

Mexico | Exchange rate and uncertainty

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There are two major sources of uncertainty regarding the Mexican economy: the outcome of the NAFTA negotiations, and the doubts that always surround presidential elections. How are these factors affecting the peso? In a context of flexible exchange rates such as that wisely adopted by Mexico more than twenty years ago, this kind of uncertainty is mainly reflected in the exchange rate. That is intentional - the fact that the exchange rate is a floating rate allows it to absorb adverse external shocks.

For the past two years, the uncertainty concerning what might happen with NAFTA has been a significant external shock to the Mexican economy and, as such, the main factor affecting the exchange rate. Indeed, from April 2016, when it started to look as though Donald Trump really might become the Republican candidate for the US presidency, the peso started to underperform against the other major emerging countries' currencies. These were appreciating against the dollar, while the peso depreciated significantly. As a result, in 2016 the peso depreciated more than any other currency in the world.

From February to August 2017, when it seemed that the US intended to negotiate NAFTA quickly and constructively, the peso was the world currency that appreciated most, going from 22 to 17.4 pesos to the dollar. The Trump administration then introduced a series of clearly protectionist proposals, prominent among which was the 50% US content requirement in order for cars to qualify for zero-import duties. From that point, the peso started to weaken again. Now that there seems to be better prospects for the negotiations. Based on the US having withdrawn the above-mentioned proposal, the peso has strengthened once more. The national currency has seen high levels of volatility (among the highest in the world) since doubts about the future of NAFTA started to arise.

What can we expect going forward? I believe that until such time as we have some clarity regarding the outcome of the negotiation process, we will continue to see significant fluctuations. If NAFTA were to collapse, a scenario to which I assign a less than 10% probability, the currency could depreciate, but not to the levels seen in January 2017, when the market was assuming not just the collapse of NAFTA but an even worse scenario, with the US slapping 30% import tariffs on Mexico's automotive exports. In the collapse scenario, the peso might go to levels of 20.5 pesos to the dollar.

On the other hand, in the event of a successful outcome of the negotiations, a scenario to which I assign a 50% probability, the exchange rate would move towards levels more consistent with the country's macroeconomic fundamentals; I think it could settle at around 16.5 pesos to the dollar. If we reach an impasse, with the negotiations being prolonged (which I think has a 40% probability of occurring), the currency could fluctuate between 18 and 19 pesos per dollar.

It is also worth asking how the electoral process has affected the currency market. In other recent electoral cycles, as the elections drew near we started to see a negative differentiation of the peso relative to other major emerging currencies. This time around we have not seen this. However, it is very difficult to assert on

this basis that the electoral uncertainty is not having an effect on the currency market. The reason for this is that there is a more powerful factor exerting its influence on the peso, in the shape of NAFTA.

It could be that the peso would have appreciated more on the back of the good news about the agreement had it not been for the electoral noise. In any event, if there is an effect it would not appear to be very significant. Nevertheless, judging by earlier electoral cycles, as the elections draw near we may well see greater volatility. We should therefore prepare ourselves to see high variability in the peso in the near future. This is not a bad thing in itself - it is after all what flexible exchange rates are for.

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