BTMU LATIN AMERICA TOPICS

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MEXICO: REVISITING THE GROWTH AND POLICY OUTLOOK AS THE REFORM OPPORTUNITY APPROACHES

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Economic activity: Moderated growth this year.

Following a weak 1Q13, activity continued to be sluggish in May.

- Activity indicators point to weakness in external and domestic demand in 2Q13, suggesting that the cyclical deceleration of the Mexican economy is reflecting more than the calendar and post-election effects that slowed activity in 1Q13. During May, the index of economic activity (IGAE)—a monthly GDP proxy—was up 1.7% year-on-year, decelerating from 4.5% yoy in April. In January-May 2013, the IGAE rose 1.7% yoy versus 4.9% yoy in the same period a year ago.
- The cyclical downturn so far this year will subdue growth to below 3% in 2013, lower than the potential growth rate of 3.5% and last year's growth of 3.9%.
- While year-on-year figures show weakness, the improvement in sequential month-on-month terms suggests that growth should be tentatively accelerating as it enters 2H13. Following a 0.7% month-on-month/sa decrease in April, the IGAE rose 0.45% month-on-month/sa in May. The two main sectors of the economy grew. Industrial production registered an increase of 1.4% mom/sa (versus -1.8% in April), while services rose by 0.3% mom/sa (versus -0.5% in April).

Stronger growth prospects in 2H13 and 2014.

- Economic activity is expected to pick up in 2H13 and, for next year, the market consensus is expecting higher growth of 4%. The Mexican economy will benefit from a gradually improving US economy, given the strong linkages between the two countries in manufacturing and trade.
- The trade surplus improved in June, resulting in a smaller trade deficit for 2Q13 (USD841m) versus 1Q13 (USD1,021m). Manufactured export growth was flat in seasonally-adjusted terms from May, but rose 3.1% yoy. June imports fell 1.2% versus May and rose just 1.7% yoy amid subdued domestic demand.
- Going into 2H13, a materialized rebound in manufacturing—in addition to an expected pick-up in construction from higher public spending—should support the softened labor market and underpin the growth of the services sector.

The higher growth outlook is increasingly dependent on the favorable investment climate related to the structural reforms.

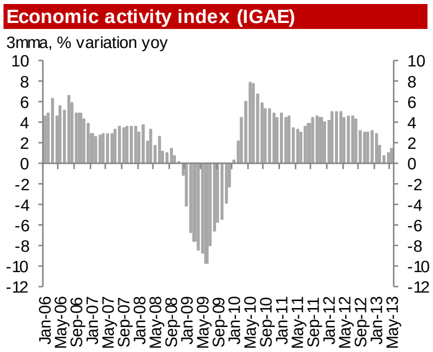
- Mexico's economic growth should also be boosted by the prospects for the advancement of the domestic reform agenda. The scope of the reforms and their successful implementation are key to maintaining investors' confidence and attracting foreign direct investment to support higher growth. Likewise, it is important to keep in mind that any major setbacks in terms of advancing the reforms could pose downside risks to the growth outlook.
- With the July local elections behind, the heavily-packed reform agenda can move forward. The ongoing progress of the political reform is important since it will set the pace for negotiations on the critical energy and fiscal reforms in the coming months. With the opposition PAN party having outlined its initial energy reform proposal, discussions have begun. Congress is expected to review the energy and fiscal reforms when the ordinary sessions resume in September.

Policy flexibility: Central Bank is keeping its options open.

Monetary policy: Still on hold.

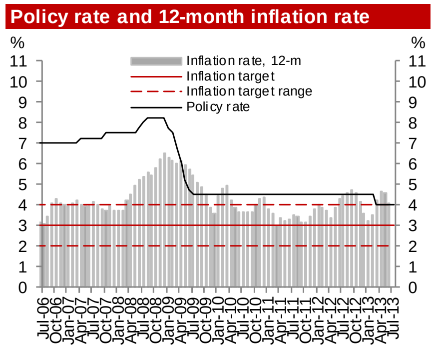
- The Central Bank (Banxico) has kept the policy rate on hold at 4.0% following a one-off 50bp cut in March. Moderating growth and falling inflation are still unlikely to prompt a rate cut since Banxico is also placing importance on the stance of monetary policy relative to that of the US.
- The 12-month consumer price inflation (INPC) for the 1H of July came in at 3.53%, dropping rapidly from the reading of 4.09% yoy for the month of June as the result was assisted by deceleration of both non-core and core inflation. Headline inflation is falling upon lower agricultural prices. Core inflation came in at 2.6% yoy in 1H of July, down from 2.8% yoy in June, since domestic demand has moderated and the labor market has softened. Falling inflation has opened the door to a possible rate cut by the end of the year; yet, if Banxico were to ease policy, slower growth and a stable MXN would be key conditions for a rate cut.
- We remain of the view that Banxico will put off rate cuts this year in order to discourage outflows of short-term capital and preserve the stability of prices and financial markets. In the minutes from July 12th's monetary policy meeting, released on Friday, Banxico stated concerns over weak growth and falling inflation, as well as over the implications of the US Federal Reserve's QE tapering policy on financial stability. Another reason to keep the policy rate on hold is that Banxico is still expecting that the economy will accelerate in 2H13 and that inflation will converge to the 3% target.
- The MXN stabilized in July after having weakened since May—along with other emerging market currencies—in the wake of the Fed's talk of QE tapering. The MXN is a liquid emerging market currency, so it exposed to volatility in the short-term; however, as long as global risk sentiment is supportive, MXN appreciation from current levels (12.7:USD1) towards 12.0-12.5:USD1 by 2014 should be backed by firm fundamentals, growth outlook, and policy flexibility.

Economic activity index (IGAE)



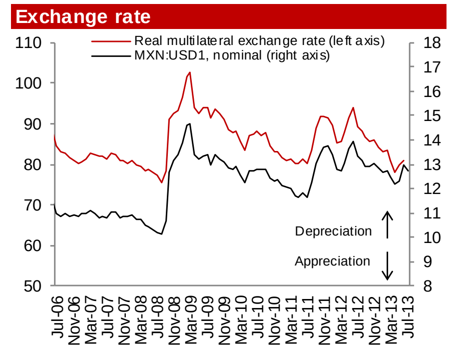
Source: INEGI; BTMU Economic Research.

Policy rate and 12-month inflation rate



Source: Central Bank; BTMU Economic Research.

Exchange rate



Source: Central Bank; BTMU Economic Research.

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