

ECONOMIC VIEWPOINT



Mexico's Economy: Calm Within the Storm

The Future Remains Highly Uncertain

For Mexico, 2017 was a year with a lot of upheaval. Despite everything from natural disasters to the U.S. protectionist threats, the country still saw its real GDP increase by 2.0%. Even though the economy remains stable, the political instability in its relations with its northern neighbour and the looming Mexican federal election in July penalized investment. However, other factors could weaken Mexico's economy over the longer term.

The Election Could Bring On Some Changes

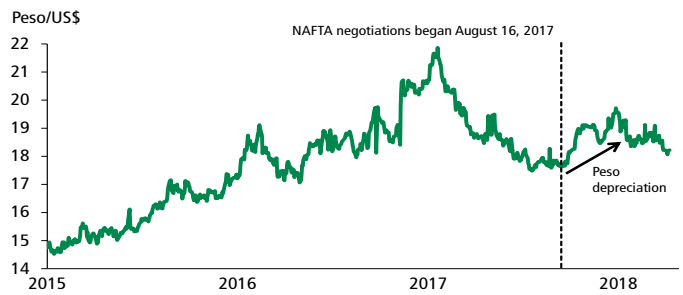
The Mexican federal election scheduled for July 1st, 2018 is adding its share of uncertainty for the country's economy. José Antonio Meade, the candidate for the ruling Institutional Revolutionary Party (PRI), is running third in voting intentions. The PRI's multiple corruption scandals and failure to decrease the violence associated with organized crime have sharply eroded the party's popularity. For now, the candidate representing the National Regeneration Movement (Morena), Andrés Manuel Lopez Obrador, leads in the polls. As a left-wing candidate, his election promises primarily emphasize on reducing crime and violence, fighting corruption, fostering youth employment, and reallocating investment in a new international airport in Mexico to social programs. Commonly referred to as AMLO, Andrés Manuel Lopez Obrador is also known for his opposition to privatization reforms, especially in the energy sector. Although close advisors say he will not overturn the 2013 energy reforms, AMLO himself has not confirmed that. There is also a risk he could block future auctions of oil companies and delay the progress made.

Relations with the United States Are Becoming More Complex

The election also comes in the middle of the North American Free Trade Agreement (NAFTA) renegotiation, which could become even more complicated if AMLO wins, given his criticism of the agreement and how the United States has been treating Mexico. He is unlikely to take Mexico out of the agreement, but he would want to make major changes in Mexico's favour. This is also why the three NAFTA members are trying to speed up the process. The risk of a NAFTA cancellation is also generating

a lot of concern in Mexico. The Mexican peso's weakness since a U.S. withdrawal has become increasingly likely illustrates investors' greater pessimism about Mexico's economy (graph 1).

GRAPH 1
The fears surrounding NAFTA negotiations pulled the Mexican peso down against the U.S. dollar



NAFTA: North American Free Trade Agreement
Sources: Datastream and Desjardins, Economic Studies

The agreement is important mostly because Mexico's economy is now heavily integrated into that of its northern neighbour. In 2017, 80% of Mexico's exports went to the United States; over 90% of these exports were from the manufacturing sector. The auto industry alone accounted for over one third of Mexico's exports to the United States. If the United States dropped NAFTA, average tariffs of 3.1% in the United States and 10.5% in Mexico could be imposed on automotive products. Given that the two countries' production chains are heavily integrated, this would be a major curb on investment and the Mexican labour market.

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According to a [study conducted by Moody's](#), Mexico would stand to lose the most if the agreement was cancelled, but the impact on the economy as a whole should not be catastrophic. Moody's projects that economic growth would slow compared with a baseline scenario that includes NAFTA, without going into recession. On the one hand, manufacturing wages are much lower in Mexico, at just 10% of comparable wages in the United States. The peso's weakness against the greenback gives Mexico another advantage. Note, however, that the simulation was done prior to the U.S. tax reform that gave companies somewhat of an advantage for producing in the United States.

On the other hand, Mexico has made an effort to become less dependent on the United States. Recently, it broadened its trade horizons, signing the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP); it has 11 other free trade agreements, as well. It is also in the process of modernizing its Global Agreement with the European Union to include clauses on investment and services; negotiations have also begun with Argentina. Surprisingly, despite NAFTA, international trade between Mexico and Canada remained low in 2017, with Canada accounting for less than 3% of Mexico's exports and imports. However, the two economies seemed heavily integrated in the auto sector as it accounted for nearly one third of Mexico's exports to Canada.

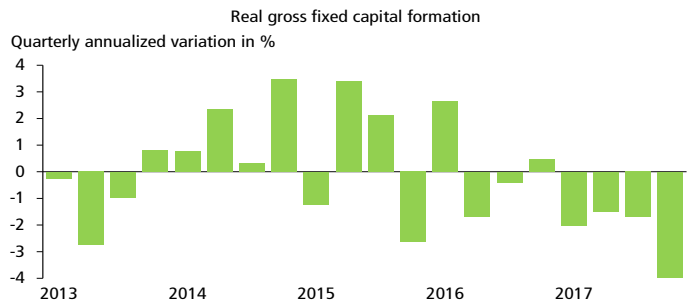
An Economy That Is Performing Nevertheless

Despite the instability generated by U.S. protectionist threats and the election scheduled for July 2018, Mexico's economic growth remains at a relatively strong 2.0% for 2017, which is still slower than 2016's 2.9% gain. The country was hit by hurricanes and earthquakes in September, which certainly sapped growth: GDP contracted at an annualized rate of 0.7% in the third quarter of 2017. Even though Mexico's economic situation remains highly uncertain, the International Monetary Fund (IMF) increased its economic growth forecast. It is expecting growth of 2.3% in 2018 and 3.0% in 2019.

The myriad uncertainties hurt investment the most. Gross fixed capital formation posted an annual contraction of 1.5% in 2017 (graph 2). Natural disasters destroyed capital in September, but that is not the only reason for the contraction, as investment was still declining three months later. This suggests that a lack of confidence in Mexico's economy is to blame. For its part, the flow of foreign direct investment in Mexico did not change much from 2016, declining 0.2%. The manufacturing sector posted the biggest pullback in terms of foreign direct investment. On the other hand, trade, transportation and construction went up substantially. The fears surrounding NAFTA's future were the main drag on investment in manufacturing.

For their part, natural disasters and Donald Trump's threats do not seem to have discouraged consumers, although confidence slightly retreated in 2017. It was another good year for private consumption, which increased 3%. This component helped

GRAPH 2
The uncertainty in U.S.–Mexican trade relations may have penalized investment in Mexico

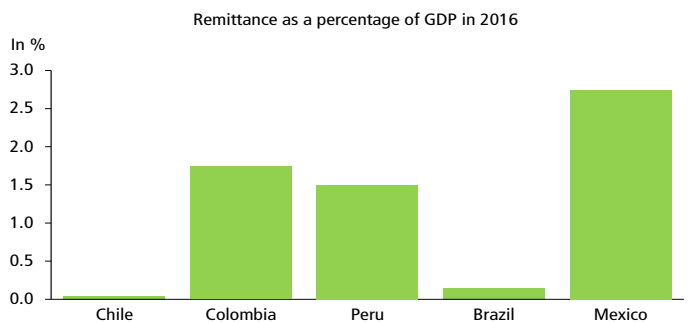


Sources: Instituto Nacional de Estadística, Geografía e Informática and Desjardins, Economic Studies

support strong economic growth as it represented two thirds of GDP. Note that consumer credit has been growing much more quickly than disposable personal income. This major trend seems to result from households' greater inclusion in the financial system, rather than being a sign of excess debt. According to a government study, the percentage of the adult population with at least one chequing or savings account at a formal financial institution went from 36% in 2012 to 44% in 2015.

One noteworthy fact about Mexico's economy is that a substantial proportion of household income comes from remittances, primarily from workers established in the United States. They represented about 2.5% of GDP in 2017, much more than the ratios in other countries in Latin America (graph 3). To illustrate, remittances exceeded the value of oil exports by nearly US\$9B in 2017. President Donald Trump threatened to impose a tax on these transfers, creating some concern.

GRAPH 3
Remittances are an important component of Mexico's economy



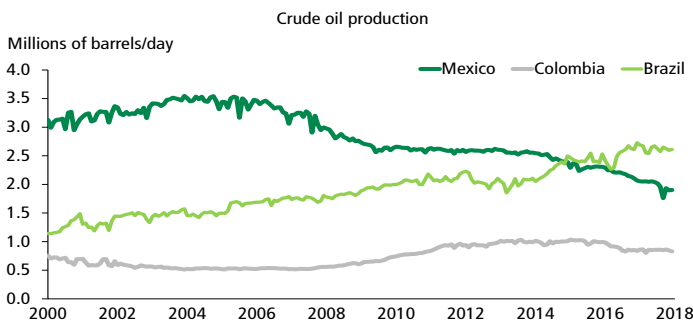
Sources: World Bank and Desjardins, Economic Studies

The Oil Industry Is Still Dragging

Unlike other countries, like Canada and the United States, Mexico has not been able to increase its oil output to capitalize fully on the 2017 surge in oil prices. In fact, investment has

been weak for several years, penalizing the sector's productivity heavily (graph 4). However, this situation should not last, as the 2013 industry reform, which privatized the sector and opened the door to foreign investors, is starting to pay off. There were several major discoveries in 2017, including one that is among the largest in the world since the last decade. However, Mexican crude oil production is expected to decline for a few more years until the new finds can be exploited.

GRAPH 4
Mexico's oil industry is less and less productive

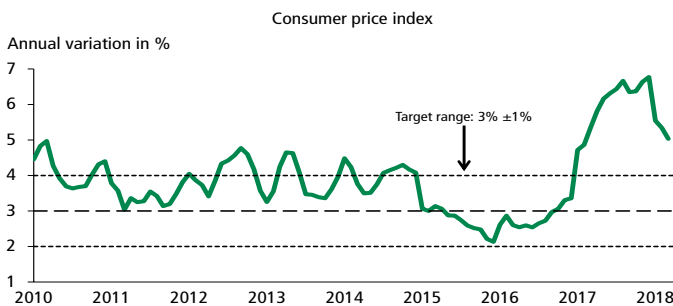


Sources: Energy Information Administration and Desjardins, Economic Studies

Inefficient Monetary Policy

Inflation has been oscillating close to the target range for several years, but the Bank of Mexico seems to have lost control recently, as the annual change in the consumer price index is significantly above the 3% target (graph 5). This prompted the Bank of Mexico to raise its key rate quickly; it went from 3.25% in January 2016 to 7.5% recently. Inflation has slowed lately, dropping from 6.8% in December 2017 to 5.0% in March, but whether the trend will continue remains to be seen. The higher interest rates should put pressure on household consumption, as well as on the Mexican government's finances. The government has cut spending due to the weight of the public debt, which hit a high of 58% of GDP in 2016. The debt ratio fell to 53%

GRAPH 5
Mexico's total inflation jumped to more than twice the central bank's target rate



Sources: Instituto Nacional de Estadística, Geografía e Informática and Desjardins, Economic Studies

in 2017, but rising interest rates could hurt Mexico's capacity to pursue this consolidation.

Uncertainty Is the Main Factor Reining In Mexico's Stock Market

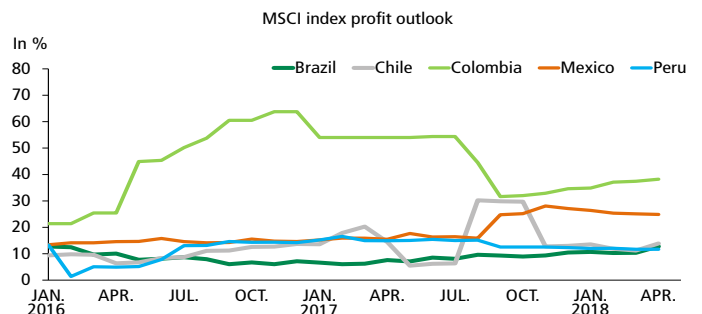
In contrast with other Latin American countries, the Mexican stock market has not risen in the last two years. The Mexican stock market's main index, the S&P/BMV IPC, barely changed relatively to April 2016, while the Brazilian, Chilean, Peruvian and Colombian stock markets have all increased (graph 6). Fears about relations between Mexico and the United States since the 2016 U.S. election campaign have certainly been a drag on Mexican assets. The NAFTA renegotiation is going fairly slowly, which should also generate uncertainty within the stock market until they are resolved. The Mexican peso's sharp depreciation has also hurt the stock market. However, the peso should rise as the economy gains steam, inflation falls, and uncertainty over relations with the U.S. and the Mexican federal election wanes. The MSCI index's price-earnings ratio for Mexico's stock market has been on a clear downtrend since 2017, dropping from 21.0 to 17.5 in one year. Nevertheless, the longer-term outlook has improved, with expected profit growth going from 15% in January 2017 to 25% lately, largely exceeding other economies in the region (graph 7).

GRAPH 6
The erosion of U.S.–Mexican relations affected Mexico's stock market



Sources: Datastream and Desjardins, Economic Studies

GRAPH 7
Expectations of long-term growth for Mexican stock market profits have increased



Sources: Datastream and Desjardins, Economic Studies

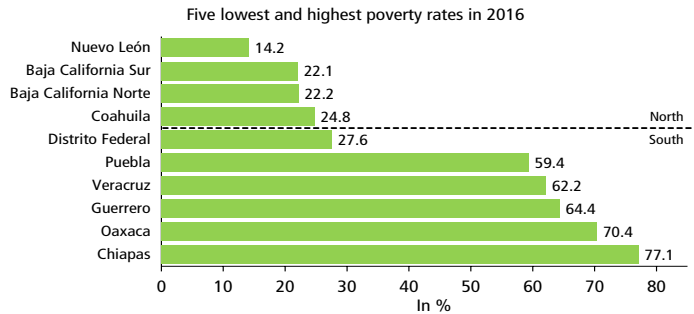
Some Problems Persist...

Worker's Integration

Mexico's labour market is disproportionate. Although its unemployment rate is substantially lower than its peers', at 3.4% in 2017 according to International Labour Organization (ILO) numbers, its participation rate remains very low (graph 8). Moreover, some groups seem to have more difficulty entering the job market. According to the ILO, women aged 15 and older had a participation rate of just 43% in 2017. In comparison, Peru (62.5%), Colombia (57.5%), Brazil (52.7%) and Chile (48.7%) were doing better in this area.

GRAPH 9

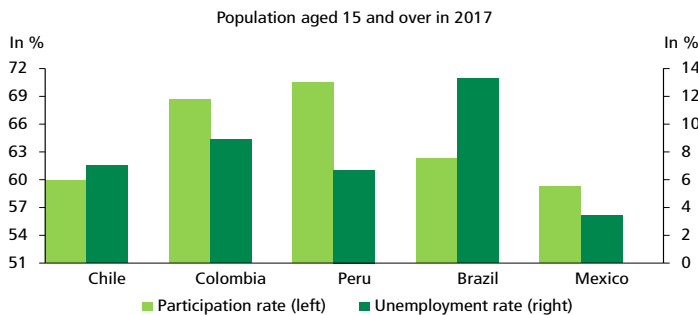
Mexico has large regional disparities



Sources: Instituto Nacional de Estadística, Geografía e Informática and Desjardins, Economic Studies

GRAPH 8

Mexico's low jobless rate hides the fact that few people are in the labour market



Sources: International Labour Organization and Desjardins, Economic Studies

Inequality

Mexico has a fairly sharp divide between the richer industrialized north and the poorer agricultural south. Moreover, national GDP per capita looks pretty high for an emerging country, at US\$19,500 in 2016, but this does not accurately represent the poverty faced by many Mexicans. In 2016, the national poverty rate¹ was 44%; it ranged from 15% in the state of Nuevo León, close to the U.S. border, to 77% in Chiapas, in the south (graph 9). All of the states with poverty rates higher than 40% were in southern Mexico; these were also the states with the biggest populations.

Corruption

Corruption is one of the central themes of the current election; the public views the ruling party as corrupt and self-interested. Transparency International's Corruption Perceptions Index ranked Mexico 135th out of 180 countries in 2017, with only 4 other countries in the Americas doing worse, including Venezuela (it came in 169th). Its score has also deteriorated substantially since 2014.

Criminality

Mexico continues to grapple with the violence associated with organized crime. Despite the government's war on narcotics, the arrest of several heads of drug cartels left a vacuum that new players are trying to fill. It is hard to measure the scope of illicit drug-related activity. One measure, although not perfect, would be the number of seizures, which has gone up since 2012. On the one hand, this reflects the effort the government has made to stop these activities; on the other, it shows the trend in the illegal drug market. In 2017, the homicide rate per 100,000 inhabitants was 17.9, much higher than the other members of the Organisation for Economic Co-operation and Development (OECD). This adds to the problems of inequality, as the poorest do not have the means to protect themselves from organized crime, and are often more prone to being recruited.

Conclusion

Although shaken by instability, Mexico's economy seems resilient. A lot of uncertainty persists, however, which should continue to drag on its performance. Mexico has made a lot of progress in the area of economic and social development, but still faces many challenges before it can achieve the stability seen in more developed nations.

Carine Bergevin-Chammah, Economist

¹ A person is characterized as poor if he or she has at least one social deprivation (with respect to the indicators for education, access to health services, access to social security, access to adequate housing, basic housing services, and food) and his or her wages are insufficient to cover the goods and services required to meet food and non-food needs.

BOX
Picture of U.S. and Canadian Trade with Mexico in 2017

In 2017, trade between Mexico and NAFTA's two other members primarily comprised manufactured products, particularly in the auto industry. Mexico was the United States' second biggest partner and Canada's third. However, Mexico's share of Canadian trade was only around to 5%. With the United States, it was close to 15%. Among the provinces, Mexico has a much bigger share with Ontario, comprising 5% of Ontario's trade; in contrast, it only had 2% of Quebec's. This is primarily due to the weight of the auto industry in Mexico and Ontario, as well as the integration of their production chains.

TABLE 1
The three largest export and import categories with Mexico in 2017

IN C\$M	EXPORTS TO MEXICO	IMPORTS FROM MEXICO
United States	Total goods: 315,545 Machinery and appliances for nuclear reactors: 55,669 Electrical equipment or electronics: 53,615 Mineral fuels: 33,899	Total goods: 407,819 Motor vehicles and parts: 108,605 Electrical equipment or electronics: 80,434 Machinery and appliances for nuclear reactors: 70,108
Canada	Total goods: 7,845 Motor vehicles and parts: 1,271 Grains, seeds and fruit: 941 Machinery and appliances for nuclear reactors: 768	Total goods: 35,491 Motor vehicles and parts: 12,036 Electrical equipment or electronics: 6,705 Machinery and appliances for nuclear reactors: 5,367
Quebec	Total goods: 1,755 Aluminium: 407 Iron and steel: 282 Motor vehicles and parts: 124	Total goods: 1,900 Motor vehicles and parts: 364 Aircraft, spacecraft: 346 Electrical equipment or electronics: 295
Ontario	Total goods: 3,208 Motor vehicles and parts: 1,145 Machinery and appliances for nuclear reactors: 625 Electrical equipment or electronics: 333	Total goods: 28,510 Motor vehicles and parts: 10,932 Electrical equipment or electronics: 5,433 Machinery and appliances for nuclear reactors: 4,423

Sources: U.S. Census Bureau, Statistics Canada and Desjardins, Economic Studies