Mexico's Macroeconomic Performance: Third Quarter 2016

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Overview

- The Mexican Government reported a third quarter GDP growth of 2.0% YoY. This third quarter growth in Mexico is the weakest it has been since 2014. The service sector continues to be the main driver of the economy, while the industry sector continues to perform poorly due to a decrease in oil and gas production and weak household consumption. The early indications of economic momentum in 2016 have begun showing signs of slowing down.

- Exports have been affected by the decrease of manufacturing exports. Investment has also declined due to weak industrial activity. This decline was mainly driven by a decrease in both the mining and construction sectors. The latter could continue to be affected by weak household consumption.

- Even though Mexico will close the year with modest growth, headwinds for Mexico are appearing on the horizon. External shocks, such as Trump being elected president of the United States and the resulting potential policy changes on trade and immigration in the United States, could put extra stress on the Mexican economy. As a result of these potential shocks, some forecasts for 2017 are already lowering their GDP growth rate to 1.9%.

- The fiscal deficit is expected to improve in 2016 due to an increase in both tax revenues and non-tax revenues. This improvement was driven by a fiscal reform implemented at the beginning of 2016 and also by using the operation remnant amount that Mexico's Central Bank received in 2015.

- Monetary policy in 2016 has focused on mitigating upward pressures on the inflation rate, driven principally by the constant depreciation of the Mexican peso, through rate hikes – a total of four so far this year. The Central Bank is likely to continue increasing interest rates in order to mitigate the upward inflationary pressures.

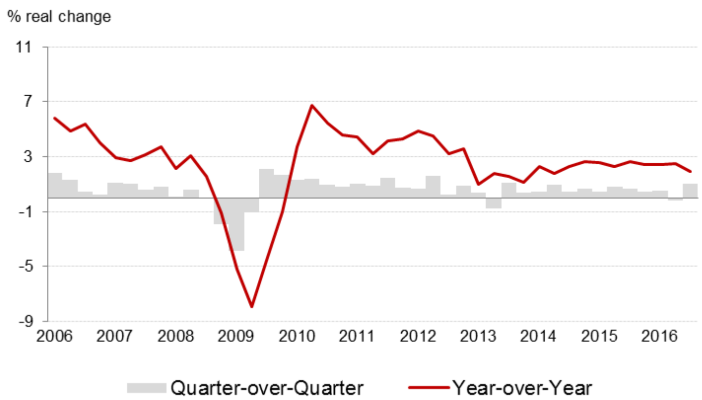
1. GDP, Economic activity

Mexico's GDP grew by 2.0% in the third quarter of 2016 compared to the same period in last year (Figure 1). This growth rate was still the weakest it has been since 2014. Quarter-over-Quarter growth demonstrated a modest rebound, growing 1.0% from the second to the third quarter of 2016.

The Mexican economy is beginning to show signs of slowing down. The service sector continues to be the main motor of economic growth in Mexico, contributing around 60% to GDP for at least the last ten years and having a steady growth of around 3.0% throughout the first three quarters of 2016 (Figure 2). The industry sector, on the other hand, has struggled throughout 2016, contracting by 0.8% in the third quarter principally, due to a decline in oil and gas production; further exacerbating these supply side issues, global oil prices continue to be depressed. This tendency is expected to continue in the short term as the international prices of oil and metals continue to be low.

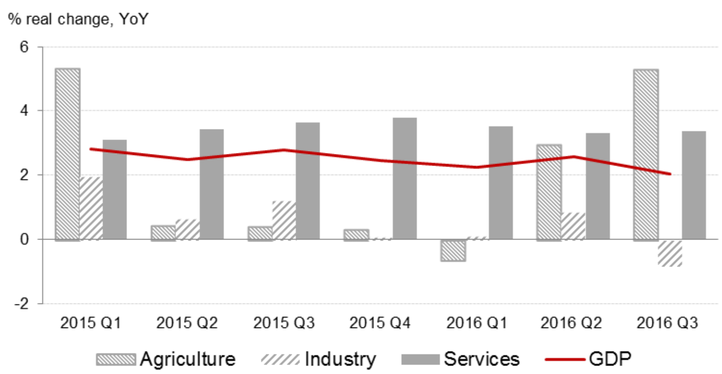
Mexico reported a 1.0% YoY decline in both exports and Gross Fixed Capital Formation (GFCF) for the second quarter of 2016 (Figure 3), continuing the negative trend that began in the second quarter of 2015.

Figure 1: GDP growth



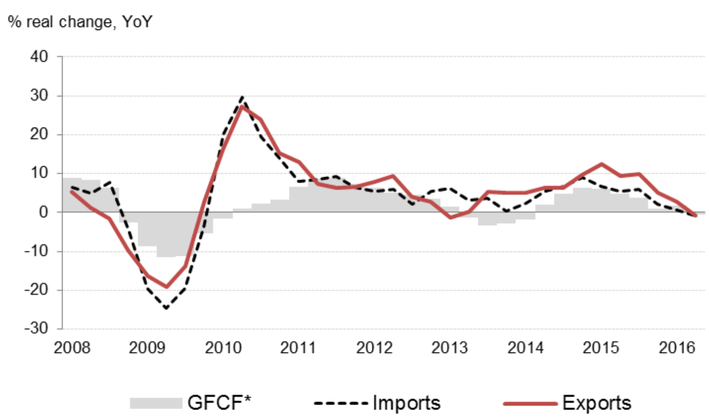
Source: INEGI, MUFG

Figure 2: GDP by Sector



Source: INEGI, MUFG

Figure 3: Investment, Exports and Imports

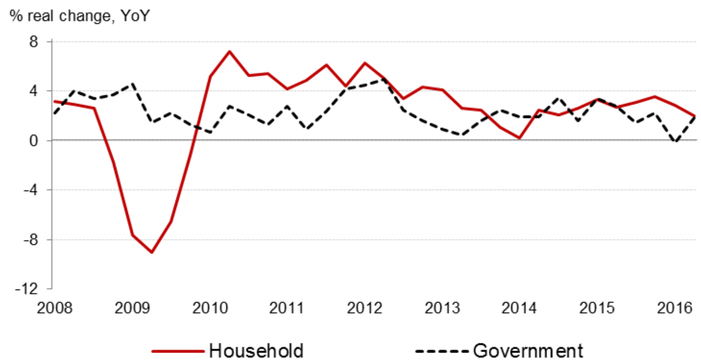


*Gross Fixed Capital Formation
Source: INEGI, MUFG

The fall in exports was mainly due to a decline in manufacturing exports (principally automotive exports to the United States). The decrease in the investment was consistent with the previously mentioned weak industrial activity. This decline was mainly driven by a decrease in both the mining and construction sectors. The latter could continue to be affected by weak household consumption.

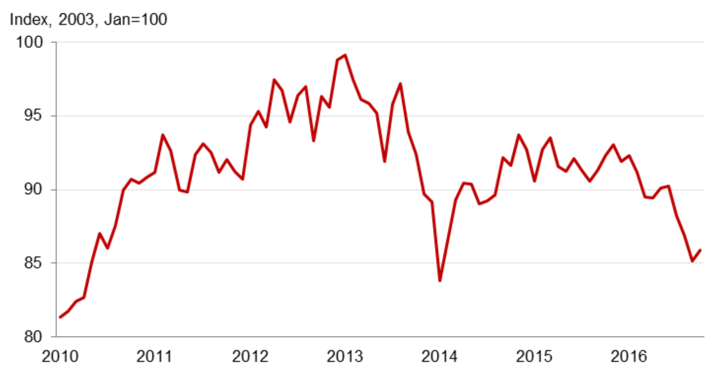
While household consumption remains positive in the second quarter of 2016, it experienced its weakest growth since 2014 at 1.9% YoY (Figure 4). In addition to that, the consumer confidence index[1] declined 7.0% (YoY) in September (Figure 5). Households believe that the economic situation of the country is worse than it was one year ago and that it will further deteriorate in the coming year. These aspects are influenced by the loss of value of the Mexican peso, the rate hikes from the Central Bank in order to combat inflationary pressures, and other potential external shocks that would principally emanate from the United States.

Figure 4: Consumption



Source: INEGI, MUFG

Figure 5: Consumer Confidence



Source: INEGI, MUFG

The Mexican government has already lowered the economic growth forecasts for 2016 to be in the range of 1.8% to 2.3%. The IMF forecasts Mexico to grow at 2.3% in 2017, while the Central Bank of Mexico, in its last report lowered its forecast for 2017 to the rage of 1.5% to 2.5%. These forecasts are highly susceptible to external shocks, the most likely of which would emanate from the United States. In fact, immediately following the United States' election and the release of Mexico's Q3 GDP, some economic forecasters have cut their growth forecasts for 2017 to 1.9%[2], below what the IMF is forecasting.

[1] The Consumer Confidence Index has 5 components, (1) current households' economic situation compared to one year ago; (2) households' economic situation expectations for next year; (3) current country economic situation in comparison to one year ago; (4) country economic situation expectations; (5) current households' access to durable goods (mainly household appliances) in comparison with one year ago.

[2] Consensus Economics, Nov 2016

It is still too early to say how any changes to US-Mexico ties will affect the Mexican economy, but the main channels would likely be through trade and immigration policy changes from the United States[3]. In any case, the Mexican Government will need to be prepared to implement economic policies to mitigate the effects of any changes the US Government makes in its relationship with Mexico.

2. Fiscal Policy

The fiscal deficit in 2015 stood at 3.4% of GDP, a slight expansion of the deficit when compared to 2014 (3.2%). It is expected, based on preliminary estimates, that the fiscal deficit will decline in 2016, mainly due to an increase of 12.3% in real terms of public revenues through August 2016. This increase was due to an increase in both tax revenues (11.2%) that were an effect from the fiscal reform the government approved for 2016, and non-tax revenues (85.2%) (Table 1). The non-tax revenue increase was mainly due to Banxico's (Central Bank of Mexico) operation remnant[4], amounting to almost 14 billion USD. Although oil revenues showed a slight increase of 0.9%, this was mainly the result of the federal government providing a cash infusion to PEMEX (Petróleos Mexicanos[5]) because of its financial struggles in accordance with the Federal law of budget and fiscal responsibility. If the federal government transfers to PEMEX are not taken into account, total oil revenues declined by about 20% due to the decrease in global oil prices.

Table 1: Mexico's Public Finance

	January-September			
		2016		
	2015 (MXN Bn)	MXN Bn	% yoy (nominal terms)	% yoy (real terms)
A. Revenues*	**3,033.5**	**3,497.6**	**15.3**	**12.3**
Oil	596.0	617.4	3.6	0.9
Federal Government	333.8	238.5	-28.6	-30.4
Pemex (1)	262.2	378.9	44.5	40.8
Non Oil	2,437.5	2,880.2	18.2	15.1
Tax Collection	1,788.1	2,041.5	14.2	11.2
Non Tax Collection (2)	197.4	375.4	90.1	85.2
Other	452.0	463.2	2.5	-0.2
B. Spending (3)	**3,503.2**	**3,763.4**	**7.4**	**4.6**
C. Primary Balance (A - B)	**-469.7**	**-265.8**	**-43.4**	**-44.9**

* Includes federal government transfers to PEMEX of 160MXNbn(2,3) and Banxico's operation remnant of 239 MXNbn pesos (1)

Source: Central Bank of Mexico, MUFG

These numbers continue to reflect how dependent Mexico's public finances are on oil prices, as well as the Federal Government's commitment towards creating sounder

[3] A more detailed analysis about these policies and their impact on the Mexican economy is being prepared and will be released after this document.

[4] The Operation Remnant is the accounting gain the central bank obtained in an accounting year. The Bank of Mexico makes profits because of the credits by which the money that is put into circulation accrue interest and the total of that income has been greater than the sum of all the operating expenses. In 2015, the depreciation of the exchange rate produced an increase in capital in the final balance of the Bank of Mexico.

[5] Mexican state-owned petroleum company is engaged in the exploration, production, transportation, refining, storage and sale of hydrocarbons and derivatives.

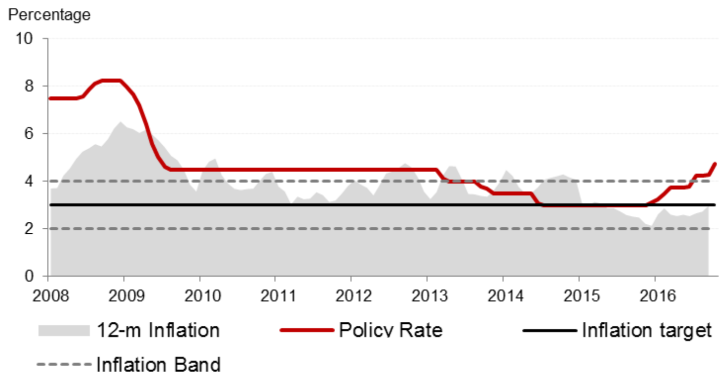
policies and public finances through the reallocation of resources coming from the Central Bank.

3. Monetary Policy and Financial Markets

The Central Bank of Mexico has been attempting to combat inflationary pressures and to keep inflation expectations anchored to the target rate via a series of rate hikes that began in December 2015. While, YoY inflation in September (2.97%) was still right around the target rate (Figure 6), the Central Bank expects inflation will end 2016 slightly above the target rate of 3.0%. This higher than expected rate is principally due to the evolution of the prices of goods, especially food, that increased as a result of the depreciation of the Mexican peso.

As we can see in Figure 7, the Mexican Peso has had the worst performance among all similar economies in Latin America, including Brazil. Shocks such as the electoral victory of Donald Trump as president of the United States have added extra stress to the economy that could deteriorate Mexico's terms of trade (NAFTA's renegotiation terms). This concern is one of the principal reasons why the Mexican peso abruptly lost 9.0% of its value in the day following Trump's victory.

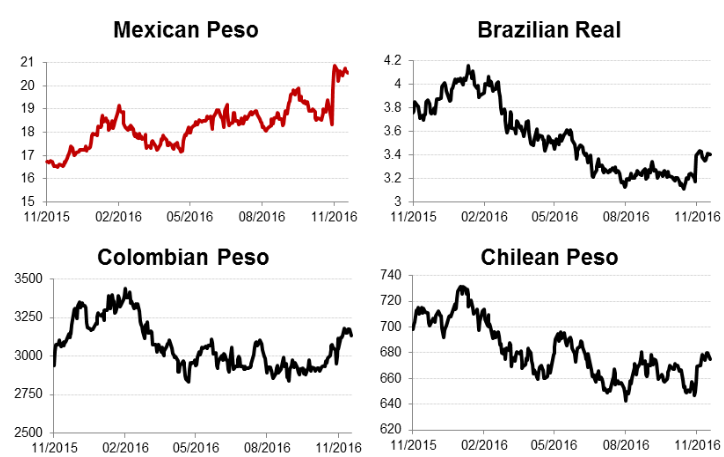
Figure 6: Inflation and Policy Rate



Source: INEGI, Central Bank of Mexico, MUFG

Figure 7: Nominal Exchange Rate

Nominal Currency to USD



Source: Bloomberg, MUFG

The Mexican government and the Central Bank will attempt to smooth the transition to a Trump presidency using a combination of currency reserves and continuing with interest rate hikes in order to support the Mexican peso. In fact, just one week after the US elections, the Central Bank of Mexico decided to increase the interest rate another 50 basis points to 5.25%, the fourth such increase this year, due to a reduction in capital inflows and potential measures from the US hindering foreign trade and investment. These potential measures could have a direct impact on the exchange rate and this could lead to higher inflation. The Mexican Central Bank will also pay close attention to the actions of the Federal Reserve of the United States and its likely decision to increase interest rates in December. If the Federal Reserve does decide to raise interest rates, this could have two immediate and negative impacts on the Mexican economy: it will increase the cost of borrowing and/or lead to an outflow of financial capital to the United States. Both of these possible scenarios would result in a further depreciation of the Mexican peso, further increases of interest rates by the Mexican Central Bank, leading to further declines in economic activity.