

## Mexico | The peso still has room for further appreciation

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The past few months have seen very high volatility in Mexico's financial variables, and particularly in the exchange rate. Whereas from 8 November when Donald Trump was elected president of the US to the end of January the peso depreciated more than any other currency in the world, from then until now it has gained more than any other currency. This week the exchange rate has been at slightly lower levels than those prevailing before Trump's election; in other words the peso has recovered all the ground lost since then, although we should bear in mind that at the time of the US elections it had already depreciated significantly in anticipation of his possibly being elected.

Bonds too have shown a significant degree of volatility: a few weeks before the US presidential election the rate of ten-year government bonds was below 6%. When the news of Trump's election broke, the rate jumped, reaching 7.7% at the end of January; like the peso, since then it has performed better, and is now at 7.1%.

What is the explanation for this volatility, and what can we expect going forward? The main factor behind this behaviour of the financial variables is the perception of what might happen with NAFTA. Between 8 November and the end of January the exchange rate went from 18.3 to nearly 22 pesos to the dollar. This is because it was during that period that we heard the worst of Trump's anti-NAFTA rhetoric. It was also the period in which Ford announced the cancellation of its plans to invest US\$1.6 billion in a new automotive plant in Mexico.

It seemed that trade relations between Mexico and the US might be seriously affected. And those trade relations have been the main growth driver for the Mexican economy in the past twenty years. That is why we saw such a negative reaction in the markets. However, from late January the Trump administration started sounding more positive about NAFTA, and a few weeks ago it sent notice to Congress of its intention of renegotiating the agreement. All this was reflected in the exchange rate, with the peso strengthening every time a positive signal was sent out about NAFTA (with a few reversals, such as when the news leaked that Trump was thinking of pulling out of the agreement). Since 20 January the peso has appreciated by approximately 17%.

Another factor that strengthened the peso, albeit to a lesser extent, was the result of the electoral process in Mexico State. The peso appreciated by 2% on the back of these results. Further contributions to the strengthening of the peso and of government bonds came from the process of fiscal consolidation and the central bank's operating surplus, which reduced the possibility of a downgrade to Mexico's sovereign credit rating.

I believe there is still room for the peso to appreciate further. A value consistent with the country's macroeconomic fundamentals would be around 17.50 pesos to the dollar. Once the uncertainties surrounding the Mexican economy are dispelled (mainly those relating to NAFTA, the Fed's monetary policy and Mexico's 2018 presidential elections), the peso should approximate to those levels. But until that happens, I think we will see more volatility. In the next few months we may see significant movements in the currency, in both directions. The factors that may lead to depreciation of the peso are: i) renegotiation of NAFTA running into difficulties ii) the US Federal Reserve's announcing a steeper-than-expected hike

trajectory in its key rate, and iii) increased uncertainty about the 2018 presidential elections.

In summary, I think that if NAFTA can be satisfactorily renegotiated, the Fed continues its gradual pace of withdrawal of monetary stimulus measures and the uncertainties about the electoral process in Mexico are dispelled - all of which in my opinion are more likely to occur than not - the peso, which despite the gains of the past few weeks is still undervalued relative to what ought to be an equilibrium level, should appreciate. Meanwhile the path will be serpentine.

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