1. In summary

The general improvement in consumer confidence data, the growth in world trade and, above all, the uptick in investment in China thanks to the monetary and fiscal stimulus measures taken there in 2016, are the main factors behind the acceleration in economic activity during the first few months of the year. We expect worldwide growth to be 3.3% in 2017 and 3.4% in 2018, in both cases 0.1 pp higher than our previous forecasts.

One of the main characteristics of the improved performance of the world economy is without doubt the consolidation of the recovery in the US. Although the likelihood of the new administration's being able to implement fiscal reform and of this having a positive effect in the short term has declined, the economy continues to grow above its potential, supported by the acceleration of investment and a labour market that is close to its full employment level. So, the US economy is expected to grow by 2.3% this year and 2.4% in 2018.

The solid growth of the US economy, together with the recent statements by several high-ranking officials in the Trump administration in favour of a sensible renegotiation of the North America Free Trade Agreement (NAFTA), make the economic panorama for Mexico less gloomy than it was at the beginning of the year. In January it seemed likely that NAFTA would come to an end or that there would be significant increases in tariff and non-tariff barriers to Mexican exports to the US. This likelihood is now greatly reduced in our opinion. In fact, our baseline scenario, to which we assign a 70% probability, is that NAFTA will be renegotiated and that the results will be beneficial for all three countries involved.

Mainly as a consequence of this, but also based on greater dynamism in external demand, we are revising our growth forecasts upwards, from 1.0% to 1.6% for 2017 and from 1.8% to 2.0% for 2018. The revision for 2017 is supported by three factors: a) improved performance by the external sector. We expect the US manufacturing sector to post significant growth this year, which will be reflected in renewed dynamism of Mexican exports, which we estimate will grow at an annual rate of 4.5%.; b) an upward revision of GDP growth figures for the second half of last year and higher-than-expected growth in 1Q17. These changes produce a positive base effect for growth in the first quarter of the year; and c) a less restrictive monetary policy than we were anticipating in January as the downward pressures on the peso ease.

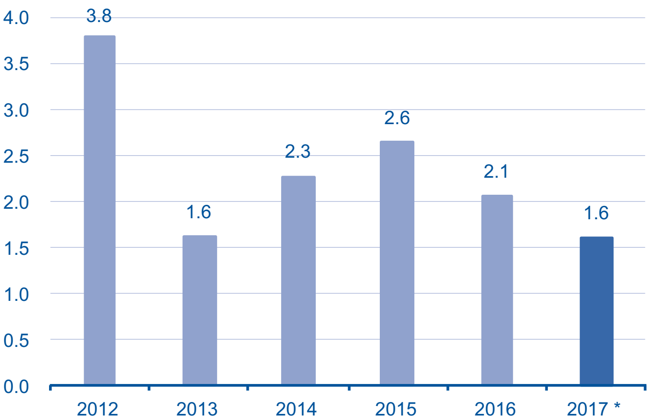
The domestic financial variables also reflect the shift towards a less gloomy panorama. The peso has appreciated significantly - by nearly 15% - since Donald Trump took office, the biggest currency appreciation worldwide. The improved prospects of a NAFTA 2.0 reduce the probability of our seeing falls like those at the beginning of the year. Largely in connection with this appreciation, implied inflationary expectations on the bond market have shown a significant downward trend, which has translated into expectations of a less restrictive monetary policy and a decrease of more than 50 bps in yields on long-term government bonds compared to the beginning of the year.

Given this significant appreciation of the peso, we have moderated our forecasts of increases in inflation, although it will continue to increase, reaching 6.0% during the summer. We expect it to start falling in 4Q17, ending the year at around 5.6% (0.4 pp less than forecast in January). In January 2018, a highly favourable base effect will allow a decline of 1.2 pp to 4.4%, and from February of that year we expect to see a gradual downward trend, with inflation ending the year slightly below 4.0% (3.9%), within the central bank's target range.

Based on these prospects for inflation, and in the absence of generalised second-order effects, the end of the cycle of monetary tightening is closer and will be reached at lower levels than we expected in January. In short, we expect less restrictive financial conditions than we did at the beginning of 2017.

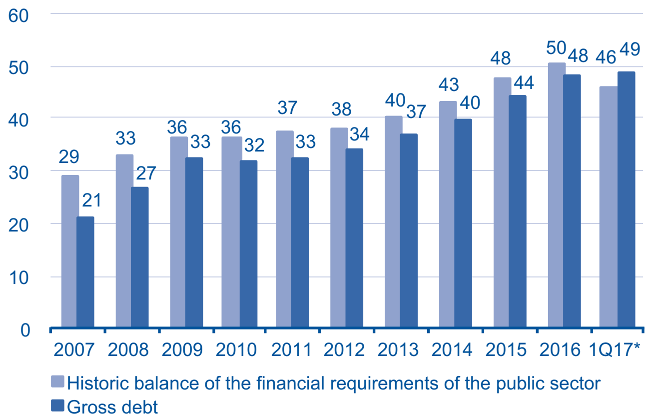
As regards public finances, the efforts made towards fiscal consolidation over the course of the year and the central bank's operating surplus will allow a primary surplus of at least 0.5% of GDP to be achieved and the ratio of public sector debt stock (SHRFSP) to GDP to stop growing in 2017. Meeting these objectives will go some way towards ensuring that the rating agencies do not downgrade Mexico's sovereign debt rating. Nevertheless, the federal government will have to continue with a policy of containing programmable expenditure in view of the pressure that will continue to be exerted on public finances by spending on pensions, payments to states and municipalities and the cost of the debt in the coming years.

Figure 1.1 Quarterly GDP (Chge. % QoQ and YoY, sa)



p= preliminary; sa = seasonally adjusted. * 2017 = estimated
Source: BBVA Research based on information from INEGI (National Statistics Institute).

Figure 1.2 Gross debt and public sector financing requirement* (as % of GDP)



* To calculate total debt stock and public debt we used the preliminary GDP figure for the first quarter and a GDP deflator of 5.2%.
Source: BBVA Research based on Ministry of Finance and INEGI data

The improvement in the panorama strengthens our expectation expressed three months ago as regards the high probability that the effects of the current US administration's economic policies on the Mexican economy would end up being cyclical rather than structural. Nonetheless, the risks have not dissipated entirely, and we now face a long period of trade negotiations in which the various players' statements may bring an end to the favourable conditions experienced in the past few months. Also, geopolitical risks and fluctuations in the prices of commodities and financial assets could lead to renewed bouts of uncertainty and volatility for the Mexican economy.

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