prudence regarding any change in rates in the near future. Also, as we commented in the section on the exchange rate, this could also come under pressure in the run-up to the presidential elections in July. We therefore believe that in the most likely scenario Banxico will keep its monetary policy on hold until the third quarter of 2018, when it will begin to reduce the benchmark rate to achieve a reduction of around 100 bps over the whole of next year. We should highlight the fact that this scenario is based on the assumption that NAFTA will not be dissolved, which is without doubt the main risk factor hanging over the economic scene.

**Figure 5.5** 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 5.6** Expectations of the monetary policy rate implied in the IRS curve (%)




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

# 6. Indicators and forecasts

**Table 6.1** Macroeconomic forecasts: Gross Domestic Product

| (YoY growth rate, %) | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|
| United States | 2.6 | 2.9 | 1.5 | 2.1 | 2.2 |
| EMU | 1.4 | 2.0 | 1.8 | 2.2 | 1.8 |
| Germany | 1.9 | 1.5 | 1.9 | 2.2 | 1.8 |
| France | 1.0 | 1.0 | 1.1 | 1.7 | 1.7 |
| Italy | 0.2 | 0.9 | 1.1 | 1.5 | 1.3 |
| Spain | 1.4 | 3.4 | 3.3 | 3.1 | 2.5 |
| UK | 3.1 | 2.3 | 1.8 | 1.4 | 1.2 |
| Latin America* | 0.9 | -0.4 | -1.3 | 1.1 | 1.6 |
| Mexico | 2.3 | 2.6 | 2.0 | 2.2 | 2.0 |
| Brazil | 0.5 | -3.8 | -3.6 | 0.6 | 1.5 |
| Eagles** | 5.4 | 4.7 | 5.2 | 5.3 | 5.1 |
| Turkey | 5.2 | 6.1 | 2.9 | 6.0 | 4.5 |
| Asia-Pacific | 5.6 | 5.6 | 5.6 | 5.5 | 5.3 |
| Japan | 0.2 | 1.1 | 1.0 | 1.4 | 1.0 |
| China | 7.3 | 6.9 | 6.7 | 6.7 | 6.0 |
| Asia (exc. China) | 4.2 | 4.5 | 4.7 | 4.4 | 4.6 |
| World | 3.5 | 3.4 | 3.3 | 3.5 | 3.5 |

* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
** Saudi Arabia, Bangladesh, Brazil, China, Philippines, India, Indonesia, Irak, Mexico, Nigeria, Pakistan, Russia, Thailand and Turkey.
Forecasts closing date: 3 de November 2017.
Source: BBVA Research & IMF

**Table 6.2** United States indicators and forecasts

| Macroeconomic Indicators | 2015 | 2016 | 2017 | 2018 | 1Q17 | 2Q17 | 3Q17 | 4Q17 | 1Q18 | 2Q18 | 3Q18 | 4Q18 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| GDP (real % change) | 2.9 | 1.5 | 2.1 | 2.2 | 1.2 | 3.1 | 2.4 | 2.4 | 2.3 | 1.9 | 1.8 | 1.8 |
| Personal consumption (real % change) | 3.6 | 2.7 | 2.6 | 2.1 | 1.9 | 3.3 | 2.0 | 2.0 | 2.2 | 1.8 | 1.8 | 2.1 |
| Government consumption (real % change) | 1.4 | 0.8 | -0.1 | 0.5 | -0.6 | -0.2 | -0.1 | 0.7 | 0.4 | 0.8 | 0.6 | 0.6 |
| Gross fixed investment (real % change) | 5.2 | -1.6 | 2.5 | 3.3 | -1.2 | 3.9 | 1.4 | 2.9 | 4.6 | 3.2 | 3.3 | 2.1 |
| Construction[1] | 10.2 | 5.5 | 2.0 | 0.8 | 11.1 | -7.3 | 3.5 | -0.8 | 0.9 | 2.2 | 2.1 | 0.9 |
| Industrial production (real annual % change) | -0.7 | -1.2 | 1.6 | 1.6 | 1.6 | 5.6 | -0.1 | 0.0 | 1.5 | 2.4 | 2.5 | 1.8 |
| Current account balance (% of GDP) | -2.4 | -2.4 | -2.4 | -2.3 | -2.4 | -2.6 | -2.4 | -2.3 | -2.3 | -2.3 | -2.3 | -2.3 |
| Final annual inflation | 0.7 | 2.1 | 1.6 | 1.8 | -1.9 | -2.9 | 2.6 | -4.1 | -3.6 | -0.6 | 1.3 | -4.5 |
| Average annual inflation | 0.1 | 1.3 | 2.0 | 1.7 | -2.2 | -1.6 | 0.3 | -1.7 | -4.4 | -1.4 | 0.4 | -2.2 |
| Primary fiscal balance[2] (% of GDP) | -2.4 | -3.1 | -3.9 | -2.8 | -3.9 | -4.2 | -4.4 | -3.5 | -2.8 | -2.9 | -2.8 | -2.8 |

1: Residential investment
2: Fiscal balance (% of GDP)
Note: **Bold** figues are forecast
Source: BBVA Research

**Table 6.3** Mexico indicators and forecasts

| | 2015 | 2016 | 2017 | 2018 | 1Q17 | 2Q17 | 3Q17 | 4Q17 | 1Q18 | 2Q18 | 3Q18 | 4Q18 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Economic Activity** | | | | | | | | | | | | |
| **GDP (seasonally-adjusted series)** | | | | | | | | | | | | |
| Real annual % change | 2.6 | 2.0 | **2.2** | **2.0** | 2.6 | 3.1 | 2.1 | **1.3** | **1.5** | **1.6** | **2.2** | **2.7** |
| Per inhabitant (US dollars) | 9,177 | 8,247 | **8,702** | **9,657** | 8,455 | 8,980 | 8,938 | **8,702** | **8,992** | **9,185** | **9,546** | **9,657** |
| US$ billions | 1,110 | 1,008 | **1,075** | **1,205** | 1,044 | 1,109 | 1,104 | **1,075** | **1,122** | **1,146** | **1,191** | **1,205** |
| **Inflation (average, %)** | | | | | | | | | | | | |
| Headline | 2.72 | 2.82 | **5.96** | **4.63** | 4.98 | 6.10 | 6.48 | **6.29** | **4.74** | **4.05** | **3.71** | **3.68** |
| Core | 2.36 | 2.97 | **4.69** | **3.51** | 4.19 | 4.78 | 4.91 | **4.64** | **3.99** | **3.44** | **3.30** | **3.30** |
| **Financial Markets (eop, %)** | | | | | | | | | | | | |
| **Interest rates** | | | | | | | | | | | | |
| Bank funding | 3.02 | 4.29 | **6.73** | **6.80** | 6.17 | 6.75 | 7.00 | **7.00** | **7.00** | **7.00** | **6.83** | **6.33** |
| 28-day Cetes | 3.25 | 4.33 | **6.77** | **6.78** | 6.20 | 6.75 | 7.04 | **6.99** | **6.99** | **6.99** | **6.82** | **6.32** |
| 28-day TIIE | 3.44 | 4.58 | **7.06** | **7.10** | 6.53 | 7.13 | 7.33 | **7.33** | **7.33** | **7.33** | **7.20** | **6.70** |
| 10-year Bond (%, average) | 5.94 | 6.22 | **7.11** | **7.37** | 7.26 | 7.11 | 6.85 | **7.23** | **7.25** | **7.50** | **7.45** | **7.30** |
| **Exchange rate (average)** | | | | | | | | | | | | |
| Pesos per dollar | 15.97 | 18.71 | **18.90** | **18.30** | 19.90 | 18.55 | 17.81 | **18.90** | **18.50** | **19.00** | **17.90** | **17.80** |
| **Public Finances** | | | | | | | | | | | | |
| *FRPS (% of GDP) | -4.1 | -2.9 | **-2.9** | **-2.5** | | | | **-1.4** | | | | **-2.5** |
| **External Sector**[3] | | | | | | | | | | | | |
| Trade balance (US$ billions) | -14.7 | -13.1 | **-14.7** | **-15.3** | -2.7 | -0.1 | -6.1 | **-3.8** | | | | |
| Current account (US$ billions) | -28.2 | -22.4 | **-29.5** | **-30.9** | -8.4 | -0.3 | **-7.9** | **-7.4** | | | | |
| Current account (% of GDP) | -2.5 | -2.1 | **-2.8** | **-2.9** | -3.3 | -0.1 | **-3.1** | **-2.9** | | | | |
| **Employment** | | | | | | | | | | | | |
| Formal Private (annual % change) | 4.3 | 3.8 | **3.8** | **3.2** | 4.3 | 4.2 | 3.7 | **3.1** | **2.9** | **3.0** | **3.2** | **3.6** |
| Open Unemployment Rate(% active pop.) | 4.3 | 3.9 | **3.6** | **3.7** | 3.5 | 3.6 | 3.6 | **3.6** | **3.5** | **3.7** | **3.7** | **3.7** |

3: Accumulated, last 12 months
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, Banxico, INEGI & SHCP data

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