Mexico's Macro Matters

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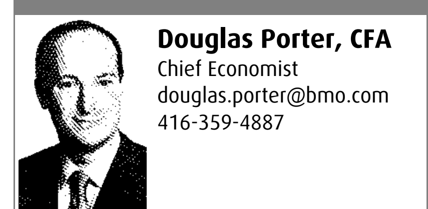
Mexico's underlying economic performance has been overshadowed in the past year by the NAFTA negotiations and by the July 1 elections. With the latter now out of the way, here's a look at what incoming President Lopez Obrador will be dealing with on the economic front, along with the mounting trade uncertainties. In a nutshell, it's a backdrop of cooling growth, high (but moderating) inflation, rising interest rates, a volatile/weak peso, and auto production that has doubled in a decade. Combined with the messy trade outlook, it's fair to conclude that for the Mexican economy: It's complicated.



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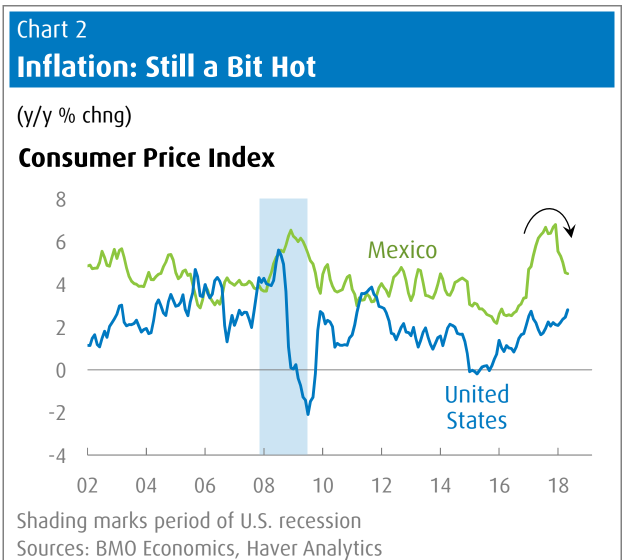
Growth: Real GDP rose at a 2.3% y/y pace in Q1 (on a seasonally adjusted basis), versus a recent peak of just over 3% in late 2016. Rising interest rates and NAFTA uncertainty have dulled growth, although domestic demand remains solid. In particular, real consumer spending is clicking along at a 3.5% y/y pace. Private capital spending popped in Q1, but this followed an outright decline (-0.5%) for all of 2017 amid the trade talks. From a big-picture view, the Mexican economy tends to track the U.S. very closely *(Chart 1)*—the high correlation between the two countries' GDP growth rate over the past 20 years (0.77) is eerily similar to the figure between the U.S. and Canada. This is a relatively new development, as there was almost zero correlation between U.S. and Mexican GDP prior to the 1994 NAFTA deal. However, given the uncertain near-term future for trade, we are likely to see a notable divergence over the next year, with Mexico expected to underperform U.S. growth by at least half a point.

Chart 1
Mexico GDP: Look Familiar?

Shading marks periods of U.S. recession
Sources: BMO Economics, Haver Analytics

Inflation: After peaking at almost 7% late last year, Mexico's headline inflation rate has eased to a still-meaty 4.5% y/y pace (and 3.7% for core CPI). Given that the Bank of Mexico aims to keep inflation within 1 point of a 3% target, these trends are still on the uncomfortably high side. After staying nicely within the target zone for years, inflation punched higher in late 2016 and early 2017 as the peso swooned and as gasoline prices spiked when government subsidies were cut *(Chart 2)*. With those factors largely falling away, both headline and core inflation have receded markedly in 2018. From a big-picture view, inflation is now close to its 4% average over the past 15 years—a period that has seen Mexico's CPI running roughly 2 percentage points faster than the U.S. rate. Still, that's a massive improvement from earlier decades, when Mexican inflation topped 50% as recently as 1996, and peaked at 180% in 1988, aka the bad old days.

Chart 2
Inflation: Still a Bit Hot



Shading marks period of U.S. recession
Sources: BMO Economics, Haver Analytics

Interest Rates: The high-side inflation readings in recent years have prompted the Bank of Mexico to aggressively tighten, more so even than the Fed. From a low of 3.0% in 2015, the Bank has cranked its overnight rate by a cumulative 475 bps. While the Bank initially matched the first rate hike of the cycle by the Fed, it has since acted much more forcefully in the face of the deep drop in the peso and the ensuing inflation jump, especially through 2016.

However, over the past year, Banxico has essentially matched the FOMC step-for-step, including a 25 bp hike in June *(Chart 3)*. Still, similar to the inflation story, the rate environment is in a different world from 20 or 30 years ago, when rates peaked as high as 50% in the 1990s or more than 100% in the 1980s.

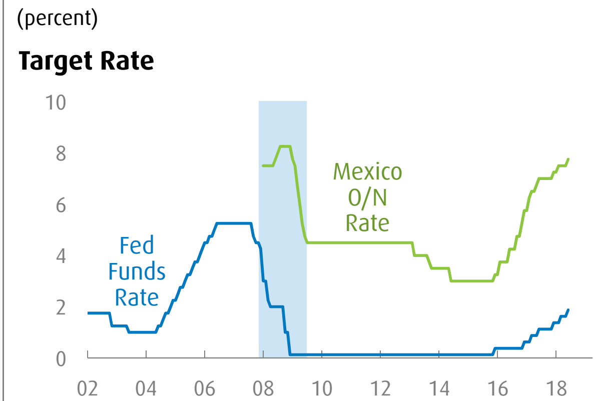
Exchange Rate: The big-time tightening by the Bank of Mexico has helped support the peso, after it fell heavily through the 2015-16 period. The peso hit rock bottom shortly after the 2016 U.S. election, at one point almost touching 22 pesos/US$—a 40% depreciation in under three years *(Chart 4)*. Since 2017, the currency has swung violently on shifting NAFTA tides and in the lead-up to the July 1 elections. As it became increasingly clear that Lopez Obrador would win, and as NAFTA prospects dimmed, the peso sank heavily through the spring. However, the market reaction to Obrador's post-election comments on the economy and trade was one of relief, and the peso has recouped half of those spring losses. The *big-picture view* is that the currency remains nearly 40% weaker than just five years ago against the U.S. dollar. On a real trade-weighted basis, it stands roughly 20% below its long-run average. (For comparison, the Canadian dollar is now about 5% below its long-run mean on the real effective exchange rate.)

Trade: In a classic case of unintended consequences, the highly competitive level for the peso has further supported Mexico's trade position. In other words, Trump's tough trade rhetoric, much of which has been trained on Mexico, has played a big role in pounding the peso in recent years, which in turn has aggravated the underlying trade irritant. Mexico's bilateral trade surplus on goods with the U.S. has widened above US$71 billion in the past 12 months *(Chart 5)*, about $10 billion more than during the 2016 U.S. election campaign (when Trump threatened a 35% tariff on Mexico). Note that including services doesn't change the picture in a big way, as the gap is still close to $70 billion (whereas the U.S. now runs a small surplus with Canada on goods and services). As an aside, Mexico also runs a large trade surplus with Canada—it hit a record C$12 billion in the past 12 months (or more than 0.5% of Canadian GDP, versus Mexico's imbalance with the U.S. which clocks in at 0.4% of U.S. GDP.) But from a *big-picture view*, even with the hefty trade surpluses with its NAFTA partners, Mexico still runs a moderate current account deficit overall (1.3% of GDP in the past four quarters).

Auto Production: There is zero doubt or debate about what generates Mexico's sizeable trade surplus with the U.S. (and Canada)—the auto industry. Over the past 12 months, Mexico has run a US$83 billion surplus with the U.S. in cars, trucks, and parts, split almost evenly between those three categories. Autos & parts alone account for more than the entire bilateral trade imbalance, as the U.S. runs a $14 billion surplus on other goods and services. This reflects the dramatic ramping up of the Mexican auto sector, which

Chart 3
Rates Rising: Faster than the Fed

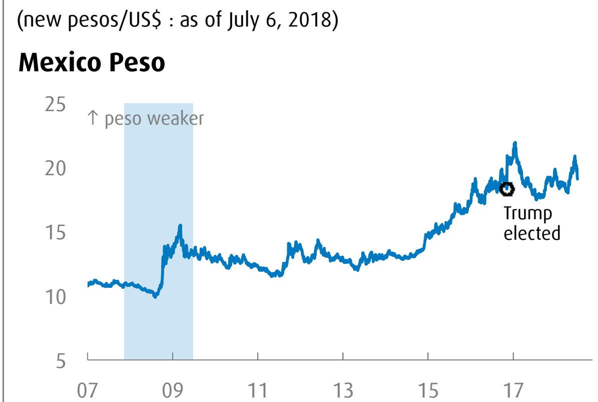
(percent)



Shading marks period of U.S. recession
Sources: BMO Economics, Haver Analytics

Chart 4
Exchange Rate: US$ Cost Rising

(new pesos/US$: as of July 6, 2018)



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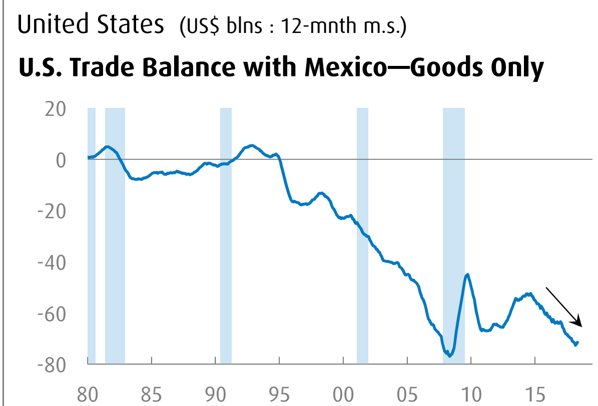
Sources: BMO Economics, Haver Analytics

Chart 5
Bilateral Trade: The Sticking Point

United States (US$ blns : 12-mnth m.s.)



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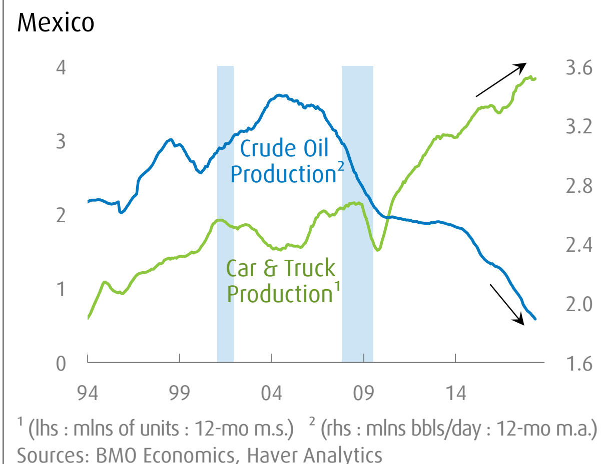
Sources: BMO Economics, Haver Analytics

has seen production triple in the past two decades—from roughly 1 million vehicles per year in the mid-1990s to more than 3.8 million now. In a sense, autos have supplanted petroleum as Mexico's chief industry and export, as oil production has plunged by more than 40% from its 2004 peak of 3.4 million bpd to less than 1.9 million today *(Chart 6)*. Curiously, that drop in oil production has been almost offset barrel-for-barrel by rising Canadian production, even as Mexican auto production has more than offset falling Canadian assemblies.

Bottom Line: It would be overly dramatic to conclude with *"Live by NAFTA, die by NAFTA"*, and too trite to say *"Ob-la-di, Obrador, life goes on"*. But there's no doubt that the Mexican economy has become much more tightly integrated with the U.S. economy—and thus much more stable—in the wake of NAFTA, largely thanks to a thriving auto sector. But that very success has fuelled the U.S. Administration's key gripe with the 25-year old trade deal, and is clearly at risk in a world threatened by U.S. auto tariffs.

Chart 6
Oil Change for Mexican Economy



[1] (lhs : mlns of units : 12-mo m.s.) [2] (rhs : mlns bbls/day : 12-mo m.a.)
Sources: BMO Economics, Haver Analytics

Lopez Obrador's Nationalist Agenda

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Lopez Obrador achieved the biggest margin of victory in a Mexican presidential election in recent history. More importantly, the better-than-expected results for his coalition in the Congressional elections—61% in the Chamber of Deputies and 53% in the Senate—indicate a very strong mandate for the incoming administration and significant leeway to implement its policy agenda. The new president may even be able to muster support for Constitutional reforms, which require a two-thirds majority in both houses, from smaller left-wing opposition parties. Such amendments also require the approval of half the state legislatures, of which Lopez Obrador's party is now expected to control 19 of 32, having won five of the nine simultaneous gubernatorial elections. While policy details are scant at this point and economic conditions could change before the new administration takes office in December, Lopez Obrador has pledged to:

- Reduce poverty and inequality by increasing spending on social programs (targeting pensions, higher education) and infrastructure and raising the minimum wage.
- Find savings worth some 2% of GDP by reducing public sector inefficiencies and fighting corruption, and avoid raising taxes or the debt burden.
- Revitalize the state oil company Pemex, build oil refinery capacity, intervene more heavily in the financial sector and provide support for the agricultural sector through farming subsidies.
- Review existing contracts awarded to private/foreign oil and gas firms amid corruption concerns and freeze new offshore exploration auctions. However, he is unlikely to pursue a full-scale reversal of the 2014 energy sector reform given the expected hit to investment.
- Uphold NAFTA and remain consistent with the current administration's negotiating stance, though he may seek to shift focus and bring new issues to the discussion table (i.e., labour, agriculture).
- Respect the independence and integrity of the central bank and the rule of law.

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