BBVA | Research

Mexico | Economic panorama 2018: resilience in the midst of uncertainty

El Financiero (Mexico)

Carlos Serrano

15 Jan 2018

The Mexican economy in 2018 will traverse a context of major sources of uncertainty, among which the renegotiations of the North American Free Trade Agreement (NAFTA) and the presidential elections stand out.

Despite these uncertainties, I estimate that economic growth will be similar or higher than that of last year, oscillating around 2%. This growth will be driven mainly by the external sector. In a context in which the manufacturing sector in the United States is growing vigorously and in which global trade is recovering from the stagnation it suffered after the global financial crisis, Mexican exports will continue to grow at high rates, which will be around 10%. For its part, the fall in consumption will slow as inflation decreases, thus leading to the recovery of real wages.

By contrast, investment will remain weak (growing at negative rates). This is because private investment will fall due to the aforementioned uncertainties, while public investment will continue fall as part of the fiscal consolidation process. We note that the contraction of the economy observed in the third quarter of 2017 was a transitory phenomenon explained by the natural disasters in September, which included both earthquakes and hurricanes.

As for inflation, during this year we will see a marked downward trajectory. Last year, inflation closed at 6.8%, its highest level since 2000. This higher level is explained by a series of temporary supply shocks and not by demand pressures or monetary expansions. This is why the 2017 increase will be transitory. It was mainly explained by the increase in petrol prices and by the depreciation of the exchange rate, which led to a rise in the prices of imported goods. When inflation started to drop, there were two other temporary shocks: the rise in LP gas rates and the increase in the price of tomatoes. Had it not been for these two increases, inflation would have closed the year at 6.1% instead of 6.8%. All these shocks are transitory in nature. More importantly, there has been no contamination of other prices nor has it led to an unpinning of inflation expectations (a phenomenon that could in itself result in higher inflation). For these reasons, inflation will decrease this year; in January we will see a major fall. I estimate that by the end of 2018 inflation will be below 4%.

Therefore, it seems to me that the Bank of Mexico (Banxico) should not keep increasing the benchmark rate. Monetary policy should not react to temporary supply shocks provided these shocks do not lead to an increase in inflation expectations, a factor that, as I mentioned, has not been observed. Banxico itself acknowledges that inflation has not increased due to demand pressures and that the inflationary increase is transitory. More increases in the monetary policy rate will mean a headwind for the economy in a situation where such increases are not necessary to contain inflation.

Regarding fiscal policy, the goals set by the government that involve a fiscal surplus of 0.9% of the Gross Domestic Product (GDP) are appropriate since they will mean that debt as a percentage of GDP continues to fall. It would be desirable for the adjustment to be made more in current spending than in investment, as has been the case up to now. This, together with the higher exports and the recovery in oil prices will ensure that the fundamentals of the economy improve. We will see a lower fiscal deficit and a lower current account deficit, which will contribute to Mexico being more attractive to international investors than most of the other large emerging countries. The exchange rate, however, will continue to be fundamentally affected by the uncertainty surrounding NAFTA. We could see a significant appreciation if a successful renegotiation of the treaty is achieved. Until that happens, we will continue to observe high levels of exchange rate volatility. In summary, it will be a year in which the economy continues showing the high levels of resilience that we saw in 2017, but in which we will also see significant episodes of volatility.