1. Summary

The positive global environment has firmed up in the past few quarters. Our new forecasts suggest that global growth is picking up pace to 3.4% in 2017-18, which implies an upward revision of around 0.2 pp this year and an acceleration from 3.2% last year. This change is due to higher growth forecast now for both China and Europe in 2017, on account of positive surprises in both regions since Q2. For the US we continue to project sustained growth of just over 2% at the forecast horizon. The factors underlying the gathering momentum and stability of world growth will remain present, even though some of them could gradually fade in the coming quarters. The most immediate will be the normalisation of monetary policy by both the US Federal Reserve and the European Central Bank, as it will lead to a gradual reduction in global liquidity and less support for capital flows into the emerging economies. On top of this, there are still a number of political risks that could influence economic confidence and the performance of the markets.

In an environment where growth remains spirited and with no inflation surprises on the downside, the central banks are pressing ahead with the gradual process of withdrawing monetary stimuli. Specifically, the US Federal Reserve has announced the start of the reduction of its balance sheet from October. This will take the form of a passive reduction, by allowing a portion of public and private bonds to simply expire, which has been clearly signalled, so that it has not led to any form of market unrest. Furthermore, the Federal Reserve still expects to implement a series of rate hikes, even though the markets have systematically shown themselves to be more dovish. We expect a 25 bps hike for official rates in December this year and then two further hikes up to 2% in 2018.

Mexico’s economy contracted in the third quarter of the year. The preliminary QoQ growth rate, annualised, was negative at 0.8%. This performance was due to reduced momentum in consumption, which in turn was due to the temporary increase in inflation, and to the falls in oil output and construction. Added to this slowdown was the negative impact of September’s hurricanes and earthquakes. For the last quarter of the year we anticipate an uptick driven in large part by the recovery of trade and the start of reconstruction work. With the growth data available so far we can already assert with a high degree of certainty that economic growth for 2017 will come in at between 2.1% and 2.2%. For next year, we estimate that the economy will grow at a similar pace to that of 2017. However, there are two risk factors to consider: the possibility of deteriorating trade relations between Mexico and the US, and the uncertainty surrounding the presidential elections in 2018. As for the public finances, we foresee the target primary fiscal surplus of 0.4% of GDP being attained. This, together with the Banco de México operating surplus will mean that debt as a percentage of GDP will fall for the first time in ten years. This substantially reduces the possibilities of a downgrade in Mexico’s sovereign rating.

Talks on NAFTA deteriorated in the fourth round, and the path towards “NAFTA 2.0” became much more challenging. The US put forward proposals that were unacceptable to the other parties, as well as once again stressing its intention to reduce its trade deficit. A unilateral withdrawal from NAFTA by the US can no longer be ruled out. In fact, although we continue to assign a probability of more than 50% to a positive outcome of the talks (“NAFTA 2.0”), this is less than the 85% we had been ascribing to it until September. In other words, the probabilities of agreement and breakdown are now more evenly balanced in our opinion. That said, as we have shown in numerous earlier editions of Mexico Economic Outlook, if the US acts in accordance with its economic interests it should keep the agreement in place.

This context has been reflected in the exchange rate. The peso's depreciation since mid-August is due to the risks associated with NAFTA. The peso's poor relative performance started with the first round of talks on NAFTA 2.0, was unaffected by more hawkish comments from the US Federal Reserve, and was accentuated in October with the increased risk of NAFTA breakdown. Looking ahead, any change in trend will continue to be mainly in reaction to shifting prospects for the renegotiation of NAFTA.

We estimate that an end to NAFTA would not have an across-the-board effect on trade flows, since the weighted average import duty faced by Mexico's exports to the US under WTO most favoured nation (MFN) rules would be 3.5%. Nonetheless, it would certainly have a negative effect on investment and on particular sectors such as the production of vehicles for transporting goods (lorries/trucks). This segment accounts for 6.1% of total exports from Mexico to the US, and would face a 25% import duty under the WTO's MFN regime.[1] Thus we envisage that the elimination of the agreement would affect economic growth mainly through a fall in FDI in the heavy automotive (truck) sector and a decline in private domestic gross fixed investment in related sectors. Assuming a fall of 7.4% in FDI and a decline in domestic gross fixed investment of between 2% and 4%, we estimate that the ending of NAFTA would have a negative effect on GDP growth in 2018 of between 0.5 and 0.8 pp.

Another potential risk on the horizon is the proposed tax reform currently being discussed in the US, involving a cut in corporation tax from 35% to 20%. In Mexico this rate is 30%. Two pertinent questions arise in this respect: What effect will it have on US FDI into Mexico? Should the Mexican government respond by cutting its corporation tax rate too? Our analysis indicates that even if this tax cut were to be implemented in the US, Mexico would still have a more competitive manufacturing base. For this reason, we consider that Mexico should not respond by cutting its corporation tax rate. In the event that the Mexican government did decide to cut the rate from 30% to 20%, tax revenues would show an annual contraction of 16.9%, equivalent to 1.2% of GDP.

Lastly, inflation is at last declining. Having shown a rising trend for fourteen months in a row, headline inflation peaked in August at 6.7% and reached an inflection point in September (6.35%), as we had been anticipating since the beginning of the year. Thus, while the balance of risks for inflation has deteriorated because of the peso's recent depreciation and the risk of further depreciation, it is increasingly clear that inflation is evolving as anticipated by the central bank and, in our opinion, will quickly approach the target range (3.0% +/- 1 pp) in the first half of 2018. We forecast that inflation will end 2017 at 6.2% and for closing 2018 will be below 4.0% (at 3.7%), within the central bank's target range. The risks for inflation have an upward bias, but are moderate. Although we still expect the next interest rate move to be downwards, the context and the recent communication of Banxico (Banco de México, Mexico's central bank) make it clear that this is still some way off. Therefore we consider that in the most likely scenario Banxico will keep its monetary policy on hold until the third quarter of 2018, when it will start to reduce its key rate.

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