

Mexico

Economic Outlook

3rd QUARTER 2016 | MEXICO UNIT



01

The low growth of the Mexican economy in 1H16 leads us to revise estimated growth for 2016 down to 1.8%

02

For 2017, the modest pace of growth in the US and Brexit reduce our expectations of growth for Mexico to 2.2%

03

The fiscal challenges are difficult, but it is essential to confront them

04

The exchange rate depreciation observed in the last two years is largely due to the deterioration in the current account

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Closing date: August 31, 2016

1. In summary

The world economy continues to evolve moderately, with growth remaining below the levels seen prior to the global recession of 2008-09. Despite an increase in world trade in June and some improvement in consumer confidence data, figures for the second quarter show growth very similar to the average for the past five years. The lacklustre pace of global economic activity reflects the situation in the various regions, mainly those of the developed world.

In the US, growth data for the first half of the year were below expectations and influenced by the continuing weakness of both non-residential investment and external demand. In view of this, the growth rate for the US economy for 2016 was revised from 2.0% to 1.6%.

For the euro zone, the impact of Brexit will start to be felt, especially next year, in a deterioration of confidence which will have a braking effect on consumption and investment decisions. In this context we are maintaining our GDP growth forecast at 1.6% for 2016 and revising it downwards by 0.4% to 1.5% for 2017.

As for the developing economies, they have been holding up better, and have been favoured to some extent by the recent increase in monetary stimulus measures. In particular, in the case of China's economy, although the concerns about an abrupt slowdown have eased somewhat, risks remain in respect of financial stability, capital flight and corporate indebtedness. All of which supports the forecast of a slowdown in GDP growth to 6.4% in 2016 and 5.8% in 2017.

This environment of global weakness, particularly in the US, has affected the Mexican economy's external sector. Total exports in the period from January to July fell by approximately 10% YoY, and this was reflected in average quarterly growth of barely 0.2% in the manufacturing sector in the first two quarters of the year. Additionally, in the past few months we have seen some weakness in the service sector, which accounts for two thirds of all economic activity. The quarterly growth rate of this sector fell from 1.1% in the first quarter to -0.1% in the second. These figures largely explain the 0.2% quarterly fall in GDP in the period from April to June (-0.8% annualised quarterly), which together with a downward revision of the first quarter (from 3.2% to 2.0% annualised quarterly) leads us to reduce our expectations of growth from 2.6% to 1.8% for 2016.

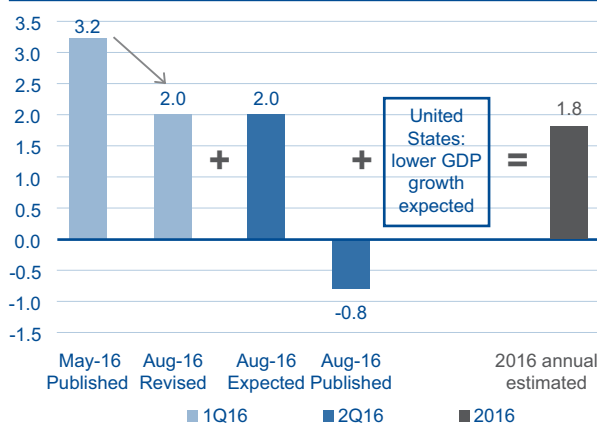
The moderation in the country's economic growth is also reflected in the public sector's total budgetary revenues. In the period from January to July 2016 these revenues showed real annual growth of 0.1% excluding the Mexican central bank's operating surplus. Net public sector expenditure in the same period showed a real annual fall of 0.3%, while gross debt stood at 47.1% of GDP at the end of the first half of 2016, showing an increase of 2.6 percentage points relative to year-end 2015.

The reduced economic growth in a context of low oil prices and tardy adjustment to public spending has been reflected in a significant increase in the current account deficit, which currently stands at around 3.1% of GDP. The rapid increase in this indicator (in 2011 the deficit was around 1.2% of GDP) and the difficulties in financing it, given the scarcity of flows from portfolio in a context of volatility in the financial markets and monetary normalisation in the US has made it one of the central bank's biggest worries. Indeed, Mexico's central bank has indicated that reducing public spending is a more efficient way of adjusting the current account, considering that it must be complemented with a reduction in private spending, and it is here that the increase in the monetary policy rate decided on in the meeting of 30 June comes into play.

The increase in public debt and the external account deficit has attracted the attention not just of the central bank but also of the rating agencies. In the past few weeks S&P changed the outlook for Mexico's sovereign debt rating to negative. The agency referred to the growth in public debt and its servicing as the main risks, so if these indicators continue to deteriorate, it could lead to a downgrading of the country's sovereign debt rating in the next 24 months.

Figure 1.1

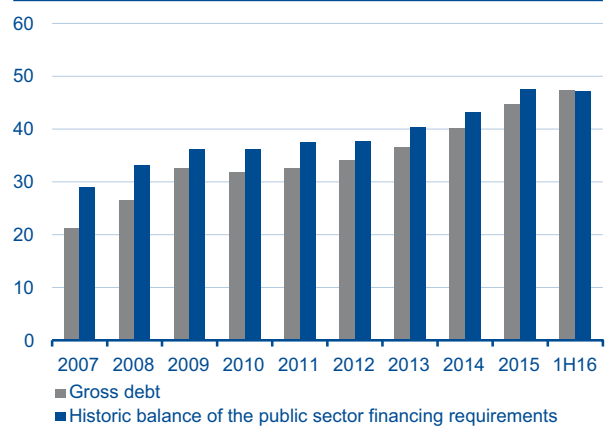
GDP growth rate (YoY % change)



Source: BBVA Research with INEGI data

Figure 1.2

Public sector financing requirement and gross debt (as % of GDP)



Source: BBVA Research with Finance Ministry (SHCP) data

In the financial markets, the search for yield, the behaviour of emerging economies' equity and currency markets and a certain reactivation of flows into these economies from outside have been favoured by the increase in monetary stimulus measures by some developed countries' central banks and the prospects of more gradual monetary normalisation in the US. In the particular case of the Mexican peso, in an environment of reduced risk aversion after Brexit, both the price of oil and the comments of Federal Reserve members regained their explanatory power. Although we have some appreciation, the exchange rate remains around 18.50 pesos to the dollar on average, influenced to some extent by uncertainty going into the second half of the year (the OPEC meeting in September, the US elections in November, etc.). In the event of a new bout of negative differentiation of the peso relative to other emerging economies' currencies, Mexico's central bank could again unhitch itself from the Federal Reserve and increase the reference rate.

2. Global outlook

In the last three months the global economy has continued the moderate trend of previous quarters, with growth rates of around 3%, well below the pre-crisis rates. In this period, global aggregate data have partially improved or have slowed their decline but one of the risks mentioned for mid-year has materialized – the result in favour of Brexit in June – which leads us to lower our forecasts in Europe. On the other hand, the quarter was also marked by the Fed's delay in normalizing interest rates amid doubts about the situation of the US economy, its long-term growth and global risks.

Global economic data have improved slightly

Our initial estimates based on the BBVA-GAIN indicator for the second quarter (0.78% QoQ) suggest that global growth remained close to the average for the past five years. Thus, and as in the first quarter, the world economy is finding it difficult to achieve more than limited growth. The most recent indicators seem to confirm this diagnosis. Industrial production shows a neutral trend changing only in April and May, when it was slightly positive. This situation results from the behaviour of the emerging economies, specifically the Asian ones, as developed countries show no signs of recovery. Confidence indicators give rather more grounds for optimism, with impetus seen in June as a result of developed countries' responses, while our indicator of global trade in goods shows strong momentum in June, after months of weakness.

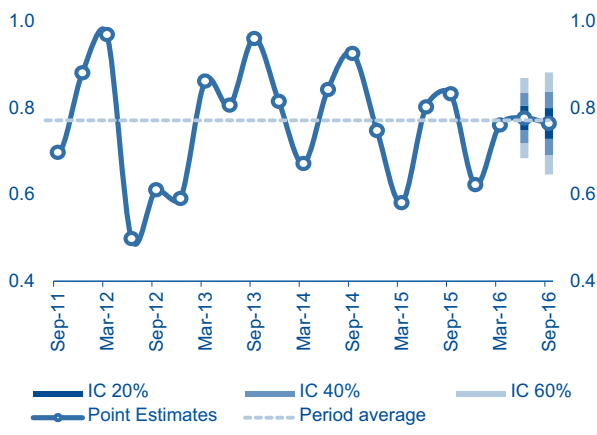
This, together with a reduction of financial stresses in both developed and emerging countries, leads us to forecast a third quarter quite similar to the first two. Indeed, our BBVA-GAIN indicator estimates that the global momentum in the third quarter will again be around the growth trend of recent years (0.76% QoQ), which is consistent with a global growth for 2016 of the order of 3.1%.

Brexit will have an impact on confidence and European foreign trade

Although the polls pointed to a dead heat or even a win for Brexit in the UK, the final result of the referendum was a surprise, which led markets to react with increased volatility and stock markets to tumble (especially in the banking sector and in Europe), although the magnitude and especially the persistence of this period of financial stress were not very pronounced, so Brexit has not been a systemic event.

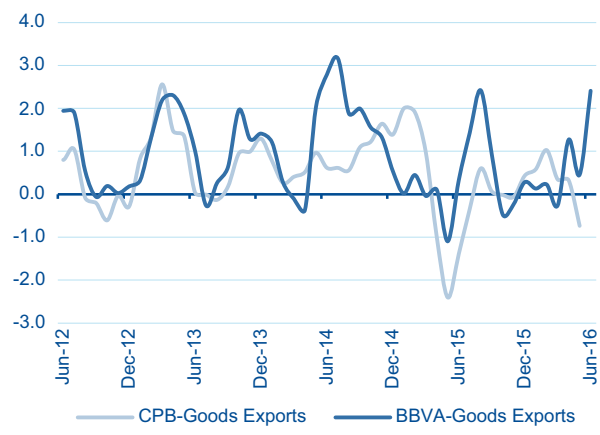
However, the political shock in the UK was substantial, and its impact on confidence will probably lead to a slight recession in the British economy, but its estimated short-term effect on the rest of Europe will be relatively limited (0.3%-0.4% lower growth in 2017), mainly through trade, while in the rest of the world the impact will be almost negligible. The greatest risk of an overall effect of the referendum is its potential political contagion to the rest of Europe, which is still to be determined.

Figure 2.1
World GDP: observed GDP growth and forecasts based on BBVA-GAIN (% , QoQ)



Source: BBVA Research

Figure 2.2
World: volume of global trade, Goods. BBVA Research and CPB index (% , QoQ)



Source: BBVA Research and CPB

Financial markets have been affected by Brexit and monetary policies

The uncertainty associated with the potential impact of Brexit and the strengthening of the dovish bias in the monetary policies of major central banks have affected the dynamic of financial markets during the last quarter. Brexit brought a substantial increase in financial volatility common to most assets and a particularly severe punishment for share prices in the European corporate sector. Its effect, however, was transient and non-systemic (in the first weeks of July, the BBVA financial stress indices for developed and emerging economies corrected the decline observed between May and June). The response of central banks, delaying the process of normalizing interest rates (in the case of the Fed) or maintaining the willingness to strengthen its stimuli scheme (ECB, BoE and BoJ) helped cushion the Brexit effect and was key in explaining the sharp drop in yields on long-term sovereign bonds of countries such as the US and Germany (both at their lowest levels in recent years, and the German bond stable in negative territory).

This time, unlike in other episodes of financial instability, emerging markets have shown greater strength. The search for profitability in an environment of very low interest rates, and the relief generated by the Fed's delaying its action on financing conditions encouraged the redirection of capital flows to the emerging bloc. In fact, in the first weeks of July, emerging countries received their largest inflow of foreign capital since 2013. By contrast, equity markets, especially in developed countries, continued to suffer doubts about the recovery of the corporate earnings cycle and the relatively worse performance of the banking sector in regions such as Europe.

Growth revised downwards in the US and delay in the process of normalizing the Fed rate

In the US, the disappointing data in the first quarter (1.1% annualized) were followed by volatile employment data in the second and persistent weakness in non-residential investment, compared to the robust growth of private consumption. This, together with other factors of uncertainty related to the elections in the second half of the year and global risks (Brexit and other risks in Europe and in China in the longer term) lead us to reduce our forecast for 2016 from 2.0% to 1.6%.

In its last meetings, the Federal Reserve expressed further doubts about the US economy's potential for growth in productivity and GDP in the long term, which also implies doubts about the natural interest rate. This, coupled with the risks of the global economy, has led it to delay its rates normalization process. In this context, we now expect an additional rise this year (probably in December, given the electoral calendar), and two in 2017 (compared with the two and four, respectively, that we expected three months ago).

China continues to be marked by a slowdown and long-term risks

In China, fears of a sharp slowdown in the economy have dissipated partly after recording a steady GDP growth of 6.7% in the second quarter, somewhat better than expected, supported by strong consumption and an increase in lending. Less optimistic signals come from weak investment (above all private investment); which on the other hand could be the beginning of the expected debt reduction, as it seems moreover to have affected sectors with excess capacity. Monetary policy will maintain an accommodative stance and may well reduce the reserve requirement ratio three more times as well as making a further cut in the interest rate in the remainder of the year. However, we are maintaining our forecast of a slowdown in growth to 6.4% in 2016 (from 6.9% in 2015) and to 5.8% in 2017. Short-term risks persist regarding financial stability, the depreciation of the renminbi and capital outflows, as well as the property market and corporate indebtedness, while long-term questions remain about growth prospects due to the slow progress of structural reforms in some key areas, particularly in public companies.

The eurozone will be affected in a limited way by Brexit, but with numerous political and geopolitical risks

In the eurozone, the strong growth posted in the first quarter was due to temporary factors, but the recovery continued at a moderate pace in the second quarter (0.3% QoQ). Brexit will weigh on the outlook for the eurozone as a whole over the forecast horizon and its impact will be especially felt in a weakening of confidence, which will weigh on consumption and investment decisions, to which we can add the increase in oil prices. With all this, it is expected that GDP growth will continue to decelerate slightly in the second half of the year, although the improved performance of the economy during the first half leads us to keep the forecast GDP growth for the whole of 2016 at 1.6%, while the forecast for 2017 is reduced by 0.4pp to 1.5%.

The risks in Europe continue to show a downside bias and are predominantly political in nature, beyond the risks linked to global growth: as well as the uncertainty about the UK exit process from the EU, there is the risk of possible political contagion to other member states, with elections in several countries in 2017 (the Netherlands, France and Germany), and above all a constitutional referendum in Italy in October which may result in severe political instability; to which is added the delicate situation of the Italian banking system. Risks, although lesser ones, also persist in Greece; and with the risk of refugee arrivals resuming if relations with Turkey deteriorate.

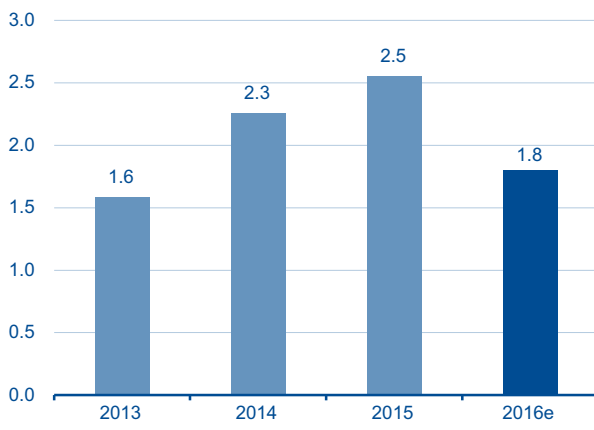
As for the ECB, the accommodative stance of other developed countries' central banks and the potential impact of Brexit on the eurozone economy have strengthened the central bank's willingness to take further stimulus measures if necessary. The fact that purchases of corporate bonds and the first TLTRO II auction took place in June gives the ECB some leeway to analyse their effects before considering a substantial change in the quantitative easing (QE) programme. What cannot be ruled out is the extension of its duration until at least September 2017 (it expires in March of that year), and the introduction of some adjustments, such as increasing the limits of acquisition by the issuer in the case of bonds without CACs, to overcome the shortage of paper at terms which already offer negative returns. In principle, additional cuts in the marginal deposit facility (at -0.4%) are less likely.

3. In 2016 GDP growth rate will be less than it was in 2015

3.1 The reduced dynamism in 1Q16 and the contraction in 2Q16 bring GDP growth for 2016 down to 1.8%

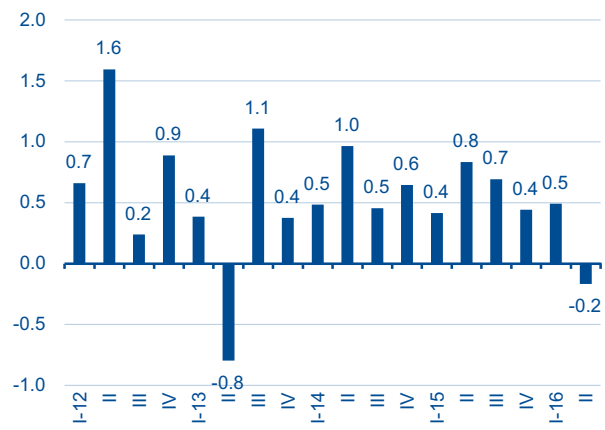
In August 2016 the INEGI (national statistics institute) reported that the quarterly change in GDP for 2Q16 was -0.2%. This contraction is equivalent to an annualised quarterly rate of contraction in economic activity of 0.8% for that quarter. Although the performance of GDP in 2Q16 was bad news per se, and for the expected rate of growth in economic activity, it should also be borne in mind that the INEGI revised GDP growth for 1Q16 downwards. Thus the INEGI's new information brought quarterly GDP growth in 1Q16 down from 0.8% (equivalent to annualised quarterly growth of 3.2%) to less than 0.5% (equivalent to annualised quarterly GDP growth of 2.0%).

Figure 3.1
Gross Domestic Product (YoY % change)



e = estimated
Source: BBVA Research with INEGI data

Figure 3.2
Trend in GDP (QoQ % change, sa)



sa = seasonally adjusted; QoQ = Quarter-on-Quarter
Source: BBVA Research with INEGI data

The INEGI's downward revision of 1Q16 GDP growth plus the contraction in GDP in 2Q16 are factors leading us to now expect a reduced rate of GDP growth for 2016. In other words the combination of lower growth at the beginning of the year and the fall in activity in the second quarter make the economic outlook for 2016 less favourable now than it was at the beginning of the year or at the time that a high rate of GDP growth for 1Q16 was announced, only to be adjusted downwards recently with the INEGI's updated data.

In view of the foregoing, we consider that GDP growth in 2016 will be 1.8% providing economic activity in the third and fourth quarters of the year show quarterly growth rates within a range of 0.7% on average in each. We should mention that from 1Q12 to 2Q16 the average quarterly GDP growth rate was 0.5%, and that quar-

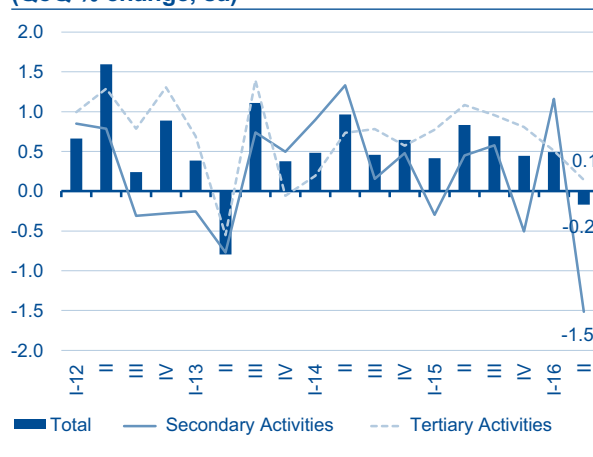
terly growth rates averaging less than the 0.7% referred to imply less dynamism in economic activity in 2016. This point indicates that during the second half of the year economic activity will have to grow at relatively high quarterly rates or at annualised quarterly rates of around 3%.

Table 3.1
GDP: second quarter of 2016
(Growth rates)

| | Seasonally-adjusted series | | | Original series |
|----------------------|----------------------------|----------------|------------|-----------------|
| | QoQ | QoQ annualized | YoY | YoY |
| Total GDP | -0.2 | -0.8 | 1.5 | 2.5 |
| Primary activities | -0.3 | -1.2 | 3.9 | 3.8 |
| Secondary activities | -1.5 | -5.9 | -0.3 | 1.0 |
| Tertiary activities | 0.1 | 0.4 | 2.4 | 3.2 |

QoQ = Quarter on Quarter; YoY = Year-on-Year
Source: BBVA Research with INEGI data

Figure 3.3
Quarterly GDP by components
(QoQ % change, sa)



sa = seasonally adjusted; QoQ = Quarter-on-Quarter
Source: BBVA Research with INEGI data

On analysing the performance of the sectors forming the GDP on the supply side, we see that in 2Q16 the secondary or industrial sector stands out due to its quarterly contraction (-1.5%). This unfavourable performance may be due in part to the equally poor performance of exports of goods, particularly manufactured goods. This matter is commented on in greater detail in the sub-section on the external sector in this section. In this regard, it is possible that the low rate of growth in GDP in the US that has been seen so far in 2016 is affecting the performance of the manufacturing sector through exports. Moreover the US is Mexico’s main trading partner, accounting for approximately 80% of its total exports.

It should be borne in mind that from 1Q12 to 2Q16 the secondary sector’s average quarterly contribution to the GDP growth rate was 0.2%. Furthermore, this sector accounts for approximately 33% of the country’s total GDP. Both its average quarterly growth and its relative weight in the GDP indicate that this sector of the economy is neither the most dynamic nor that with the greatest contribution to the growth of the country’s economic activity. For this reason we suspect that even if this sector starts posting positive quarterly growth rates again in the near future, it will not be very dynamic, or at least not for very long given its historical behaviour. This point indicates that the main thrust to GDP growth will continue to come from the tertiary or service sector, as has been the case for the last four years.

In 2Q16 the service posted limited quarterly growth of 0.1%. From 1Q12 to 2Q16 the average quarterly growth rate of this sector of economic activity was 0.7%. What is more, from 2Q15 to 2Q16 this sector lost dynamism, slowing from a quarterly growth rate of 1.1% in the first quarter to one of 0.1% in the second. Moreover, the service sector accounts for around 63% of total GDP, which combined with its relatively high average quarterly growth rate of 0.7% makes this sector the biggest contributor to GDP growth. Accordingly, an abrupt slowdown in the pace of growth of the service sector will be reflected in a significant slowdown in the rate of growth of total GDP. Therefore if the service sector does not manage to grow at relatively high rates in the second half of the year, the country’s total GDP is unlikely to grow by 1.8% in 2016.

As for the primary sector, which contributes about 4% of GDP, its quarterly average growth rate from 1Q12 to 2Q16 was 0.8%. Since this sector accounts for only a small part of GDP, its contribution to the growth of the country's total economic activity remains limited, however dynamically it may perform. In other words the characteristics of the sector also confirm that the most important part of the thrust to the country's economic activity will come from the positive performance of the service sector.

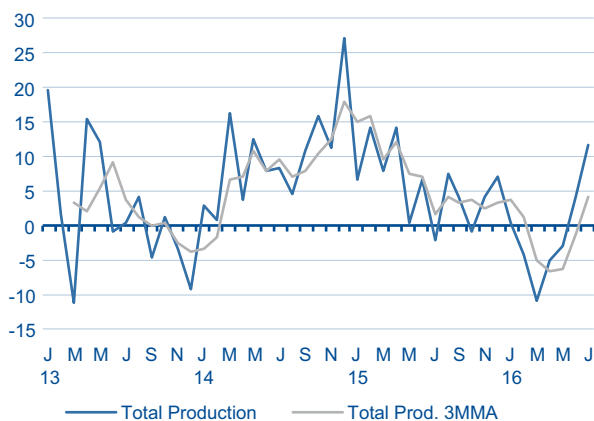
In short, we see that the rather unfavourable performance of economic activity in the first half of the year means that GDP will have to grow at annualised quarterly rates of around 3% in the second half. If it does not, the expected growth rate of 1.8% will not be achieved.

3.1.1 Recent indicators of activity in the third quarter of 2016

So far, there are few indicators referring to the behaviour of economic activity in 3Q16. One of them is total vehicle production for July. This indicator is significant since a large proportion of vehicles produced is exported, and in view of the importance of the automotive industry in the manufacturing sector. The latest available data for July suggest that we might be at the beginning of a new phase of growth in this sector, judging by its three-month moving average annual growth rate. However, the sustained expansion of this sector will depend on positive annual growth rates continuing to be posted in the next few months.

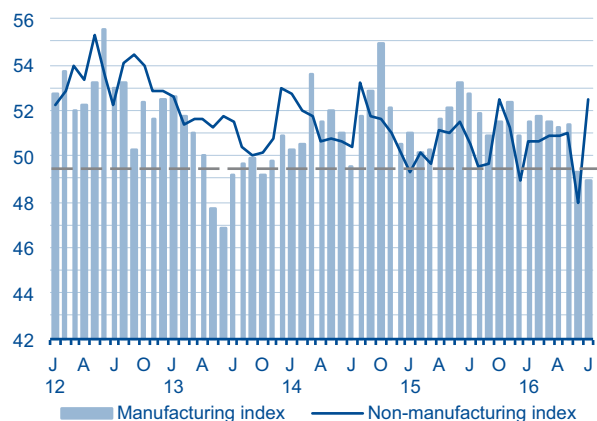
Apart from this, the IMEF Business Environment Index for July 2016 indicates that prospects for the manufacturing sector as a whole are not quite as favourable as July vehicle production figures might suggest. In other words these mixed signals from the manufacturing sector point to the possibility of continued weak expansion of economic activity throughout the year, which may however improve if the positive performance of the IMEF's July business environment indicator for the non-manufacturing sector holds. That is to say, the above data indicate that if the improved performance of the non-manufacturing sector offsets the less good performance of the manufacturing sector, and if the latter also improves in the next few months, we may expect GDP growth in the second half of 2016 to be more dynamic, bringing the annual GBDP growth rate to 1.8%.

Figure 3.4
Total vehicle production
(YoY % change, sa)



MA = moving average.
Source: BBVA Research with AMIA (Mexican Automotive Industry Association) data

Figure 3.5
IMEF Index of Mexican Business Environment
(Index)



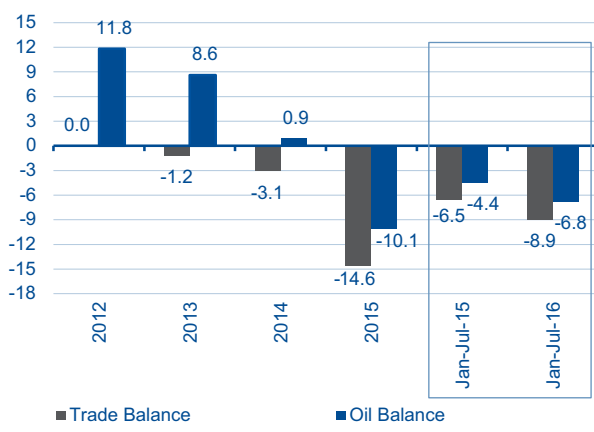
Index > 50 points = expansion; index < 50 points = contraction
Source: BBVA Research with IMEF data

3.1.2 External sector: persistent increase in trade deficit as a result of the deficit in the balance of trade in oil

So far this year the Mexican economy has faced significant challenges, one of which is the adverse behaviour of the external sector. In this context we see that the cumulative balance of trade from January to July 2016 was a deficit of US\$8.9 billion. This deficit was 37% greater than that of the same period of 2015. The main reason for the overall trade deficit is the deficit in the oil balance. For example in the first seven months of 2016 the external oil deficit was US\$6.8 billion, 52.9% more than in the same period of 2015.

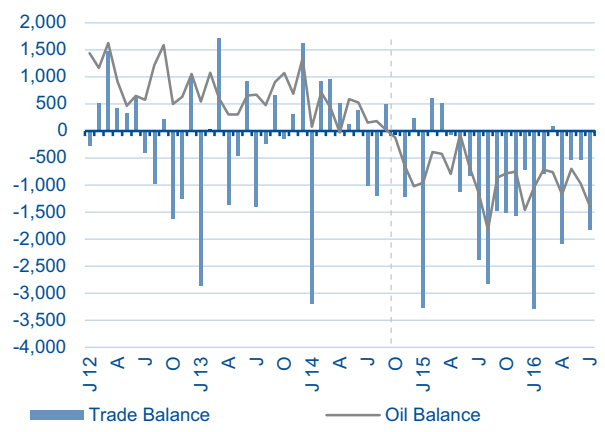
Behind the country's oil balance and therefore its balance of trade is the rapid fall in the price of the crude oil that it exports. In this context we should point out that the oil balance first went into deficit in October 2014, when it amounted to US\$123 million. At that time export crude was at US\$75.20 a barrel, whereas in January 2014 it had averaged US\$90.70. In other words a fall of US\$15 in the price of a barrel of export crude led to the first oil balance deficit. These data indicate that the oil deficit increased rapidly as a result of the headlong fall in the price of export crude. For example in July 2015 it fell to US\$46.60, in January 2016 it fell to US\$23.90, and in July 2016 it increased to US\$38.30 - barely 51% of the US\$75.20 per barrel of October 2014.

Figure 3.6
Balance of trade and balance of trade in oil (US\$ billions)



Source: BBVA Research with INEGI data

Figure 3.7
Monthly balance of trade and balance of trade in oil (US\$ billions)

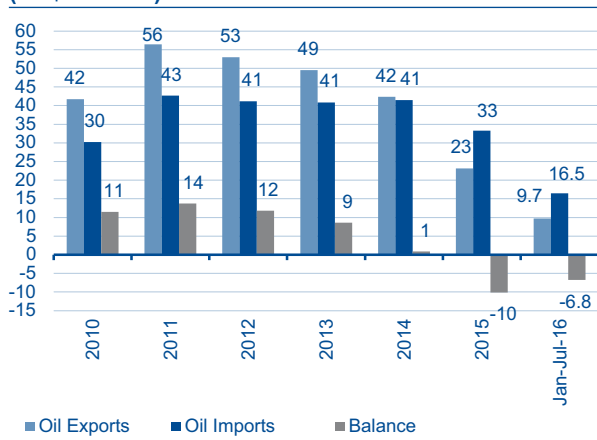


Source: BBVA Research with INEGI data

This large fall in the price of export crude explains why the monthly average oil deficit in 2015 was US\$843 million and why it increased still further to US\$967 million in the first seven months of 2016. This indicates that for as long as the country continues to need to import large volumes of petrol (gasoline) and other petroleum-based products while at the same time the price of its export crude remains substantially below US\$75 a barrel, the deficit of this account with the exterior will persist. Indeed the average price per barrel of export crude in 2014, 2015 and the first seven months of 2016 was \$86, \$43 and \$32 respectively.

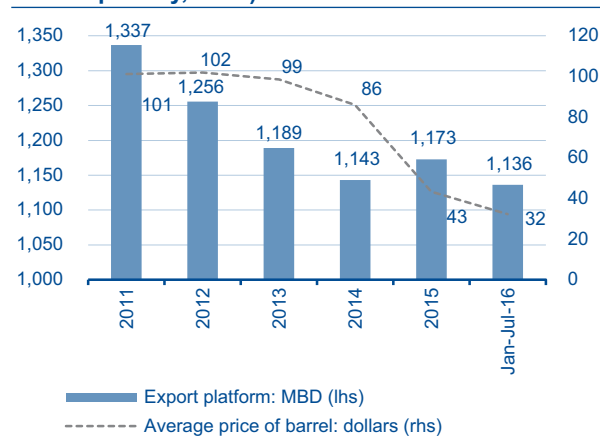
These figures show that the gap between the current price of export crude and that of October 2014 is very wide and may persist for a long time. This point is further illustrated by the fact that the hedge obtained recently by the finance ministry for the international price per barrel in 2017 was US\$38, compared with the US\$49 obtained in 2015 for 2016.

Figure 3.8
Mexico's oil balance: oil exports - oil imports (US\$ billions)



Source: BBVA Research with INEGI data

Figure 3.9
Oil exports (figures in US\$ billion and thousands of barrels per day, MBD)



Source: BBVA Research with INEGI data

Apart from this, for 2014 and 2015 the trade deficit on non-petroleum products amounted to US\$3.9 million and SU\$4.5 million respectively. This deficit for the first seven months of 2015 and 2016 amounted to US\$2.1 million and US\$2.2 million respectively. These amounts confirm that so far the non-oil balance of trade does not represent a significant imbalance of the country's external accounts as is certainly the case with the oil trade balance.

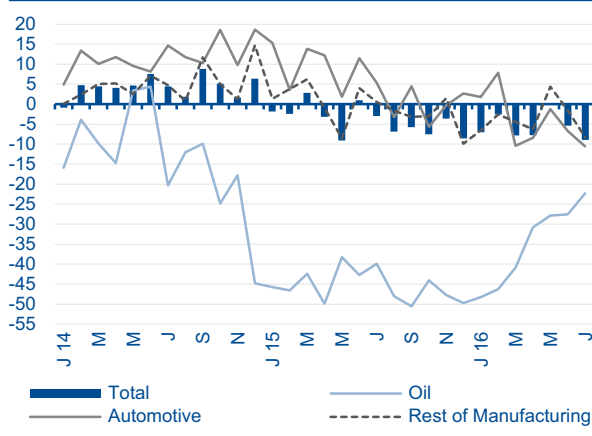
3.1.2.1 Exports of goods by type of good: from January to July 2016 exports deteriorated more than in the same period of 2015

Total exports of goods accumulated from January to July 2016 recorded a further deterioration than they had done in the same months of 2015, as the annual growth rate of cumulative exports in the first seven months of 2016 was negative (-5.7 %) and lower than in the same period of 2015 (-2.3%). Furthermore, the first seven months of 2016 saw a 3.6% contraction in exports of manufactured goods, whereas the comparable figure for 2015 was positive growth of 3.2%. We should point out that the fall in manufacturing exports in 2016 applied also to automotive exports. This point is significant, since in 2015 the strength of the external sector was considered to be largely due to automotive exports. In 2016 this has ceased to be the case, which basically implies that the country's export manufacturing sector has weakened too.

One reason for the deterioration of the non-oil exporting sector has to do with the performance of the US economy so far this year. In the first and second quarters of the year, US GDP posted annualised quarterly growth rates of 0.8% and 1.2% respectively. This slow pace of growth in the US is reflected in an adverse performance of Mexico's export sector, particularly since approximately 80% of its total exports go to the US market. In this respect it is to be hoped that the faster pace of growth shown by US GDP in the future will favour the expansion of Mexico's non-oil exports, and particularly those of manufactured goods.

Figure 3.10

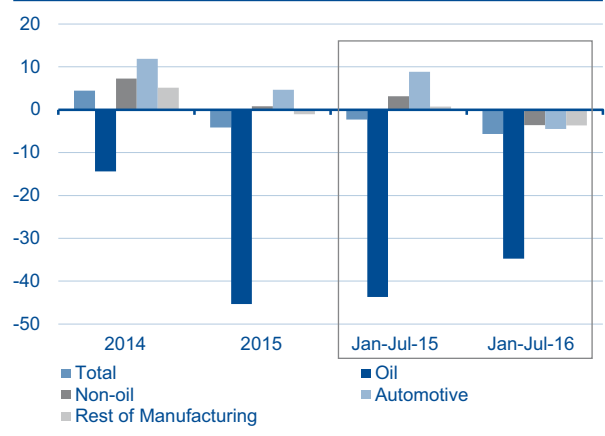
Monthly exports of goods by type (YoY % change)



Source: BBVA Research with INEGI data

Figure 3.11

Exports of goods by type (YoY % change)



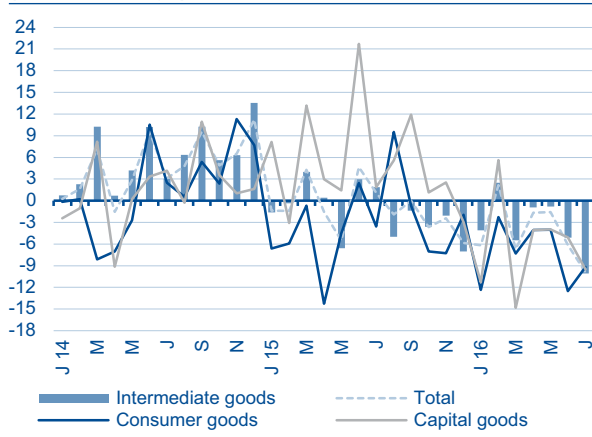
Source: BBVA Research with INEGI data

3.1.2.2 Imports of goods by type: the decline in total imports of goods reflects the unfavourable macroeconomic environment in the country

Total imports of goods accumulated from January to July 2016 also contracted on an annualised basis, by 4.4%, a bigger fall than in the same seven months of 2015 (1.2%). We should point out that imports of capital goods in the first seven months of 2015 showed positive growth of 6.6%, but in the same period of 2016 imports of these types of goods declined by 6.6%.

Figure 3.12

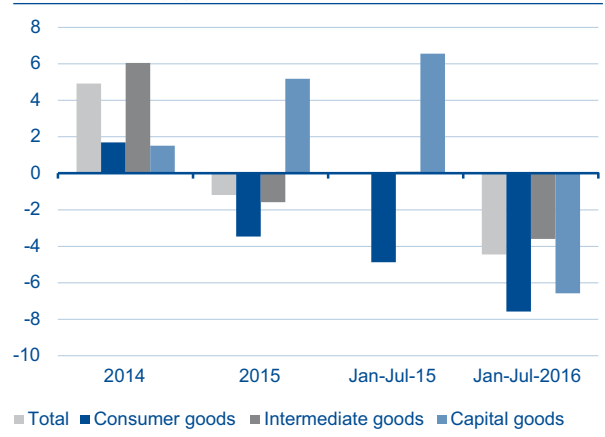
Monthly imports of goods by type (YoY % change)



Source: BBVA Research with INEGI data

Figure 3.13

Imports of goods by type (YoY % change)

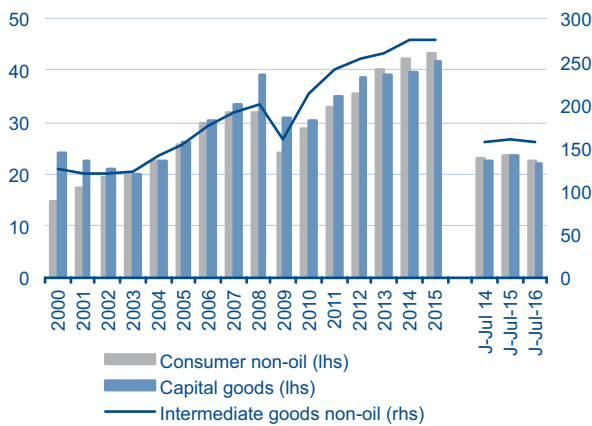


Source: BBVA Research with INEGI data

The fall in imports of capital goods in 2016 might be a reflection of, among other factors, sluggish total gross fixed investment, possibly due in turn to a shortage of opportunities for profitable new investments given the current low level of economic activity. Another possible reason for the fall in imports of goods may be exchange rate movements. In July 2014 the exchange rate was 13.00 pesos to the dollar; in December 2014 it was 14.70, at the end of 2015 17.20 pesos and in July 2016 it stood at 18.9 pesos per dollar. This has made all imports more expensive, including capital goods. Although these two reasons could largely explain the contraction in imports of capital goods so far this year, we should bear in mind that these types of imports accounted for just 10.6% of total imports in 2015. This means that the decline in imports of capital goods has only a limited effect on the reduction in total imports of goods seen in the first seven months of the year.

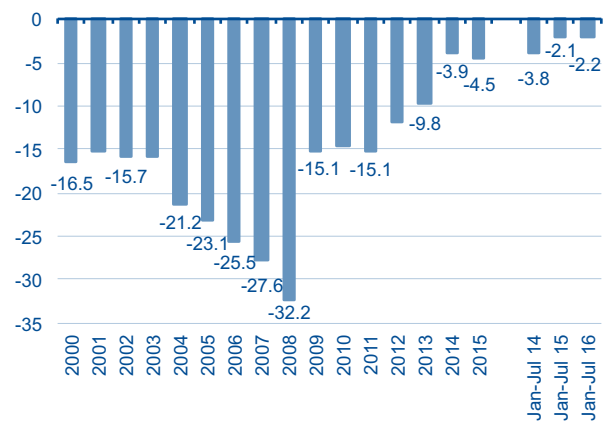
In 2015 imports of consumer goods accounted for 14.2% of total imports (3.3% petroleum-based and 10.9% non-petroleum-based consumer goods). For the first seven months of 2016, cumulative imports of consumer goods declined by 7.8% YoY, more than the 4.9% fall seen in the same period of 2015. That makes two consecutive years of contraction for these types of imports. A significant portion of the reduction in these imports may be due to the adjustments to the exchange rate seen particularly in the last two years. In this regard it is striking that the amount and relative weight of imports of non-petroleum-based consumer goods are greater than those of imports of capital goods.

Figure 3.14
Imports of non-petroleum goods by type (US\$ billions)



Source: BBVA Research with INEGI data

Figure 3.15
Balance of trade in non-petroleum goods (US\$ billions)



Source: BBVA Research with INEGI data

In 2015 imports of intermediate goods accounted for 75.2% of total imports, of which 5.1% petroleum-based and the remaining 70.1% non-petroleum-based. From January to July 2015 the cumulative amount of this type of imports grew by 0.1%, which contrasts with the negative rate posted in the same months of 2016 (-3.6%). This behaviour of imports of intermediary goods may largely reflect the high degree of correlation with that of the export sector (since some of the manufactured goods exported require imported parts), and the country's lacklustre economic activity over the past two years. This may explain why the total amount of these types of non-petroleum imports in 2015 was practically equal to that of 2014.

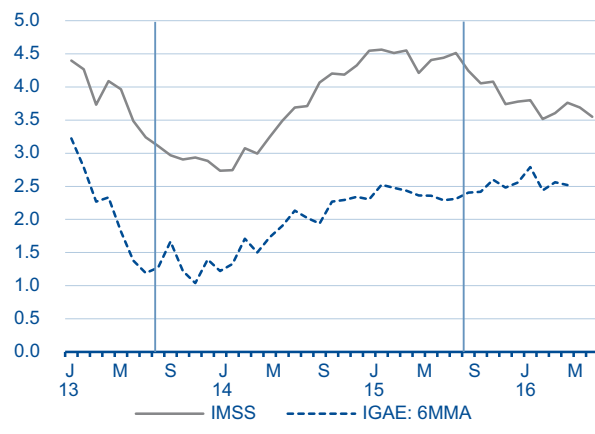
As commented earlier, the non-oil balance of trade in 2014 and 2015 and so far from January to July 2016 has not been a significant source of external imbalance. It is possible that this behaviour is due to the lower rate of growth or to the contraction seen in the various types of non-petroleum imports. In view of the above, and given that the greatest imbalance is that of the oil balance, the trade deficit will not improve or correct itself until the oil balance does so.

3.1.3 Recent trends in formal employment in the private sector (IMSS –social security–)

The total number of workers registered with the IMSS (Mexico’s social security system) represents formal employment in Mexico’s private sector. In this way the monthly increase in the number of these workers indicates the increase in formal employment in the private sector. This figure is also an important advance indicator of economic activity. As can be seen in Figure 3.16, annual growth rates in IMSS (social security) employment and in the IGAE (Global Economic Activity Indicator) show a high degree of positive correlation. For example, from January 2000 to May 2016 the correlation coefficient between these two variables was 0.77 and from January 2013 to May 2016 it was 0.80.

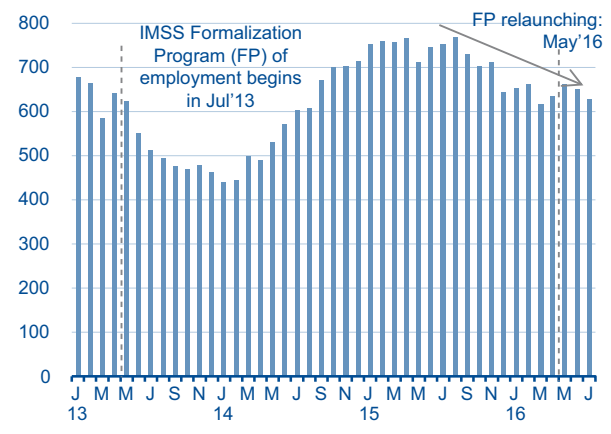
We should mention that these correlation coefficients indicate that the high degree of positive correlation between economic activity (IGAE) and formal employment (IMSS) refers to a long-term correlation between the two variables. In this regard we see that the dynamism of formal employment is a consequence and reflection of the dynamism of economic activity, since greater economic activity can expand the workforce as well as encouraging more investment to consolidate the process of economic expansion.

Figure 3.16
Total number of workers registered with the IMSS and IGAE (YoY % change)



Source: BBVA Research with INEGI data

Figure 3.17
Increase in the total number of workers registered with the IMSS in 12 months (thousands of people)

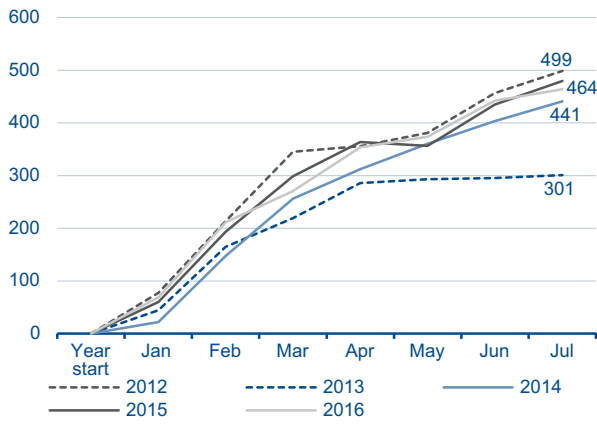


Source: BBVA Research with INEGI data

This point takes on particular significance when it is borne in mind that the social security figures for each month are published with a delay of up to 12 calendar days. The IGAE economic indicator on the other hand is published with a delay of 50 calendar days or more. For example, the IGAE indicator for June was not publis-

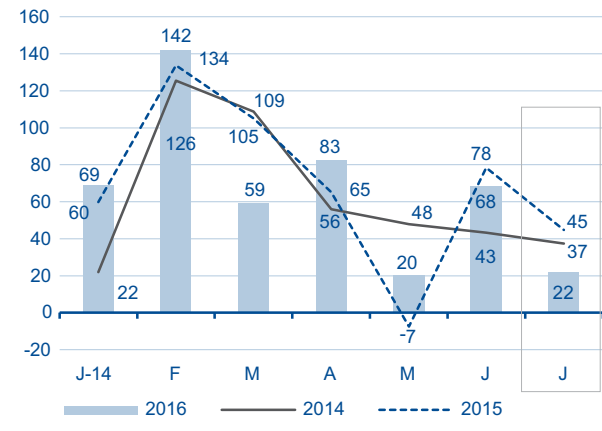
hed until 22 August by the INEGI (national statistics institute). This significant lag in the release of information on economic activity contrasts with the timeliness of the IMSS information on employment, which can therefore be considered to some extent as an advance indicator of economic activity. This indicator in turn may be complemented with additional information to discern a trend in economic activity, as well as being used as a very short-term indicator of what is happening with economic activity. It is also reasonable to think that large monthly increases in this category of employment are associated with dynamic economic activity or a high rate of growth in the IGAE economic activity indicator. Similarly, moderate or limited increases in IMSS employment are a consequence of moderate or limited dynamism in economic activity.

Figure 3.18
Cumulative monthly increase in the total number of workers registered with the IMSS from January to July (thousands of people)



Source: BBVA Research with INEGI data

Figure 3.19
Monthly increase in IMSS employment (thousands of people)



Source: BBVA Research with Labour Ministry (STPS) data

It is important to point out that from the second half of 2013 the labour authorities carried out an Employment “Formalisation” Programme. This programme consisted in getting people who were employed but had no social security since they were not registered with the IMSS to register with this institution. As a result, from the second half of 2013 the rate of growth in formal (IMSS-registered) employment increased not only because of the employment generated by economic activity but also because of existing workers being newly registered with the social security authority, or “formalised”. This point can be seen in Figure 3.17 which shows that the number of workers registered with the IMSS in a period of 12 months increased significantly, particularly from January 2014 to August 2015 as a result of increased economic activity and the employment “formalisation” programme. For example, in the twelve months from September 2014 to August 2015 the increase in the average number of employees registered with the social security was 733,000 and from September 2015 to July 2016 it fell to 664,000. These figures reflect the fact that since the last quarter of 2015 we have seen a lower rate of increase in the number of workers newly registered with the social security services. This reduced dynamism in the increase in formal employment in the private sector was not lost on the labour authorities, who relaunched the Employment Formalisation Programme in May 2016.

However, if we consider the increase in the number of workers registered with the social security authorities from January to July we see that this year has been no better than 2015, as can be seen in Figure 3.18. We should mention that the relaunch of the Employment Formalisation Programme in May can also be interpreted as an indication that the greater part of the results and benefits of this programme had already been obtained almost three years after its launch.

The smaller number of workers registering with the social security authority in the 12-month period from September 2015 to now is a result of the smaller monthly increase in employment registered with the institute. This point is particularly significant in the case of the monthly increase in formal employment in July 2016, when 22,060 workers registered with the authorities. This figure is substantially lower than that for June and also less than the monthly increases in IMSS-registered employment in July of 2014 and 2015. Moreover, it is striking that this lower increase in social security registered employment happened after the relaunch of the Employment Formalisation Programme.

One possible and important implication of the limited monthly increase in the number of workers registered with the social security system in July 2016 is that it may also reflect a slowdown in the growth of economic activity (IGAE) in that month. This would mean that the growth rate in economic activity in July, the start of the third quarter of 2016 (3Q16), may be low. This in turn will mean that the GDP growth rate for the third quarter and consequently for the whole year 2016 could be lower than expected.

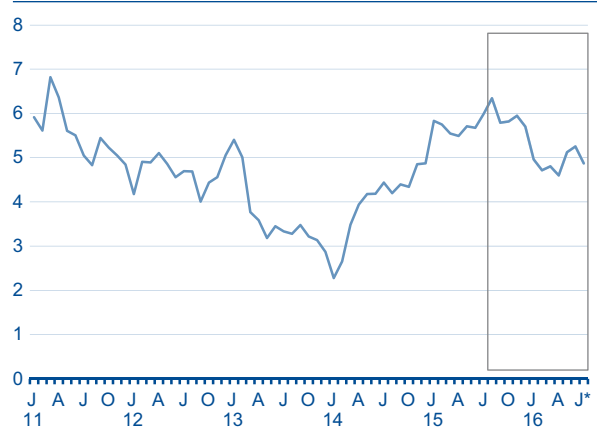
The situation described in the preceding paragraph could change for the better if economic activity and employment indicators were to improve from August. This could happen if there is a significant revival of the country's export sector and private consumption continues with the same dynamism as that seen in 2014. The absence of positive events generating greater dynamism of economic activity within the context of lower monthly growth in formal employment leads us to suspect that growth in economic activity in 3Q16 may be moderate, contributing to make Mexico's annual GDP growth for 2016 less than expected.

Figure 3.20
Real salary and annual inflation (annual % change)



Source: BBVA Research with INEGI data

Figure 3.21
Total formal IMSS payroll (real annual % change: total number of workers registered by real salary)



Source: BBVA Research with Labour Ministry (STPS) data

Since the second quarter of 2014 the real average salary associated with social security registered workers has grown in real terms as a result of lower inflation. This real increase in workers' salaries has also been reflected in a higher annual growth rate in total payrolls (total number of workers multiplied by the real salary associated with insured workers). The process of increase in the rate of annual growth in the total payroll of workers registered with the social security started in February 2014 (annual growth rate of 2.7%) and peaked in August 2015 (annual growth rate of 6.3%). From September 2015 the rate of payroll growth started to moderate, and in July we estimate that it was 4.9%, as can be seen in Figure 3.21.

The slowdown in the annual growth rate of formal payrolls which has been seen throughout the first seven months of 2016 may lead to reduced vigour in private consumption. In the past few years private consumption has been one of the aggregate demand components of GDP that has performed well, as well as contributing to GDP growth. Accordingly the slowdown in payroll growth could lead, though to reduced private consumption, to a lower than expected rate of GDP growth for 2016.

3.1.4 Public finances: current expenditure accounted for 49.0% of the annual decline of 2.6% in programmable expenditure for the period January-July 2016, reflecting part of the cuts in total public spending announced this year

Total budgetary revenues of the public sector showed a real annual growth of 9.8% during the first seven months of 2016 compared with the same period of last year. It is important to mention that this year-on-year comparison includes the amount of 239.1 billion pesos corresponding to the Bank of Mexico's operating surplus. If we were to exclude this component of the budgetary revenues, the real rate of growth would be 0.1% YoY.

In the breakdown of total budgetary revenues by component, non-tax revenues showed a real annual growth of 20.2% in the period January to July 2016. Excluding the Bank of Mexico's operating surplus would imply a decline of 34.7% in this component in real annual terms. There was a 12.0% real annual increase in tax revenues in this period. This included a 13.0% real annual increase in income tax in the period. With this annual increase in income tax, and given its 53.0% share of total taxes from January to July 2015, income tax contributed around 57.4% to the real annual growth in tax revenues.

VAT is another major component of tax revenues, accounting for 27.9% from January to July 2016. In the period from January to July of this year, VAT grew at a real annualised rate of 7.2%, comparing favourably with the 3.3% annualised growth in the same period of 2015. Trends in VAT are indisputably linked closely to national economic activity, although tax collection efforts also seem to be having a positive effect on this component.

Public sector oil revenues accounted for only 14.0% of total budget revenues from January to July 2016 (19.6% during the same period in 2015). However, oil revenues continued to fall in real annual terms, at a rate of 21.2%.

Table 3.2

Total public sector budgetary revenues from January to July (billions of pesos)

| | | | Real % | % |
|----------------------|----------------|----------------|------------|--------------|
| | 2015 | 2016 | chge. | struc. |
| Total | 2,400.2 | 2,705.2 | 9.8 | 100.0 |
| Federal Government | 1,839.9 | 2,149.8 | 13.9 | 79.5 |
| Tax | 1,415.1 | 1,625.9 | 12.0 | 60.1 |
| Income Tax | 750.2 | 870.0 | 13.0 | 32.2 |
| VAT | 412.2 | 453.7 | 7.2 | 16.8 |
| Non-tax | 424.8 | 523.8 | 20.2 | 19.4 |
| Agencies & companies | 176.0 | 188.2 | 4.1 | 7.0 |
| Gvmt. productive co. | 384.2 | 367.3 | -6.9 | 13.6 |
| Pemex | 211.1 | 204.5 | -5.6 | 7.6 |
| CFE | 173.1 | 162.8 | -8.4 | 6.0 |
| Total | 2,400.2 | 2,705.2 | 9.8 | 100.0 |
| Oil revenue | 469.7 | 379.9 | -21.2 | 14.0 |
| Non-oil revenue | 1,930.5 | 2,325.4 | 17.4 | 86.0 |

Source: BBVA Research with Finance Ministry (SHCP) data

Table 3.3

Net public sector spending in January to July (billions of pesos)

| | | | Real % | % |
|-----------------------|----------------|----------------|-------------|--------------|
| | 2015 | 2016 | chge. | struc. |
| Total | 2,804.9 | 2,868.7 | -0.3 | 100.0 |
| Projected expenditure | 2,168.7 | 2,167.4 | -2.6 | 75.6 |
| Current expenditure | 1,626.6 | 1,640.7 | -1.7 | 57.2 |
| Capital expenditure | 542.1 | 526.7 | -5.3 | 18.4 |
| Non-projected expen. | 636.2 | 701.3 | 7.4 | 24.4 |
| Investments in states | 372.8 | 415.5 | 8.6 | 14.5 |
| Borrowing cost | 234.6 | 266.1 | 10.5 | 9.3 |
| Adefas* and other | 28.8 | 19.7 | -33.2 | 0.7 |

Adefas: Liabilities carried over from previous years.

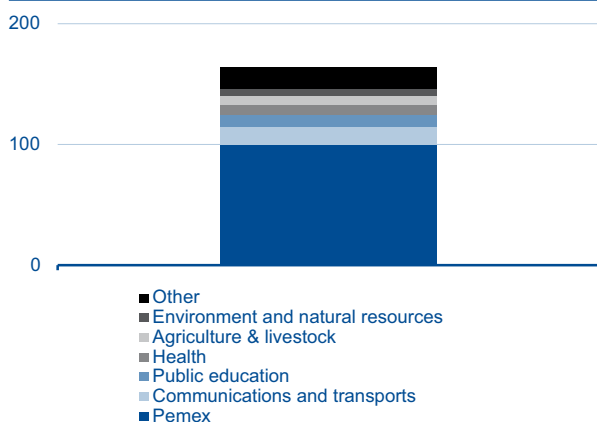
Source: BBVA Research with Finance Ministry data

Net public spending fell at an annual rate of 0.3% in real terms from January to July 2016, compared with the same period in the previous year. This was mainly due to the negative performance of programmable spending (accounting for 77.3% of total net public sector spending from January to July 2015), with a real annual decline of -2.6% for that period. Within programmable expenditure, current spending fell by 1.7% in real annual terms, thus contributing about 49.0% to the annual percentage fall seen in programmable expenditure, in which it had a share of around 75.0% in the period January to July 2015. The remainder of the contribution (51.0%) to the decline in programmable expenditure came from capital expenditure. Although this contribution was similar to that of current expenditure, capital expenditure saw a greater contraction, declining at an annual rate of 5.3% in real terms.

The trend seen in programmable expenditure in the period January to July 2016 seems already to be reflecting part of the public spending cuts of 164 billion pesos (100 billion pesos of which will be applied to Pemex spending) announced in February and June of this year. Accordingly we envisage programmable expenditure in the remainder of 2016 continuing to incorporate these cuts. However, these cuts (equivalent to 0.9% of GDP) have already been offset by increased spending.

The finance ministry's document entitled "Measures for continuing to promote transparency in public finances" indicates that there is a positive deviation in total net expenditure (excluding outlays on financial investments) of 0.2% of GDP relative to the federal expenditure budget. This is explained by: i) the increased spending of Pemex due to payables settled with suppliers and contractors (0.4% of GDP); ii) an increase in non-programmable expenditure (0.3% of GDP) due to increases in financial costs and in tax participation transfers to the states; iii) increased expenditure on state and Pemex workers' pension (0.3% of GDP); iv) increased expenditure on development support programmes (0.1% of GDP); and v) the spending adjustments announced this year (-0.9% of GDP).

Figure 3.22
Budgetary cuts announced for 2016 by area (billions of pesos)



Source: BBVA Research with Finance Ministry data

Table 3.4
Financial situation of the public sector January to July (billions of pesos)

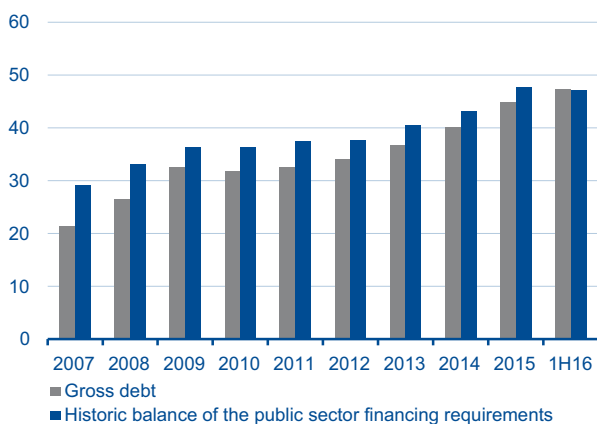
| | 2015 | 2016 | Real % chge. |
|---------------------------------|---------|---------|--------------|
| Public Balance | -380.0 | -157.2 | n.s. |
| Pub. Bal. w/o Prod. investmnt. | -93.3 | 135.5 | n.s. |
| Budget Balance | -404.7 | -163.5 | n.s. |
| Budget Revenue | 2,400.2 | 2,705.2 | 9.8 |
| Net Budget Expenditure | 2,804.9 | 2,868.7 | -0.3 |
| Federal Govnmt. Balance | -288.9 | -103.9 | n.s. |
| Agencies & Co. Balance | -115.8 | -59.6 | n.s. |
| Primary Balance | -148.9 | 121.4 | n.s. |
| Budget Balance | -170.1 | 102.6 | n.s. |
| Federal Government | -114.0 | 98.1 | n.s. |
| Agencies & Companies | -56.0 | 4.5 | n.s. |
| Pemex | -124.4 | -86.7 | n.s. |
| Other institutions | 68.3 | 91.2 | 30.0 |
| Indirectly-controlled institut. | 21.1 | 18.8 | -13.5 |

ns = not significant

Source: BBVA Research with Finance Ministry data

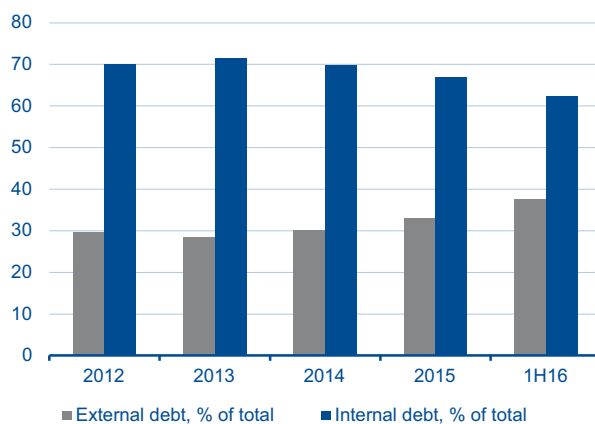
In contrast with the period January-July 2015, the public sector primary balance (which does not include investments in state-owned manufacturing companies) showed a surplus of 121.4 billion pesos. Much of the primary balance is reflected in the federal government balance. This balance seems to be reflecting the increase in budgetary revenues and, to a much lesser extent, the reductions in annual public spending in the period January to July 2016. Generating positive primary balances in the public sector is a necessary but not a sufficient condition for putting a brake on the pace of public-sector indebtedness seen over recent years and for creating some fiscal slack to allow the federal government to deal with any future economic shocks.

Figure 3.23
Gross debt and public sector financing requirement* (as % of GDP)



*Gross debt as a % of GDP was obtained using nominal GDP for the last available quarter of the year, whereas for the calculation of the public sector financing requirement the quarterly average GDP for the year was used.
Source: BBVA Research with Finance Ministry data

Figure 3.24
Percentage structure of internal and external public sector debt (% of the total debt)



Source: BBVA Research with Finance Ministry data

Gross public debt stood at 47.1% of GDP at the end of the first half of 2016. This is 2.6 percentage points higher than at the end of 2015. The depreciation of the peso in the first half of the year is a factor that largely explains this increase in the level of public debt as a proportion of GDP. This situation is also reflected in the larger share of external public debt in total public debt, which rose from 33.1% at year-end 2015 to 37.7% in the first half of 2016.

In the first half of 2016, the total public sector financing requirement was 18 percentage points of GDP higher than its level in 2007. For the ratio of public sector financing requirements to GDP to be able to start coming down, the increase in public sector financing requirements as a percentage of GDP has to be lower than the lesser of the GDP deflator and real annual GDP growth. In this regard, it is important to mention the finance ministry's intention of reducing the annual PSNCR deficit to 3.0% of GDP in 2016 (from 4.1% of GDP in 2015), to 3.0% in 2017 and to 2.5% from 2018.

The aforementioned document of the finance ministry indicates that the public sector financing requirement will reach 50.5% of GDP at year-end. In order for this balance to start decreasing from 2017 assuming an annual deficit of 3.0% for PSNCR, the Mexican economy would have to grow by at least 3.1% next year with a GDP deflator of 3.3%. However, our forecast for 2017 puts GDP growth at 2.2%. If this forecast proves correct, the public sector financing requirement as a percentage of GDP would be 50.8%.

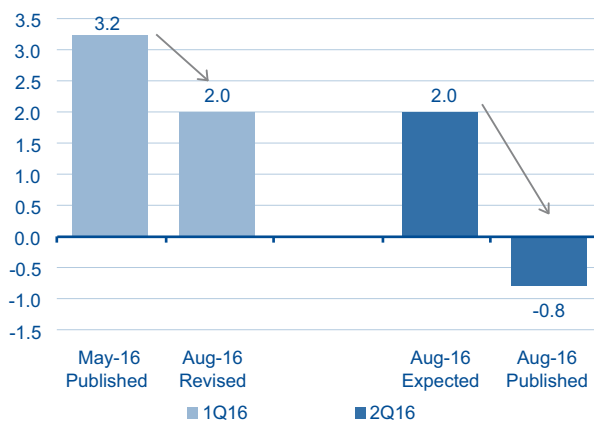
3.1.5 Outlook for the Mexican economy in 2016

As commented, we expect the rate of GDP growth for 2016 to be 1.8%. This is the result of the August revision of GDP for 1Q16, which brought the quarterly growth rate of 0.8% announced in May by the INEGI (national statistics institute) down to 0.5% (or from 3.2% to 2.0% in annualised quarterly growth terms). Additionally, August saw the announcement of negative GDP growth for the quarter of -0.2% (or annualised quarterly growth of -0.8%). At that time we were expecting quarterly GDP growth to be positive by 0.5% (2% annualised quarterly growth rate).

These two factors significantly affected the expected GDP growth rate of 2.6% for 2016 and led us to revise it downwards by eight tenths of a percentage point. The reduced quarterly GDP growth of 0.5% in 1Q16 announced in August 2016 implied a reduction of 0.3 of a percentage point from the 0.8% announced by the INEGI (national statistics institute) in May. Apart from this, we had been expecting the quarterly GDO growth rate for 2Q16 to be 0.5%, not the negative 0.2% that was announced. This meant a decrease of 0.7 percentage points in the quarterly growth rate. As indicated by the foregoing data, these two events had a significant influence on our decision to adjust the GDP growth forecast to 1.8% for 2016.

Figure 3.25

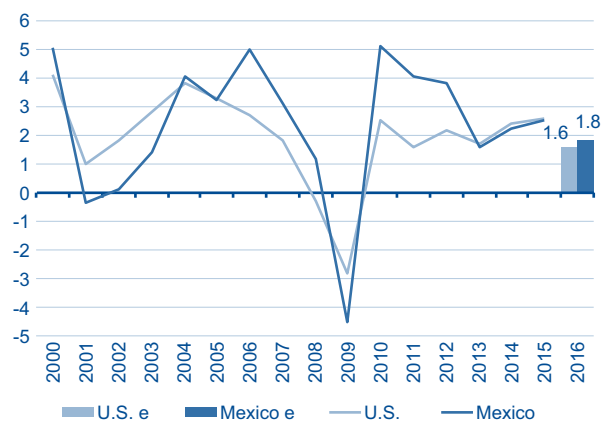
Annualised quarterly GDP growth rates: observed, revised and expected (YoY % change, sa)



YoY = year-on-year; sa = seasonally adjusted
Source: BBVA Research with INEGI data

Figure 3.26

Annual GDP of Mexico and the US (YoY % change, sa)



YoY = year-on-year; sa = seasonally adjusted
Source: BBVA Research with INEGI and BEA data

Another factor that also influenced the adjustment to our GDP growth rate for 2016 from 2.6% to 1.8% was the performance of the US economy in the first half of the year. At the beginning of the year we were expecting US GDP to grow by 2% in 2016, but the lower pace of growth seen so far this year now leads us to expect growth for the whole of 2016 to be less, around 1.6%. Given the close link between Mexico's export sector and the US economy, the reduced rate of economic expansion we now expect for the US will have repercussions for Mexico. This last point indicates that as soon as US economic activity starts to grow faster, so will Mexico's GDP.

Box 1. Positive expectations for the auction of deepwater blocks

We hope Phase 4 of Round 1 will attract the largest amount of investment and will give the biggest boost to local production of hydrocarbons

In December 2016, ten blocks will be tendered in Phase 4 of Round 1. These are the first blocks of hydrocarbon reservoirs in the deep waters of the Gulf of Mexico. We hope it is possible to successfully bid for at least 6 of them, which could bring an investment of about USD 40 billion over the next few years.

It is noteworthy that 4 of the 10 blocks are in the Perdido Area near the US part of the Gulf of Mexico, where production potential has been proved (sandstone formation is of high quality due to the turbid currents of the Bravo and Mississippi rivers that have deposited sediment over thousands of years). In fact, wells producing up to 100,000 of oil barrels per day have been found, which helps considerably to reduce unit production costs and, consequently, makes this type of projects profitable despite oil prices being relatively low.¹ We expect that all of the blocks in the Perdido Area will be successfully auctioned.

The other six blocks are located in the Saline Basin, several kilometers off the coast of Tabasco. However, there are no studies of exploratory wells revealing the potential of hydrocarbons beneath the seabed in such basin. Additionally, there are thick layers of salt in four of these blocks, which would make it even more costly to construct oil wells.² Finally, this region of the Gulf of Mexico has not been benefited by sediments deposited by rivers, which helps us anticipate that sandstone formation might not be of great quality. We estimate that at least 2 of the Saline Basin's 6 blocks will eventually be awarded in the auction.

Formation of consortia to share investment costs and risks in deep waters

It is very likely to see a Phase 4 where the winners of the blocks are consortia that allow for sharing of investment costs at the risk of finding nothing (dry holes) or too little oil during exploration. An example of this is the farm-out Pemex wants to carry out for the Trion field, whose production potential is estimated at approximately 485 million barrels of oil equivalent (at a constant production rate of 50 thousand barrels per day, 27 years of production would be reached). To put this hydrocarbon potential in context, the three previous phases of Round 1 together represent about 500 million barrels. Meanwhile, Pemex estimates investments of USD 11 billion stemming from this deepwater project. If an investment of USD 486 million is met by the consortium winning the tender, Pemex will have a 45% participation in both the project costs and cash flows.

The financial evaluation of a deepwater oil project: key to guide expectations regarding Phase 4 of Round 1

To have a better understanding of the economic factors that could be behind the decisions of companies to participate in deepwater oil projects, we carried out a financial assessment of a project under the following assumptions: (i) an investment (capex) of USD 4 billion; (ii) operating costs (opex) of USD 11 per barrel on average and adjusted with an annual increase of 5%; (iii) a production potential of 285 million barrels of oil to be commercially developed; (iv) production beginning in the year 2022 following a linear increase in the first three years, reaching a maximum of 76 thousand barrels per day that will be maintained for the next four years and will decrease

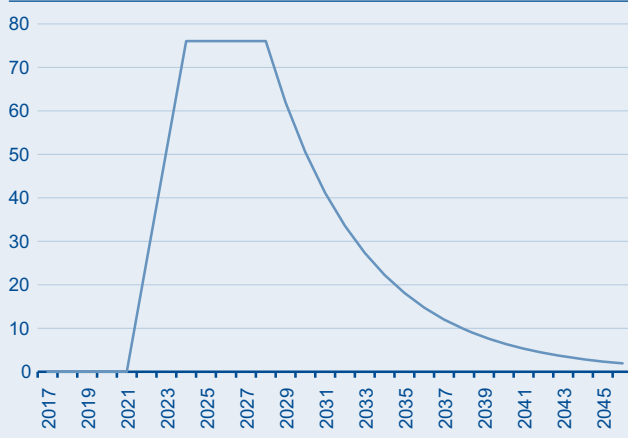
1: For more information on the areas which are relatively better for the extraction of hydrocarbons in the Gulf of Mexico per drilled well, please see Leffler *et al.* (2003).

2: In the article "Brazil's gamble on deep water oil" published on June 25, 2015 in The Guardian, it is mentioned that the cost of an oil well can reach USD 300 million when there are salt layers above the reservoir.

exponentially toward the year 2046; (v) royalties rates at 0%, 5%, 10%, 15% or 20%; (vi) an average price of an oil barrel that might be USD 50, 60, 70, 80, 90 or 100; and vii) a 10% minimum expected rate of return (hurdle rate).³

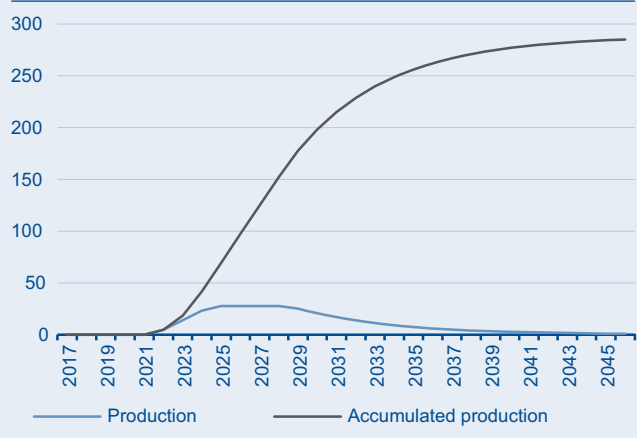
The evolution of operating costs over time will be a key piece of information to determining the year in which net cash flows will become negative. Given the assumptions listed above for the profile of these costs, this point in time will mainly depend on three factors: 1) annual oil production; 2) the price of an oil barrel; and 3) the percentage of royalties charged by the State.

Figure 3.27
Estimated oil production from a deepwater reservoir (Barrels per day)



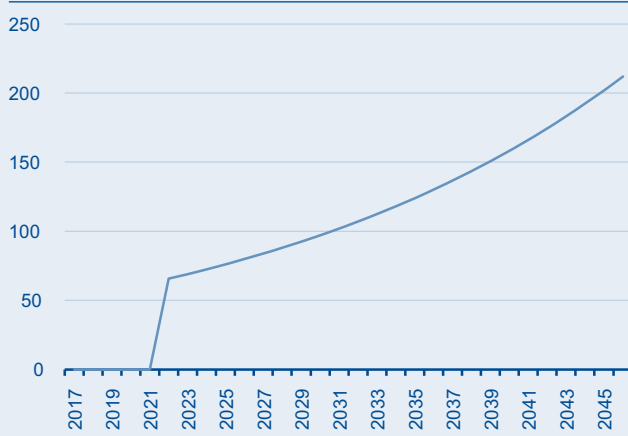
Source: BBVA Research

Figure 3.28
Estimated oil and cumulative production from a deepwater reservoir (Barrels per year)



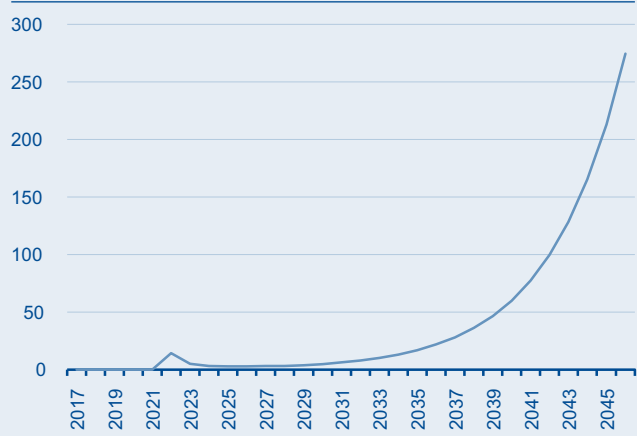
Source: BBVA Research

Figure 3.29
Expected path for the operating costs of a deepwater reservoir (USD million)



Source: BBVA Research with EIA data

Figure 3.30
Expected path for the operating costs of a deepwater reservoir (Cost per barrel in USD)



Source: BBVA Research with EIA data

3: The assumptions in (i) and (ii) are very similar to the data found for the Big Foot project in the deep waters of the Gulf of Mexico. For more information, please see the document "Trends in U.S. Oil and Natural Gas Upstream Costs" of the U.S. Energy Information Administration, March 2016.

As you can see from Figure 4, operating costs per barrel will exceed USD 100 since year 2043. That is, even if the price of a barrel were USD 100, the project would stop being profitable in 2043, or even one year earlier if the royalty rate made net cash flows negative in 2042.

The results of the financial evaluation of the deepwater hypothetical oil project are presented in terms of the Internal Rate of Return (IRR) and the Discounted Return on Investment (DROI).⁴ Figure 5 shows the financial evaluation results according to the IRR criterion, and Figure 6 shows such results using the DROI concept. From these figures, we can highlight the following conclusions: 1) the IRR and DROI increase when oil prices rise and/or there is a low percentage of royalties; 2) if the percentage of royalties imposed by the State were 20%, then the price of an oil barrel would have to be at least USD 60 for the DROI to be positive or the IRR greater than 10%; 3) at a price of USD 50 per barrel, an IRR greater than 10% or a positive DROI would only be possible with royalty rates close to zero.

Conclusions

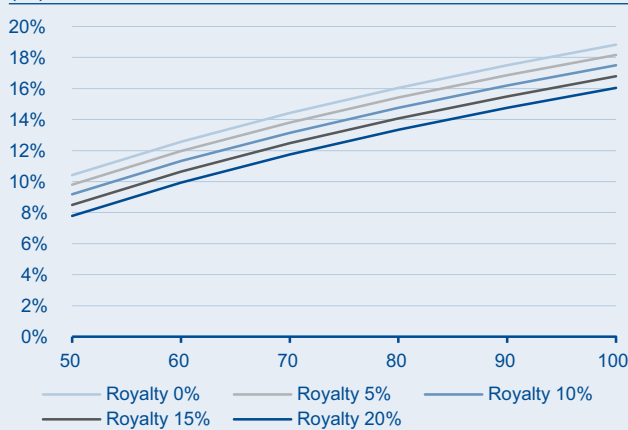
Phase 4 of Round 1 will offer a great opportunity to venture into the production of oil and gas from deep

waters for the first time in the country's history. The proved great production potential in the US region of the Gulf of Mexico, as well as the fewer technical challenges in the Perdido Area, will serve to offset the relatively low price of an oil barrel. However, the lack of exploration and major technical complexities in the Saline Basin will hinder successful auctions in that area. Meanwhile, the results of the financial evaluation of a hypothetical project in the deep waters of the Gulf of Mexico show that the price of an oil barrel would have to be at least USD 60 if the Mexican State wanted to charge a 20% royalty rate. Finally, it is important to take into account that the production of hydrocarbons from reservoirs in deep waters will take several years to materialize. This will imply even greater payback periods for investments made in these projects.

References

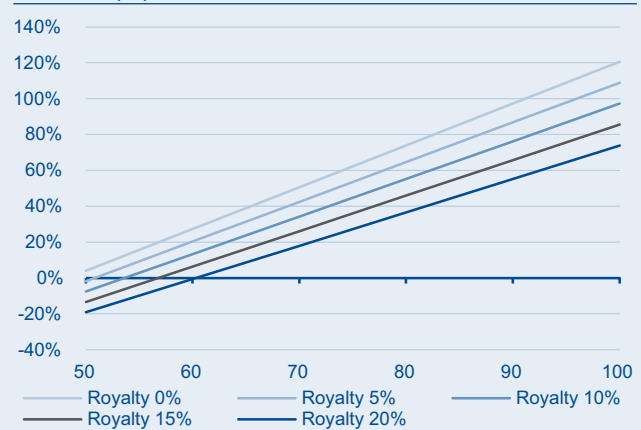
Leffler, W.L., Pattarozzi, R. y Sterling, G. (2003). Deepwater Petroleum. Exploration & Production. A Nontechnical Guide. Segunda edición. PennWell.
Seba, R.D. (2008). Economics of Worldwide Petroleum Production. Third edition. PS.
US Energy Information Administration (2016). "Trends in U.S. Oil and Natural Gas Upstream Costs", March 2016. US EIA.

Figure 3.31
Internal rate of return on a deepwater reservoir (%)



Source: BBVA Research

Figure 3.32
Discounted return on investment from a deepwater reservoir (%)



Source: BBVA Research

4: The IRR is used as a criterion to rank projects from the highest to the lowest profitable project. The higher this indicator is, the faster the project's costs will be recovered. The other criterion is the DROI (Present value of net cash flows/Investment), which could render a different rank order than the IRR criterion because it considers the total net present value. That is, more substantial net cash flows could occur much later during the life of the project.

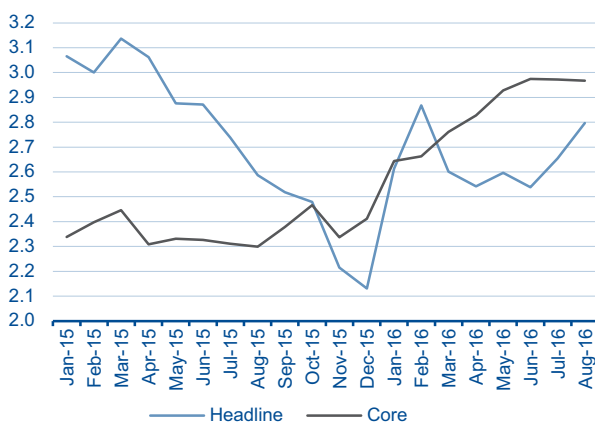
3.2 Up to the first half of August, inflation has remained below 3.0% for more than 15 consecutive months

Headline inflation has remained below the Mexican central bank’s permanent target of 3.0% for fifteen months in a row. In the first seven months of the year, annualised headline inflation averaged 2.63% and cumulative inflation to July was just 0.57 percentage points, the second lowest level accumulated during any one year, above only that of 2015. In the first half of August there was an uptick in annualised inflation, to 2.80%, partly due to the increase in petrol (gasoline) prices. However for the month as a whole we expect the pace of price increases to ease following the announcement of a 10% reduction in the price of LPG effective 17 August. As a result we expect annualised inflation for August to come in at 2.73%, which will make 16 months in a row of inflation below 3.0%. Thus we can assert that average headline inflation will be below 3.0% in 3Q16 and it is now also probable, following the announcement of the reduction in LPG prices, that it will average below 3.0% in 4Q16. As a result we envisage average annual inflation for 2016 being equal to that of last year: 2.7%. For December, we anticipate annualised inflation ending the year at 2.9%, the same level that we foresaw in January.

The outlook for inflation continues to be favourable

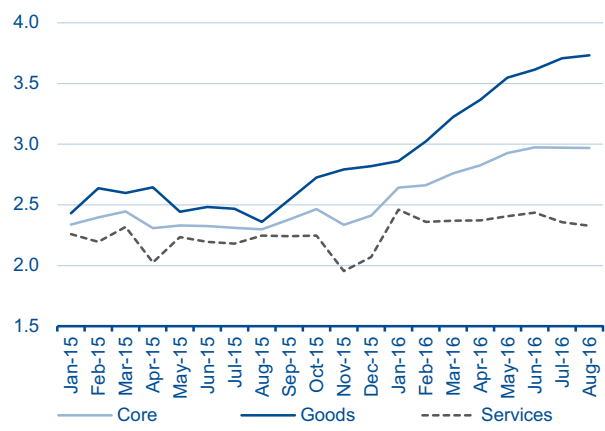
The inflation situation has remained positive in the past two years. For a short time between June and the first half of August the context seemed to be still positive but becoming somewhat less so. This was the result of increased prices of petrol (gasoline) and electricity, the further weakening of the peso and a certain uptick – which subsequently proved to have been transitory – in some measures of financial instruments in the market which reflect medium- and long-term inflationary expectations. However, about half the effect of the petrol price increase was offset in the second half of August by the aforementioned 10% reduction in the price of LPG, which shaved 0.15 pp off headline inflation. The increases in energy prices and the greater weakness of the peso had led us temporarily to revise our year-end forecast from 2.9% to 3.2%. However, in view of the announcement of the LPG price reduction, given its relatively high weight, the fact that the upper limits on petrol prices for the year had been reached, and the persistent reductions in the price of mobile phone services, we decided to revert to the 2.9% forecast which we had used from the beginning of the year.

Figure 3.33
Headline and core inflation (YoY % change)



Source: BBVA Research with INEGI data

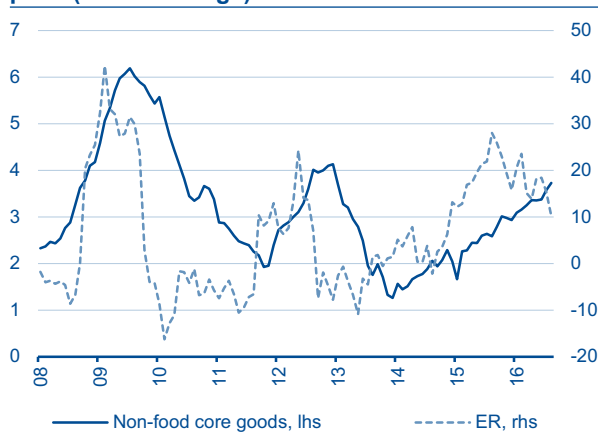
Figure 3.34
Core inflation and components (YoY % change)



Source: BBVA Research with INEGI data

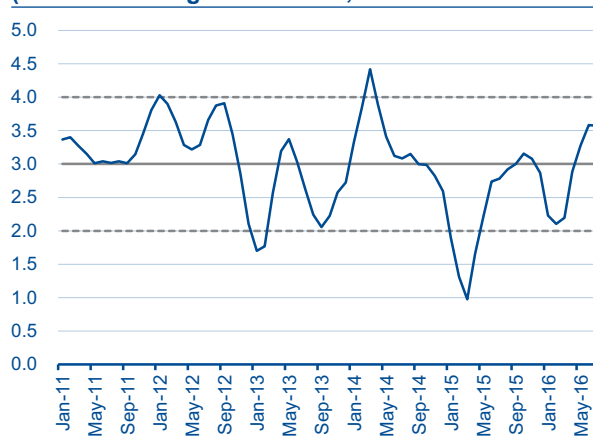
Although headline inflation remains below target, core inflation is already at 3.0% having ended 2015 at 2.4% (see Figure 3.33). The rising trend in underlying prices is due to the acceleration of the goods component, which increased from 2.8% at year-end 2015 to 3.7% in July and the first half of August. The significant depreciation of the Mexican peso so far this year implies a high probability of core inflation continuing to accelerate in the remainder of the year if as we foresee the Mexican peso does not recover strongly (see Figure 3.35). In fact, the sub-index of other goods, which because of its composition is the most closely related to exchange rate movements, has risen by 0.8 percentage points so far this year. We anticipate that this upward trend still has some way to go and that the annualised increase in this sub-index could be close to 4.0% towards the end of the year. However, the favourable behaviour of the services component prevented core inflation from increasing further (see Figure 3.36). Inflation of services excluding housing and education (tuition fees), which is closely related to the economic cycle, has remained low and steady, even decreasing last month. Having held at 2.1% from February to June, it fell to 1.9% in July and again to 1.8% in the first half of August, mainly favoured by two factors: i) further reductions in mobile telephony prices reflecting increased competition in the sector, and ii) smaller seasonal increases in tourist service prices than in the past few years. The persistent falls in the prices of mobile telephony have had a highly favourable effect on core inflation in the past two years. In fact the annual rate of telecommunications price changes has remained at levels below -5.0% during 2015-16.

Figure 3.35
Non-food inflation and rate of depreciation of the peso (YoY % change)



Source: BBVA Research with INEGI and Bloomberg data

Figure 3.36
Trend in core inflation (3m/3m % change annualised, sa)



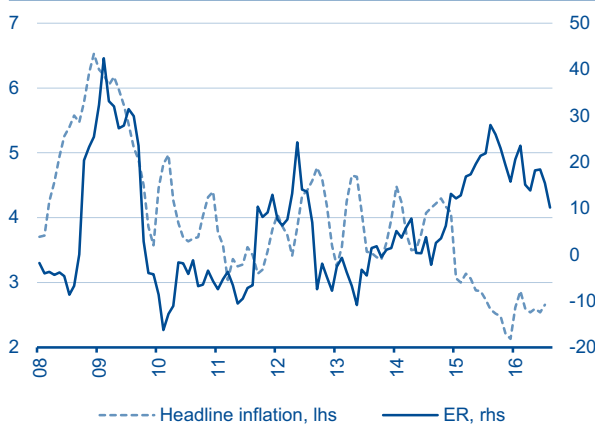
Source: BBVA Research's own calculations and INEGI

Thus in the last two years core inflation has evolved in response to changes in relative prices, with goods increasing as a direct effect of the peso's depreciation (i.e. the pass-through), and services holding at low levels and in some cases such as telecommunications showing persistent and significant reductions. All in all it is possible that the trend in core inflation may stabilise below the upper limit of the Mexican central bank's target range (4%) – see Figure 3.36 –, favoured not only by the favourable dynamic of the services component already referred to but also by the recent signs of weakening consumption, which will continue to limit companies' pricing power in a context of considerable slack in the economy. Accordingly we envisage core inflation ending the year close to 3.0% (at 3.08%). More significant than the moderate level of core inflation envisaged for year-end is the continuing absence of secondary effects on prices. In other words the significant and persistent weakness of the peso has not affected the process of price formation in the economy, and if this conti-

nues, it will ensure that we continue to see only changes in relative prices as described earlier, as opposed to a generalised trend of increasing inflation.

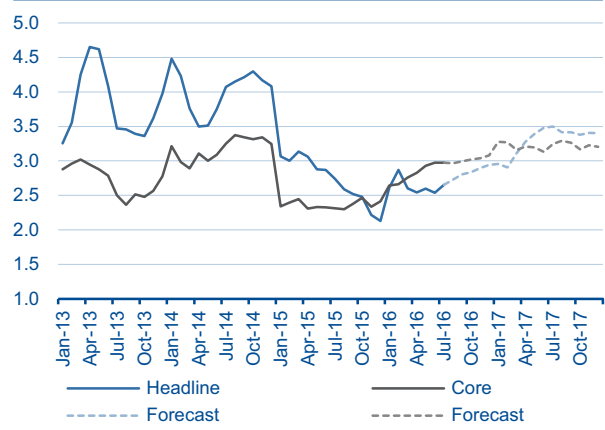
We consider that two factors will continue to contribute to this favourable effect of the peso's depreciation on inflation: i) the ongoing intensification of competition in the telecommunications sector; and ii) the credibility of Mexico's central bank and the recent increases in the reference rate which will prevent inflationary expectations slipping their anchor. We consider that the risks are more or less balanced. The main risks to the permanence of this favourable context are increased depreciation of the peso, an unexpected change in the setting of energy prices and a significant increase in farm prices. The main factors that could lead to lower inflation are associated with the economic cycle (i.e. with the possibility of more sluggish domestic demand) and with the competition deriving from the reform of telecommunications which could translate into additional reductions in the prices of these services, mainly mobile telephony.

Figure 3.37
Annual headline inflation and rate of depreciation of the peso (%)



Source: BBVA Research with INEGI and Bloomberg data

Figure 3.38
Inflation outlook (Annual % change)

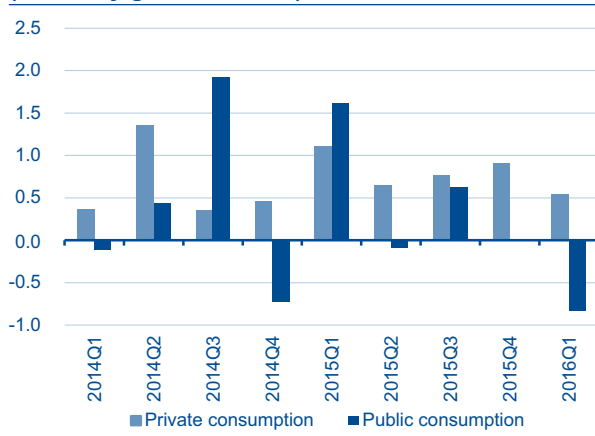


Source: BBVA Research with INEGI and Bloomberg data

3.3 Exchange rate and performance of the external accounts at the centre of attention of Mexico’s central bank

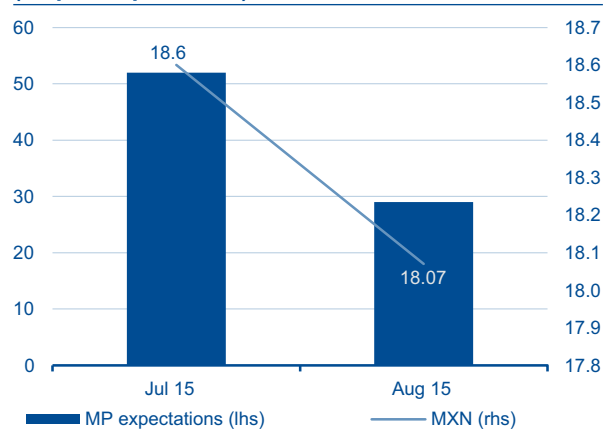
The central banks’ recent announcement following the 50 bp increase in the June meeting revealed increased concerns among members of the governing council about the deterioration in the fundamentals of the economy and its possible effects on inflation, over and above the debate on the risks of pass-through from the exchange rate to prices that had dominated last year. Indeed, the minutes of the June monetary policy meeting indicate that the increase in the interbank reference rate was partly remedial in that it helps to moderate the risks of pressure on inflation from aggregate demand. This argument has to do with the sustainability of current expenditure in the Mexican economy, the basic problem being the significant increase in the current account deficit over the past few years. The dynamism of both public and private consumption, combined with stagnating investment in a context of reduced oil prices and production have led to a deficit in the external accounts in just a few years to a level which, while not yet unsustainable, nevertheless represents a significant risk. The more so when it is borne in mind that financing depends on portfolio flows, which in an environment of monetary normalisation in the US have come to a halt in the past few months. All this has led the central bank not just to insist on measures to consolidate the public finances but to take action within its remit. Indeed, Mexico’s central bank has indicated that although reducing public spending is a more efficient way of adjusting the current account, it considers that it must be complemented with a reduction in private spending, and it is here that the increase in the monetary policy rate comes into play. According to the minutes “The adjustment to the monetary policy rate will contribute to realigning expenditure in the economy with the level of revenues”.

Figure 3.39
Private and public consumption
(Quarterly growth rate, %)



Source: BBVA Research with Bloomberg data

Figure 3.40
Implicit expectations of the funding rate in the
interest-rate and exchange rate swap curve
(%, pesos per dollar)



Source: BBVA Research with Bloomberg data

All these arguments about the possible effects of the recent deterioration in macroeconomic fundamentals on inflation are closely related to the exchange rate, which in itself continues to constitute the main source of risks for prices. In fact the latest monetary policy communiqué emphasised the factors that might trigger a fresh bout of currency depreciation, which include: the uncertainty about the US elections, mentioned for the first time in the communiqué; additional deterioration of the current account and the resumption of the process of monetary normalisation on the part of the Federal Reserve. The significance of the exchange rate in terms of monetary policy has reached the point, especially in light of the recent actions of Mexico's central bank, where the expectations of the interbank reference rate implicit in market instruments vary with movements in the exchange rate (as shown in Figure 3.40).

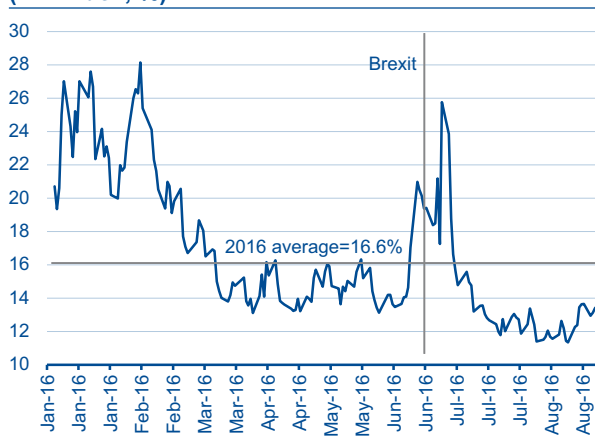
As can be seen from the foregoing, current domestic conditions have not been the catalysts for monetary policy actions. Economic growth has weakened further (Mexico's central bank reduced its growth forecast for 2016 to between 1.7 and 2.5%) which reduces the probability of our seeing demand pressure on prices and in turn secondary effects deriving from the depreciation of the currency. Inflation remains below 3.0%, the exchange-rate pass-through continues to be contained and the upward trend in prices of services (which account for about 60% of the CPI) seems to have halted. This underlines the increased significance of variables such as the external accounts and above all the exchange rate in the central bank's reactions, which will tend to lead it to maintain a cautious tone in its discourse for the rest of the year.

Looking ahead, given the central bank's determination to help reduce the risks to the fundamentals of the economy, we consider that providing there is no further deterioration in the external accounts and the exchange rate holds relatively steady, Mexico's monetary policy will keep step with that of the Federal Reserve. Specifically, in the scenario that currently seems most likely, we expect an increase of 25 basis points in the reference rate during the last quarter of the year.

3.4 Search for yield in the financial markets following Brexit

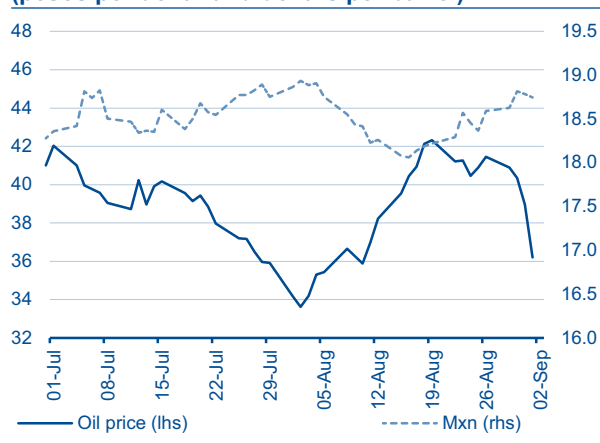
Activity in the financial markets in the past few months has been influenced mainly by a search for yield driven by the more accommodative stance adopted by some developed countries central banks as a consequence of the risks and uncertainty generated by Brexit. A few days after the UK referendum both the Bank of England and the Bank of Japan increased their monetary stimulus measures in reaction to the volatility in the markets and the risks to economic growth. This, together with expectations of a more gradual pace in monetary normalisation in the US, reawakened investors' risk appetite (the VIX fell by 25.7% to 12.8% one month after the referendum result) and their search for yield. One reflection of this change in market sentiment has been the rise in equity markets, even to all-time highs in some cases, in the past few weeks. In particular, between 24 June (the date of the UK referendum) and the end of August, the S&P500 gained 6.55%, slightly less than the 6.88% posted by the global equity markets benchmark (MSCI World), reaching a new all-time high of 2190 points on 15 August. In the case of European equity markets, gains in the period referred to (Euro Stoxx 600 +6.7%) practically offset the falls posted as a result of Brexit. Despite these increases, the biggest gains were seen in the emerging markets, whose benchmark, the MSCI EM, rose by nearly 11% in the period in question. In the case of Mexico the advance of its IPyC stock exchange index was less than that of emerging markets as a whole (+5.9%), but still sufficient for the index to reach a new all-time high in mid-August.

Figure 3.41
Risk aversion
(VIX index, %)



Source: BBVA Research with Bloomberg data

Figure 3.42
Exchange rate and Mexican Mix oil price
(pesos per dollar and dollars per barrel)



Source: BBVA Research with Bloomberg data

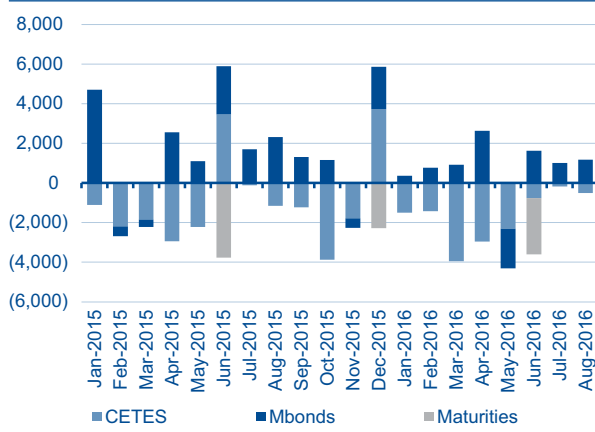
The combination of the search for yield and expectations of a more gradual raising of federal fund rates led to lower demand for dollars. After posting an increase of as much as 4.2% one month after the referendum, the US currency retreated relative to the other main global currencies (the euro, the yen, the pound and the Swiss franc) and at the end of August was at practically the same level as on 24 June. However, so far this year the dollar has lost about 2.6% against the other main currencies overall. Emerging markets' currencies have gained 3.5% relative to the dollar so far this year, 0.75% of it since 24 June. In line with this behaviour,

the Mexican peso appreciated 0.75% against the dollar following Brexit, after the dollar had reached a new all-time high of 19.51 pesos in the early hours of 24 June. In this context of reduced risk aversion, and with fewer worries about Federal Reserve rate hikes in the short term, the price of oil regained importance as a variable explaining movements in the exchange rate. In fact when the price of Mexican Mix reached US\$33.60 a barrel, its lowest price since April, the peso depreciated to 18.93 pesos to the dollar, whereas when the price of oil was above US\$42 a barrel, the exchange rate was below 18.1 pesos to the dollar.

In view of the risks to growth and the low interest rates in the industrialised countries, the demand for fixed income instruments of countries such as Mexico revived. Following significant reductions in May in foreigners' holdings of medium- and long-term bonds, the search for yield led to greater demand for Mexican government bonds, to such an extent that between 1 July and 18 August foreigners' holdings of instruments of this type increased by nearly US\$2.2 billion, bringing the cumulative year-to-date figure to around US\$6 billion. However, foreigners continue to reduce their holdings of CETES (federal treasury certificates), albeit at a slower pace, as opportunities for arbitrage fade. Such holdings have fallen by nearly US\$13.5 billion so far this year. The net reduction in foreigners' holdings of all types of medium- and long-term bonds was approximately US\$7.5 billion for the period. This figure is significant in view of the increase in the current account deficit in the past few years and the fact that it cannot be financed entirely with foreign direct investment. Thus the behaviour of foreign flows will continue to be a risk factor going forward, especially now that the country's sovereign debt rating has been placed on negative outlook in view of these imbalances.

Figure 3.43

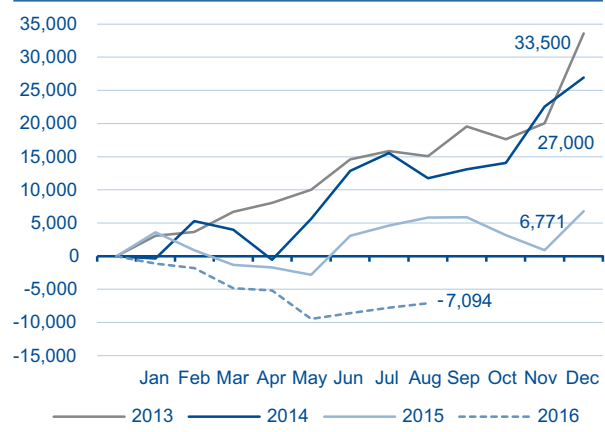
Change in foreigners' holdings of CETES (federal treasury certificates) and Mexican government bonds (US\$ millions)



Information to 18 August 2016.
Source: BBVA Research with Mexico's central bank data

Figure 3.44

Cumulative change in foreigners' holdings of CETES (federal treasury certificates) and Mexican government bonds (US\$ millions)



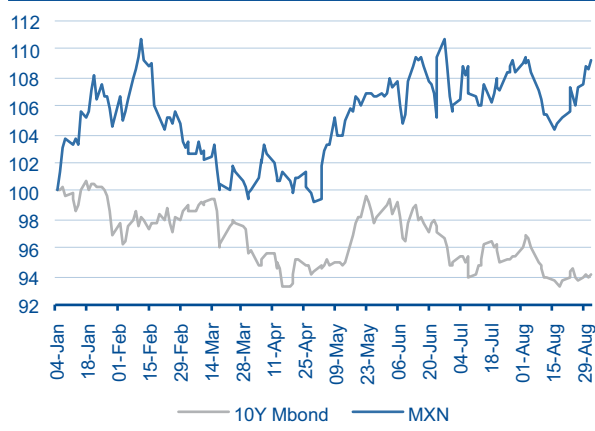
Information to 18 August 2016.
Source: BBVA Research with Mexico's central bank data

In this difficult context, with the continuing weakness of the Mexican peso (with bouts of greater intensity and phases of partial recovery) the favourable development of long-term interest rates stands out. Although during the second half of May the return of pressures on the peso seemed to be starting to have an effect on long-term interest rates (see Figure 3.45), this movement proved fleeting, and long-term bonds have not only remained remarkably steady but have even shown a certain tendency to increase in price since the beginning of June

(see Figure 3.46). In fact, these pressures on the MXN affected short-term monetary policy expectations, and at that time the market gradually started to assign a greater probability to a hike in the reference rate, as subsequently became fact when Mexico’s central bank increased its monetary policy rate to contain the risks. These expectations of a more hawkish monetary policy, mainly as a result of the additional pressures on the MXN, were what led to the uptick in the ten-year rate, which dissipated once the reference rate hike was announced (see Figure 3.45).

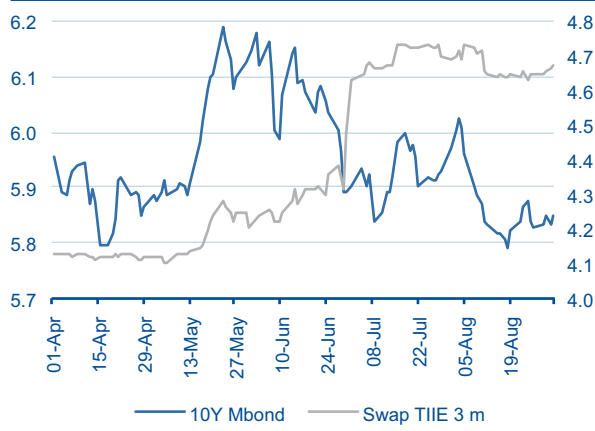
Long-term interest rates have weathered the episode of risk aversion and currency weakness over the past few years without problems. In the first eight months of the year, the yield on ten-year Mexican bonds averaged 6.01%, slightly higher than the average for the whole of 2015 (5.94%) but marginally lower than that seen in 4Q15 (6.10%). Within this average for 2016 YTD there is a notable downward trend, despite the persistent pressure on the peso and a more adverse context as regards foreign appetite for Mexican bonds. Thus while the rate of 10-year Mexican bonds averaged 6.12% in 1Q16, in 2Q16 it fell to 5.99% and in the first two months of 3Q16 it fell further, to 5.90%. It currently (1 September) stands at 5.83%.

Figure 3.45
10-year Mexican government bond and exchange rate (Index: 4 Jan 16 = 100)



Source: BBVA Research with Bloomberg data

Figure 3.46
10-Year “M”-bond and 28-day TIIE (Mexican interbank equilibrium rate) 3-month swap (%)



Source: BBVA Research with Bloomberg data

This falling trend came about in spite of the 100 bp increase in the reference rate. While it is normal to expect a flattening of the yield curve when the monetary policy rate increases from very accommodative levels, the flattening seen is due not only to the increase in the short part of the curve but also to the fall in ten-year rates (see Figure 3.46). At the end of January this year, i.e. before the Mexican central bank’s first increase of 50 bps in the interbank reference rate, the difference between the 10-year and 1-year rates was 259 bps. At the end of August, after two monetary policy rate hikes in 2016 (cumulatively 100 bps), this difference had shrunk to 128 bps. This reduction is due mainly to the increase of 112 bps in the one-year rate, but also partly to the fall of 19 bps in the ten-year rate.

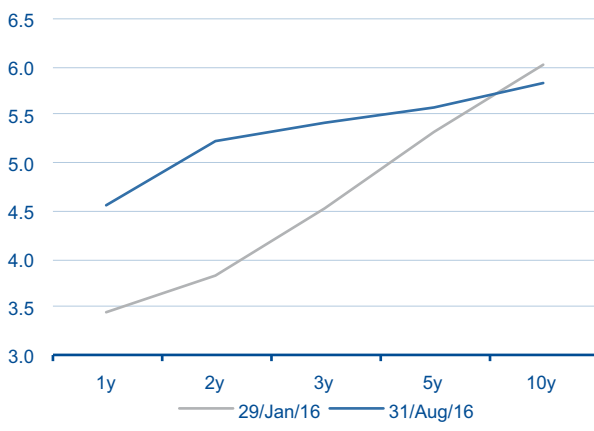
We believe that the positive performance of Mexican long-term rates has been mainly influenced by two factors. Firstly, the downward trend in long-term interest rates in the US. The ten-year Treasury Note started the year at 2.2% and in the first two months of 3Q16 it has averaged 1.53%, fluctuating between 1.4% and 1.6% depending on market expectations of the Federal Reserve’s monetary policy. This sharp fall in US long-term rates is the first factor. A second reason is the reduction in domestic currency bond issues, which translates

into slower increase in the supply of bonds in the market, which in turn produces upward pressure on their prices, i.e. downward pressure on their interest rates.

We anticipate that these two factors will continue for the rest of the year, and Mexican long-term rates will probably remain low during that time. For 2017 it is hard to see significant increases in US long-term rates, and in Mexico the process of fiscal consolidation on which the federal government is already embarked will continue to limit the supply of long-term bonds. We are accordingly revising our forecast for the 10-year M-bond rate down from 6.3% to 5.85% for year-end 2016 and we now foresee an increase of just 30 bps in 2017.

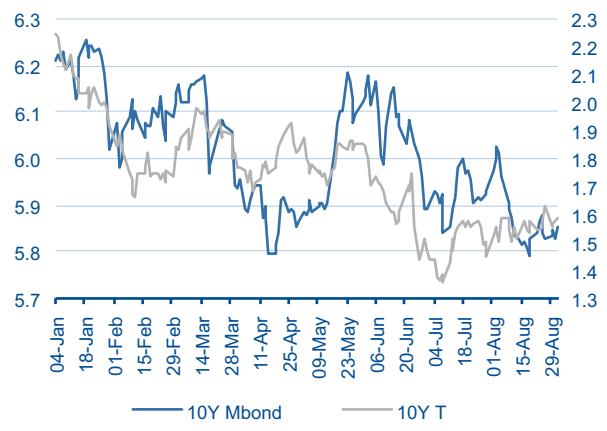
As for exchange rate expectations, the risks during the second half of the year retain an upward bias. On the external front, the US presidential election, the price of oil and continued monetary normalisation on the part of the Federal Reserve will all influence the exchange rate. On the domestic front, the public finances and the current account deficit will be variables to keep under surveillance, especially in view of the recent revision of the outlook on Mexico's sovereign debt rating. Based on these risks we expect the exchange rate to remain under pressure and to end the year towards 18.9 pesos per dollar.

Figure 3.47
Yield curve (%)



Source: BBVA Research with Bloomberg data

Figure 3.48
10-year government bond rates (Constant maturity, %)



Source: BBVA Research with Bloomberg data

4. Indicators and forecasts

Table 4.1

Macroeconomic forecasts: Gross Domestic Product

| (YoY growth rate) | 2013 | 2014 | 2015 | 2016 | 2017 |
|-------------------|------|------|------|------|------|
| United States | 1.7 | 2.4 | 2.6 | 1.6 | 2.1 |
| EMU | -0.2 | 0.9 | 1.6 | 1.6 | 1.5 |
| Germany | 0.4 | 1.6 | 1.4 | 1.4 | 1.5 |
| France | 0.7 | 0.2 | 1.2 | 1.5 | 1.4 |
| Italy | -1.8 | -0.3 | 0.6 | 1.0 | 1.1 |
| Spain | -1.7 | 1.4 | 3.2 | 3.1 | 2.3 |
| UK | 1.9 | 3.1 | 2.2 | 1.5 | 0.4 |
| Latin America * | 2.7 | 0.6 | -0.4 | -0.9 | 1.8 |
| Mexico | 1.3 | 2.3 | 2.5 | 2.6 | 2.6 |
| Brazil | 3.0 | 0.1 | -3.9 | -3.0 | 0.9 |
| EAGLES ** | 5.6 | 5.2 | 4.5 | 4.7 | 4.8 |
| Turkey | 4.2 | 3.0 | 4.0 | 3.9 | 3.9 |
| Asia-Pacific | 5.9 | 5.6 | 5.5 | 5.3 | 5.1 |
| Japan | 1.4 | 0.0 | 0.5 | 0.5 | 0.6 |
| China | 7.7 | 7.3 | 6.9 | 6.4 | 5.7 |
| Asia (exc. China) | 4.4 | 4.3 | 4.3 | 4.4 | 4.5 |
| World | 3.3 | 3.4 | 3.1 | 3.1 | 3.2 |

* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.

** Saudi Arabia, Bangladesh, Brazil, China, Philippines, India, Indonesia, Irak, Mexico, Nigeria, Pakistan, Russia, Thailand and Turkey.

Forecast closing date: 5 August 2016.

Source: BBVA Research & FMI

Table 4.3

United States indicators and forecasts

| | 2014 | 2015 | 2016 | 2017 | 1Q15 | 2Q15 | 3Q15 | 4Q15 | 1Q16 | 2Q16 | 3Q16 | 4Q16 |
|---|------|------|------|------|------|------|------|------|------|------|------|------|
| Macroeconomic Indicators | | | | | | | | | | | | |
| GDP (real % change) | 2.4 | 2.6 | 1.6 | 2.1 | 2.0 | 2.6 | 2.0 | 0.9 | 0.8 | 1.1 | 3.1 | 2.8 |
| Personal consumption (real % change) | 2.9 | 3.2 | 2.7 | 2.7 | 2.4 | 2.9 | 2.7 | 2.3 | 1.6 | 4.4 | 2.9 | 3.2 |
| Gov. consumption (real % change) | -0.9 | 1.8 | 0.9 | 1.0 | 2.6 | 3.2 | 1.9 | 1.0 | 1.6 | -1.5 | 1.2 | 0.4 |
| Gross fixed investment (real % change) | 5.5 | 4.0 | 0.2 | 2.1 | 3.7 | 4.3 | 5.7 | -0.2 | -0.9 | -2.5 | -1.1 | 2.3 |
| Construction | 3.5 | 11.7 | 4.1 | 1.8 | 13.4 | 14.8 | 12.6 | 11.5 | 7.8 | -7.7 | -3.9 | -2.8 |
| Industrial prod. (real annual % change) | 2.9 | 0.3 | -0.5 | 3.2 | 2.4 | 0.4 | 0.1 | -1.6 | -1.6 | -1.1 | -0.4 | 1.0 |
| Current account balance (% of GDP) | -3.0 | -2.5 | -2.9 | -3.0 | -2.6 | -2.5 | -2.7 | -2.5 | -2.7 | -2.7 | -2.9 | -2.8 |
| Final annual inflation | 0.8 | 0.7 | 1.9 | 1.9 | -0.1 | 0.1 | 0.0 | 0.7 | 0.9 | 1.0 | 1.7 | 1.9 |
| Average annual inflation | 1.6 | 0.1 | 1.3 | 2.0 | -0.1 | 0.0 | 0.1 | 0.5 | 1.1 | 1.1 | 1.3 | 1.7 |
| Primary fiscal balance (% of GDP) | -2.8 | -2.5 | -3.0 | -3.0 | | | | -2.5 | | | | -3.0 |

Note: **Bold** figures are forecast

Source: BBVA Research

Table 4.4

Mexico Indicators and Forecasts

| | 2014 | 2015 | 2016 | 2017 | 1Q15 | 2Q15 | 3Q15 | 4Q15 | 1Q16 | 2Q16 | 3Q16 | 4Q16 |
|---|--------|--------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Economic Activity | | | | | | | | | | | | |
| GDP (seasonally-adjusted series) | | | | | | | | | | | | |
| Real annual % change | 2.2 | 2.5 | 1.8 | 2.2 | 2.5 | 2.3 | 2.6 | 2.4 | 2.4 | 1.5 | 1.7 | 1.7 |
| Per inhabitant (US dollars) | 10,619 | 9343.0 | 8,333 | 8,635 | 9,772 | 9,569 | 8,996 | 9,035 | 8,585 | 8,495 | 8,130 | 8,123 |
| US\$ billions | 1,271 | 1130.6 | 1,019 | 1,067 | 1,182 | 1,158 | 1,089 | 1,093 | 1,050 | 1,039 | 994 | 993 |
| Inflation (average, %) | | | | | | | | | | | | |
| Headline | 4.02 | 2.72 | 2.72 | 3.30 | 3.07 | 2.94 | 2.62 | 2.27 | 2.69 | 2.56 | 2.73 | 2.89 |
| Core | 3.18 | 2.36 | 2.91 | 3.22 | 2.39 | 2.32 | 2.33 | 2.40 | 2.69 | 2.91 | 2.98 | 3.05 |
| Financial Markets (average, %) | | | | | | | | | | | | |
| Interest rates | | | | | | | | | | | | |
| Bank funding | 3.00 | 3.02 | 3.73 | 4.35 | 3.00 | 3.00 | 3.00 | 3.08 | 3.58 | 3.92 | 4.25 | 4.33 |
| 28-day Cetes | 3.00 | 3.25 | 3.41 | 4.31 | 2.94 | 3.01 | 3.05 | 3.04 | 3.61 | 3.88 | 4.04 | 4.29 |
| 28-day TIIE | 3.35 | 3.44 | 3.72 | 4.66 | 3.30 | 3.31 | 3.32 | 3.39 | 3.89 | 4.09 | 4.26 | 4.65 |
| 10-year Bond (% average) | 6.01 | 5.94 | 6.00 | 6.10 | 5.66 | 6.00 | 6.05 | 6.20 | 6.00 | 6.00 | 6.00 | 5.90 |
| Exchange rate (average) | | | | | | | | | | | | |
| Pesos per dollar | 13.4 | 16.0 | 18.2 | 17.8 | 15.1 | 15.5 | 16.6 | 16.8 | 17.8 | 18.0 | 19.0 | 19.4 |
| Public Finances | | | | | | | | | | | | |
| *FRPS (% of GDP) | -4.6 | -4.1 | -3.0 | -3.0 | - | - | - | -4.1 | - | - | - | -3.0 |
| External Sector³ | | | | | | | | | | | | |
| Trade balance (US\$ billions) | -2.8 | -14.5 | -16.4 | -21.1 | -4.0 | -3.5 | -6.6 | -5.5 | -5.2 | -4.7 | -5.8 | -5.4 |
| Current account (US\$ billions) | -24.2 | -31.4 | -32.8 | -37.0 | -6.9 | -8.7 | -8.1 | -9.1 | -9.1 | -9.4 | -9.3 | -9.2 |
| Current account (% of GDP) | -1.9 | -2.8 | -3.2 | -3.5 | -2.8 | -2.9 | -2.8 | -2.6 | -2.6 | -3.4 | -3.3 | -3.6 |
| Employment | | | | | | | | | | | | |
| Formal Private (annual % change) | 3.5 | 4.3 | 3.0 | 2.8 | 4.5 | 4.4 | 4.4 | 4.0 | 3.7 | 3.2 | 2.6 | 2.4 |
| Open Unemployment Rate (% active pop.) | 4.8 | 4.4 | 4.5 | 4.5 | 4.4 | 4.4 | 4.3 | 4.4 | 4.5 | 4.5 | 4.5 | 4.6 |

Continues on next page

Mexico Indicators and Forecasts

| | 2014 | 2015 | 2016 | 2017 | 1Q15 | 2Q15 | 3Q15 | 4Q15 | 1Q16 | 2Q16 | 3Q16 | 4Q16 |
|--|------|------|--------------|-------------|------|------|-------|-------|-------|-------|--------------|-------------|
| Aggregate Demand⁴ (annual % change, seasonally-adjusted) | | | | | | | | | | | | |
| Total | 3.1 | 3.1 | 1.0 | 2.1 | 3.6 | 3.1 | 3.4 | 2.4 | 2.0 | 0.8 | 0.6 | 0.6 |
| Domestic Demand | 1.9 | 1.1 | 0.8 | 1.4 | 0.8 | 1.0 | 1.3 | 1.4 | 1.7 | 0.6 | 0.3 | 0.5 |
| Consumption | 1.8 | 3.0 | 1.6 | 2.1 | 3.3 | 2.6 | 2.8 | 3.3 | 2.0 | 1.7 | 1.5 | 1.1 |
| Private | 1.8 | 3.1 | 1.9 | 2.2 | 3.3 | 2.6 | 3.0 | 3.5 | 2.5 | 2.0 | 1.8 | 1.3 |
| Public | 2.2 | 2.4 | -0.5 | 1.2 | 3.3 | 2.7 | 1.4 | 2.2 | -0.7 | -0.3 | -0.6 | -0.4 |
| Investment | 2.9 | 3.9 | -1.2 | 0.5 | 6.1 | 4.9 | 3.8 | 1.0 | 1.2 | -1.8 | -2.6 | -1.4 |
| Private | 4.8 | 6.3 | 1.2 | 1.7 | 8.3 | 6.3 | 7.2 | 3.7 | 4.6 | 1.0 | -0.8 | 0.1 |
| Public | -4.7 | -6.5 | -12.6 | -6.3 | -2.8 | -1.4 | -10.4 | -11.4 | -14.0 | -15.1 | -11.8 | -9.1 |
| External Demand | 6.9 | 9.1 | 1.5 | 3.8 | 12.6 | 9.2 | 9.9 | 5.1 | 2.7 | 1.3 | 1.3 | 0.8 |
| Imports | 5.9 | 5.1 | -1.5 | 1.8 | 6.9 | 5.4 | 6.0 | 2.2 | 0.7 | -1.4 | -2.8 | -2.6 |
| GDP by sectors (annual % change, seasonally-adjusted) | | | | | | | | | | | | |
| Primary | 4.5 | 0.5 | 3.4 | -0.1 | 2.9 | 0.2 | -0.3 | -0.9 | 2.7 | 3.9 | 2.6 | 4.6 |
| Secondary | 2.7 | 1.0 | 0.4 | 1.5 | 1.7 | 0.8 | 1.2 | 0.2 | 1.7 | -0.3 | -0.1 | 0.2 |
| Mining | -1.5 | -5.7 | -4.4 | -2.8 | -5.6 | -7.7 | -5.6 | -4.0 | -3.6 | -4.3 | -5.1 | -4.4 |
| Electricity | 8.2 | 4.1 | 4.3 | 4.5 | 6.7 | 2.4 | 3.6 | 3.6 | 2.0 | 6.4 | 4.5 | 4.4 |
| Construction | 1.9 | 2.7 | 1.5 | 2.6 | 4.6 | 3.3 | 3.2 | -0.3 | 3.3 | 1.5 | 1.1 | 0.2 |
| Manufacturing | 4.1 | 2.6 | 1.0 | 2.1 | 3.7 | 2.6 | 2.9 | 1.3 | 1.2 | 0.5 | 0.7 | 1.4 |
| Tertiary | 1.8 | 3.3 | 2.7 | 2.7 | 2.9 | 3.2 | 3.4 | 3.7 | 3.4 | 2.4 | 2.6 | 2.2 |
| Retail | 3.1 | 4.5 | 1.7 | 2.7 | 6.0 | 3.6 | 4.7 | 3.9 | 2.4 | 1.5 | 1.4 | 1.4 |
| Transportation, mail and warehouse | 3.1 | 3.5 | 1.5 | 2.1 | 3.5 | 3.0 | 4.1 | 3.3 | 1.5 | 1.9 | 1.3 | 1.3 |
| Massive media information | 0.2 | 10.0 | 5.8 | 4.5 | 5.1 | 4.9 | 11.7 | 18.6 | 10.4 | 8.6 | 6.0 | -1.0 |
| Financial and insurance | -0.8 | 0.9 | 7.6 | 7.6 | -0.6 | -0.4 | 1.9 | 2.8 | 6.4 | 7.3 | 7.1 | 9.4 |
| Real-estate and rent | 2.0 | 2.3 | 2.2 | 2.6 | 1.7 | 3.1 | 2.3 | 2.2 | 2.2 | 1.6 | 2.3 | 2.6 |
| Prof., scientific and technical servs. | 1.3 | 3.8 | 5.6 | 0.9 | 2.5 | 5.9 | 3.1 | 3.9 | 7.4 | 6.5 | 5.6 | 3.2 |
| Company and corporate management | 7.2 | 1.9 | 3.5 | 3.4 | -1.8 | 0.9 | 4.8 | 3.9 | 4.9 | 4.3 | 0.9 | 4.2 |
| Business support services | -0.1 | 1.0 | 2.9 | 2.6 | 2.2 | 0.4 | 0.7 | 0.8 | 2.7 | 3.1 | 2.9 | 3.0 |
| Education | 0.1 | 0.7 | 1.2 | 0.4 | 0.2 | 0.5 | 0.4 | 1.7 | 1.2 | 1.7 | 1.1 | 0.9 |
| Health and social security | -0.6 | 1.3 | 1.9 | 1.9 | 1.3 | 1.5 | 1.1 | 1.3 | 0.4 | 1.9 | 2.7 | 2.7 |
| Cultural and sport | -1.4 | 4.7 | 3.5 | 1.6 | 3.9 | 5.7 | 4.4 | 4.7 | 2.2 | 4.0 | 4.2 | 3.7 |
| Temporary stay | 2.9 | 5.9 | 2.5 | 0.9 | 3.6 | 5.0 | 7.0 | 7.8 | 6.1 | 3.1 | 1.3 | -0.2 |
| Other services, except govnt. activities | 1.6 | 2.3 | 5.3 | 1.3 | 3.1 | 1.6 | 1.3 | 3.4 | 5.7 | 6.6 | 5.3 | 3.8 |
| Government activities | 1.9 | 2.6 | -0.4 | 1.3 | 5.2 | 3.9 | 1.0 | 0.5 | -3.0 | -0.5 | 0.8 | 1.0 |

1: Residential investment

2: Fiscal balance (% GDP)

3: Accumulated, last 12 months

4: Base 1993=100; GDP by sector base 2003=100. The observed data of the primary sector, secondary and tertiary seasonally-adjusted by INEGI, the rest own seasonally-adjusted

bd: billions of dollars

dpb: dollars per barrel

*FRPS: Financial Requirements of the Public Sector

na: not available

 Note: **Bold** figures are forecast

Source: BBVA Research with Census Bureau, Federal Reserve, Bureau of Labor Statistics, Banco de México, INEGI and SHCP data

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