How Mexico is reaping the economic rewards

Mexico is on a much stronger footing following two years of strict economic policies

Source: Shutterstock

One last hike this week?

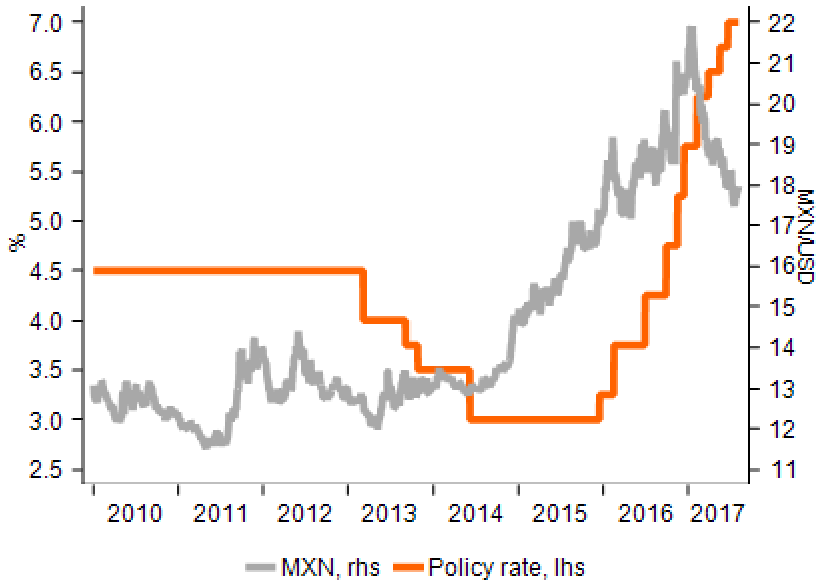
Ahead of the latest central bank meeting on August 10th, it's clear that Mexico is on a much stronger footing to face its next major challenges, notably the renegotiation of the North American Free Trade Agreement (NAFTA) and uncertainties related to next year's general elections. How these play out could add significant volatility to forex markets in the first half of 2018. Mexico's monetary and fiscal policy adjustments are now likely near the end. This week's policy meeting should tell us if the 25 basis point interest rate increase to 7.0% in June was the last rate hike. Interest rates rose 400 basis points to 7% over the past two years and helped stabilise the Mexican Peso; this should also be enough to keep inflation expectations low in the medium term.

We think bank officials should downplay the risk of a quick reversal in monetary policy.

In fact, market analysts are now wondering if the Central Bank will reduce interest rates. Investors eagerly expect such a rate reduction in the near future, but bank officials should indicate that the uncertainty related to the July 2018 presidential elections is likely to make the Mexican Peso more volatile, preventing an interest rate reduction at least until August 2018.

Aggressive interest rate hikes helped reverse FX trends

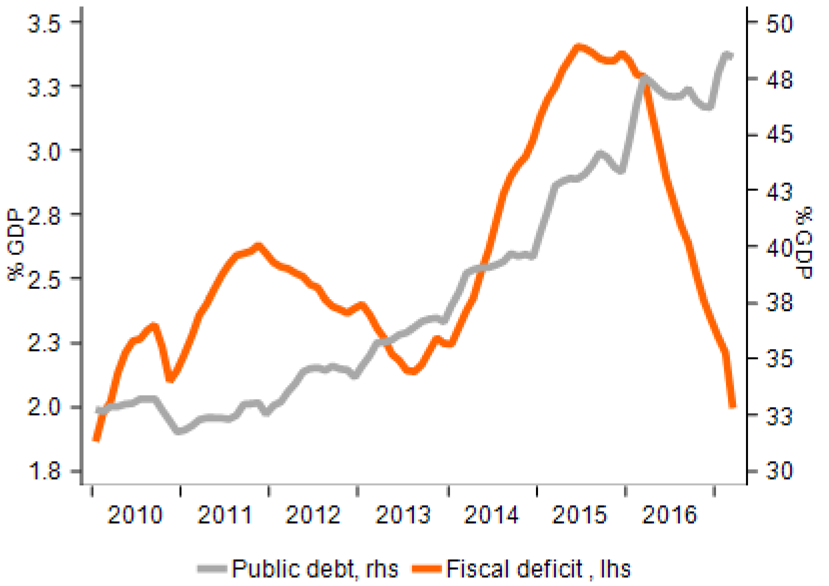
Source: Macrobond



Low risk of credit-rating downgrades

The current President, Enrique Peña Nieto, introduced austerity measures in the form of significant cuts to government spending to compensate for the decline in oil-related revenues. These measures also helped control the growth in public debt and triggered a positive reaction from rating agencies. S&P and Fitch both recently raised their credit rating outlook for Mexico to stable from negative, mostly due to the improving fiscal deficit. The risk of a credit rating downgrade in the near future is, therefore, very low.

Sharp reduction in fiscal deficit should improve public debt trends ahead



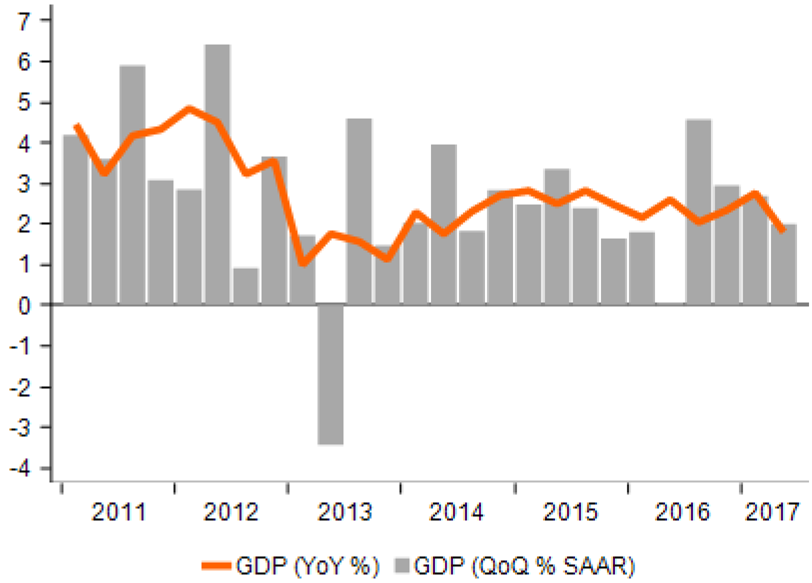
Source: Macrobond

Concerns of fiscal deficit worsening over the next few quarters

Rating agencies may, however, remain cautious due to two reasons. Moody's, for example, may be waiting to see how the fiscal policy changes during the next few quarters. The recent fiscal deficit improvement was largely due to higher revenue from one-off sources, such as the Banxico's unusually high dividend distribution. Government spending, on the other hand, tends to increase during election years. Both these factors could cause the fiscal deficit to moderately worsen over the next few quarters. Moreover, before the recent improvement, public debt levels had increased sharply, about 15 percentage points to nearly 50% of GDP, implying that there is less possibility of fiscal stimulus measures, such as increased government spending funded through debt, being implemented.

The other reason for rating agencies to remain cautious is NAFTA. In particular, whether Moody's will upgrade Mexico to a 'stable' outlook, appears to depend on trade relations between Mexico and the US remaining essentially the same after NAFTA negotiations. Any substantial change to NAFTA could significantly harm the Mexican economy, primarily through weaker economic growth, and could result in a ratings downgrade.

Remarkably steady GDP growth dynamics



Source: Macrobond

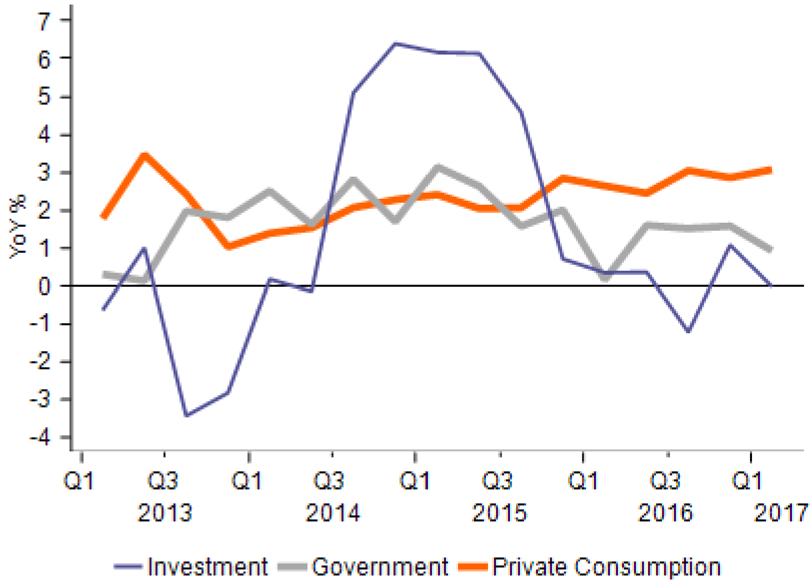
Steady GDP growth in the first half of 2017 a surprise

Rating agencies have also noted the impressive resilience of Mexico's economic data. Mexican GDP growth did not slow down in the first half of 2017, growing at 2.3% year-on-year, the same rate seen in 2016. This was in spite of the stricter economic policies and the collapse in business sentiment due to the risk of a worsening US-Mexican relationship. This also contrasts with the weaker-than-expected economic activity seen across Latin America in 2017, and stands out especially given the pessimism early this year.

Domestic consumer spending was the key driver of economic growth in the first half of 2017.

The weak peso also helped for a while as it caused people to reduce imports and substitute with local products. Investment and government spending were generally low and contributed little to the economy. The strong labour market, with unemployment levels near zero, and the surge in workers' remittances, can partially explain the strong increase in domestic consumer spending. Yet, overall, given the higher interest rates as well as the sharp increase in inflation, this increase in domestic consumption has been a surprise.

Consumption up, investment down (GDP)



Source: Macrobond

Services growing; industrial sector declining

Domestic consumer spending mainly caused the services sector to grow, while industrial activity continued to falter. The lack of growth in the industrial sector is primarily due to the sharp contraction in mining as well as in oil-related activities, as domestic crude oil production continues to drop. The construction sector also remains weak due to the decline in public and private investment. Manufacturing has become the bright spot across the industrial sector. Still, the ongoing rise in manufacturing exports to the US, led by the auto industry, is not enough to offset the poor performance seen elsewhere in the industrial sector.

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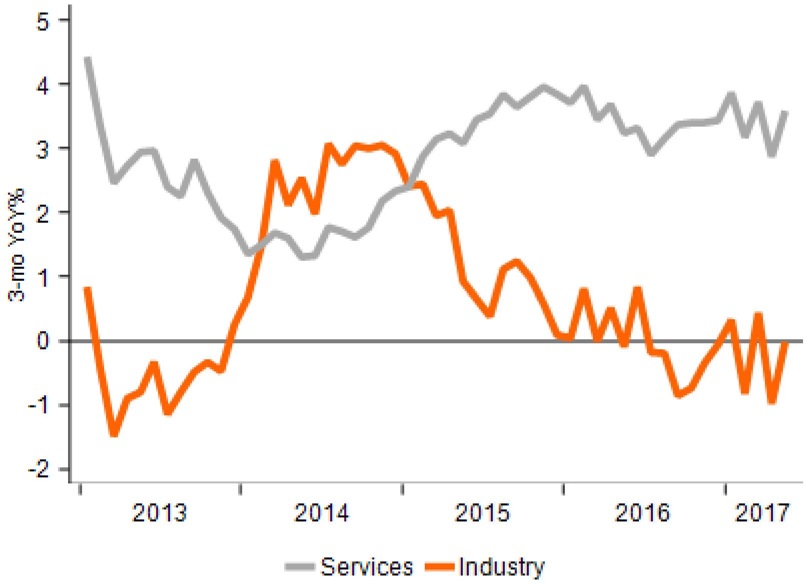
Services continue to boom while industrial activity remains a drag



Source: Macrobond

Economic growth forecast at 2.2% in 2017

The second half of the year may turn out to be softer than the first half. Limited benefit from unemployment rate improvements, faltering investments due to fiscal constraints as well as the uncertainty related to NAFTA will all drive the slightly softer second half.

> *Economic policies are likely to remain strict and the domestic credit markets will only soften gradually.*

Still, the stronger-than-expected economic activity seen during the first half, with the statistical carryover from first-half GDP growth already at 1.9%, suggests that economic activity should end this year at around 2.2%, close to last year's 2.3%, likely marking a remarkably steady four-year run. For the long term, assuming NAFTA negotiations go smoothly, the outlook for the domestic oil industry should remain an important catalyst for the economy. In particular, the recent announcement of a large oil find should help breathe new life into exploration auctions, with the next round scheduled for January. Also, gradually improving finances for the Mexican state-owned petroleum company, PEMEX, should eventually help relieve the biting constraints it still faces to ramp up investments and stabilise production. This, of course, assumes that Mexico's next president will continue to focus on expanding the private sector presence in the energy sector, which is unlikely if a left-wing candidate like Lopez Obrador wins the race.

Uncertain NAFTA timelines

Regarding NAFTA, formal negotiations will start later this month and may not be concluded until the first quarter of 2018. Investors have largely downplayed the risk of any US trade restrictions, but the unpredictability that has been a feature of some of the Trump administration's actions suggests that the market may be complacent. Markets are assuming that tariffs will not be a part of the new treaty, with most changes concentrated in rules-of-origin requirements, indicating a modest impact on bilateral relations. Timing is key, however, considering the politically sensitive nature of the topic and the looming presidential race in Mexico. In particular, if NAFTA negotiations stretch too far into the Mexican presidential campaign season, room for a compromise would be reduced, as domestic political considerations could force President Enrique Peña Nieto to adopt a stricter stance.

> *For Peña Nieto, any perception of weakness in the face of US pressure is bound to be politically costly.*

As for Trump, as the recently released transcript of a call with Peña Nieto indicated, the US president cares deeply about how his political base views US-Mexico relations, and Trump will be eager to claim "victory" in NAFTA. Mexican officials continue to plead with their US counterparts to accelerate the renegotiation timetable. However, Bloomberg reported recently that, according to Mexico's Economy Minister Ildefonso Guajardo, even if the terms of the new treaty are agreed upon by year end, the required legislative approvals and final sign-off may happen only after Peña Nieto's tenure. This adds another source of uncertainty to the future of NAFTA, given that the treaty, and state of the US-Mexico relations more broadly, are likely to figure prominently during the electoral campaign. In other words, with the timeline for NAFTA negotiations still unclear, uncertainties relating to the future of the treaty and Mexico's political outlook may linger at least until the presidential race is concluded.