1. In summary

The global environment improved in the last months of 2016 and is continuing to do so in early 2017. Global growth accelerated in the last quarter of 2016, there has been a notable increase in confidence indicators in all areas, and the indicators for the industrial sector are growing alongside a budding improvement in world trade. In particular, in the US we anticipate growth of 2.3% and 2.4% in 2017 and 2018. In China we expect growth of 6.0% in 2017, which would be reduced to 5.2% in 2018, given the vulnerabilities with which the economy is faced and an economic policy geared more towards ensuring financial stability than maintaining growth. Thus, global growth should increase slightly from 3.0% in 2016 to 3.2% in 2017 and 3.3% in 2018.

Despite this acceleration, the outlook for 2017 and 2018 is plagued with uncertainty, which mainly stems from the new US administration's economic policy. So far, the promises of tax breaks, deregulation and an ambitious infrastructure plan have been well received by the capital markets against a background of low risk aversion. However, threats of protectionism and the anti-migration stance adopted by the new US President introduce a bias of downside risks. There is also the risk that fiscal stimulation policies will not affect growth and will cause an unexpected increase in inflation, which in turn could lead the major central banks to adopt a tighter monetary policy with global consequences.

This uncertainty surrounding the new US administration is exacerbated in the case of Mexico. The economic scenario in Mexico has become more adverse since the unexpected result of the US elections in November, although there is a lot of uncertainty about how strong this adversity may be. Mexico's prevailing growth model over the last two decades is certainly at risk from the new President's avowed threat to modify commercial relations. However, despite the importance of this issue, the final effects on the economy will depend on to what degree trading conditions will change between the two countries. As things stand, considering that the prevailing commercial treaties are beneficial to both countries, we believe the most likely outcome is that these effects will end up being only cyclical and not structural. However, the threat alone and the uncertainty it causes have already had negative impacts on market variables, and as a result 2017 will be a challenging year.

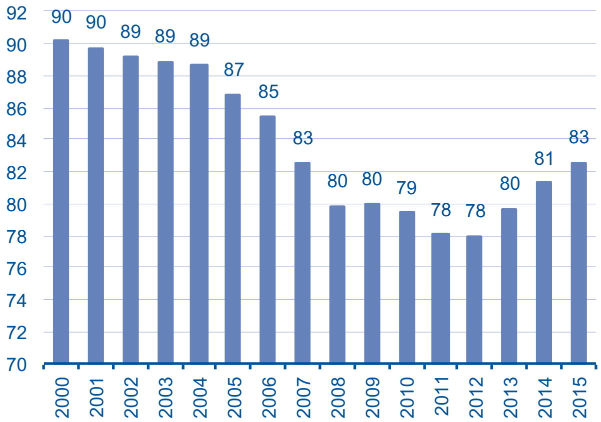
Financial variables have already factored in this degree of uncertainty about the possible scenarios for the future performance of the Mexican economy. The exchange rate has depreciated substantially since the election, down to 20 pesos per dollar. Other effects mainly of this depreciation were increased implicit inflationary expectations on the bonds market, immediately prompting an expected more restrictive monetary policy and an increase of up to 100 base points in yields on long-term sovereign bonds.

With this new depreciation in the exchange rate and liberalisation of petrol prices, inflation rose above 4.0% and this trend is expected to continue until it reaches 6.0%. While for the time being it has not had any knock-on effects on prices, there is more risk that they will be observed from now on. Logically enough - given its single mandate of price stability - the central bank began the year with a 50 bp hike in its official policy rate and it is expected to continue to tighten so as to anchor inflationary expectations and to avoid the knock-on effects in prices, until it reaches a rate of 7.50% at the end of the year. In short, more austere financial conditions are expected this year.

The changes we have described in nominal financial variables are expected to be mainly fed through by consumption to economic performance. Higher inflation will lead to less purchasing power, which, coupled with the rise in interest rates, will push down private consumption. On top of that, with the lower expected investment due to the uncertainty about US/Mexican commercial relations, it is likely that a good part of aggregated demand will see lower growth than it did in 2016. The external sector, however, would be expected to show a good performance. Aside from the question of commercial relations, Mexican exports are expected to improve in tune with higher growth in the US economy, although such growth will not suffice to offset the fall in the other components, so we estimate the economy will grow by 1.0% during 2017.

Figure 1.1

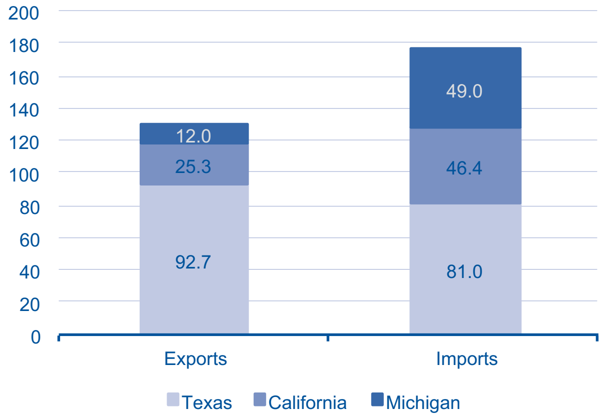
Non-petroleum exports to the US. (% of total non-petroleum exports)



Source: BBVA Research with INEGI data

Figure 1.2

Trade of selected U.S. states with Mexico (USD billion)



Source: BBVA Research with US Census data

Clearly, this scenario is not the very promising, but, crucially, taking into account the information we now have at our disposal, the most likely outcome is that the effects of the policies adopted by the new US President on the Mexican economy will be cyclical and not structural. This assertion is based on the fact that the close commercial relations between Mexico and the US are beneficial to both countries. Total exports and imports between these two countries total US$525 billion, and the way they are integrated through value chains makes North America one of the most competitive regions worldwide. 16% of US exports are to Mexico, making it the second most important importer of US products, behind only Canada. In fact, Mexico is the most important trade partner of states such as California, Texas and Arizona, and the second most important one for twenty other US states. California and Texas are the two most important states in economic terms. The US has the largest trade deficit with China, not with Mexico, amounting to US$347 billion, 5.5 times as high as the deficit with Mexico.

In short, we believe that the commercial relations will not be destabilised because it is not in the interests of either country. Accordingly, we expect the adverse effects seen at present to be a short-term phenomenon and that they will fade away in the future. In fact, based on the expectations described and less uncertainty looking forward, we believe that the modest growth of 1.0% this year will be followed by recovery in 2018 with 1.8% growth.

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Mexico Economic Outlook
First Quarter 2017

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