Mexico

Factoring in the T factor

- **Mexico is in the frontline of the new US administration's swerve towards protectionism and anti-immigration policies.**
- **The Mexican peso has been heckled since Donald Trump's election, interest rates have climbed and the country's short-term economic prospects have been revised significantly downwards.**
- **Our simulations show that the implementation of Donald Trump's programme may lead to a contraction in Mexico's GDP in 2018.**

President Trump's rhetoric and his first protectionist and anti-immigration measures are a big source of uncertainty and concern for Mexico, given its dependence on the United States and its economic and financial openness, which lies at the core of its economic model.

The Mexican peso (MXN) has regained some strength since end-November 2016 but has depreciated by 8% since the 8 November election. CDS premiums on foreign-currency government bonds rose 50 basis points (bp) in just a few days before gradually easing to 134 bp on 2 March. The Mexican Stock Exchange's general index has also picked up, but it was still down 3% in the local currency and 10% in USD for the past four months. Yields on 5-year domestic bonds rose 130 bp over the period to 7.17%.

Under these conditions, Mexico's short-term economic prospects have been revised significantly downwards. The consensus forecast of economists for 2017 GDP growth was lowered from 2.2% in October 2016 to 1.4% in February's latest survey, while 2018 prospects were lowered from 2.8% to 2%, respectively.

Whatever the US decides, and even though it will probably take several months or even quarters before any policy changes actually materialise, the size of the negative shock on confidence and the wait-and-see behaviour of non-resident and local investors are likely to have a big impact on investment spending in Mexico in the months ahead. Consequently, investment is likely to contract in 2017. Already shaken by a big fuel price increase announced in January, household confidence is also expected to deteriorate, straining private consumption. Nor should we expect any support from economic policies. Fiscal policy is likely to remain relatively restrictive, as it has been over the past two years, against a backdrop of declining oil revenues and the financial difficulties of the state-owned company Pemex. Constrained by the peso's sharp drop and surging inflation, the monetary authorities are likely to tighten monetary conditions more severely than was expected just a few months ago, largely leading the Fed rather than following behind. Paradoxically, exports might end up being the only support factor for economic growth while awaiting the concretisation of US trade retaliation measures.

Impulse response of real Mexican GDP to external shocks (standardised at 1 percentage point)

	Real US GDP	US 10-year rates	Yield spreads	Real exchange rate MXN/USD
Q1	0.24	-0.11	-0.16	-0.13
Cumul Q1-Q4	0.86	-0.55	-0.81	0.09
Cumul Q5-Q8	0.12	-0.09	0.29	0.20
Cumul Q1-Q8	0.98	-0.63	-0.52	0.29

Table 1 Source : BNP Paribas

To estimate the concrete consequences that future US economic and trade policies could have on Mexico's economic performance, we used a vector auto-regression (VAR) econometric model to evaluate the effects of different external economic and financial shocks on economic activity in Mexico.

Our model can be written as follows *(for further details see Conjoncture of February 2017: "Mexico: US anchor called into question")*:

$$y_t = [\Delta y_t^{US},\ IR10_t^{US}, Spread_t\ , RER_t\ , \Delta y_t^{Mex}, IR_t^{Mex}]$$

where Δy_t^{US} is real US GDP growth, $IR10_t^{US}$ is the interest rate on 10-year US Treasury bonds, $Spread_t$ is the yield spread on 10-year Mexican government bonds in foreign currency, RER_t is the real exchange rate of the peso against the US dollar, Δy_t^{Mex} is real Mexican GDP growth and IR_t^{Mex} is the Mexican interbank interest rate.

The breakdown of annual Mexican GDP growth (Cholesky matrix) confirms that external factors are key explanations, mainly US GDP growth (31%) and yield spreads (20%), which are influenced by international market conditions, but also by internal factors specific to Mexico (political risk, stability of public finances).

The results of our simulation, summarised in Table 1, can be interpreted as follows: an initial shock on US GDP growth of 1 percentage point (pp) would generate an instantaneous response of 0.24 pp of real GDP growth for Mexico, a cumulative response over four quarters of 0.86 pp, and a cumulative response over eight quarters of 0.98 pp.

Using VAR, we construct a system of equations to predict real GDP growth for Mexico using the following three alternative scenarios based on whether or not Donald Trump's programme is realised (see table 2):

S1: most favourable scenario for Mexico
US GDP growth accelerates to an annual average of 2.3% in 2017 and 2.8% in 2018, bolstered by a fiscal stimulus package (infrastructure), corporate tax cuts (acceleration of investment and job creations rather than hoarding or dividend payments) and financial deregulation (acceleration of lending). At the same time, we consider a mild increase in tariffs on Mexican imports, which would be proxied by a 10% appreciation in the real exchange rate in Q3 2017.

S2: intermediate scenario
The same assumptions for US growth as in S1, but with the introduction of major tariff and non-tariff barriers on Mexican goods, which would be proxied by a 30% appreciation in the real exchange rate in Q3 2017.

S3: worst-case scenario for Mexico
No stimulus in the US (GDP growth would average between 2% and 2.2% in 2017-18) accompanied by major trade barriers, identical to those in S2.

We conclude (see chart 1) that under the most favourable scenario (S1), Mexican economic growth would stall on a year-on-year basis in Q4 2017 and Q1 2018, reducing the carryover for 2018, before regaining some traction to finish 2018 with an average annual growth rate of 0.5%. In both S1 and S2, real GDP growth would average 1.2% in 2017. Yet in S2, economic activity would slump from Q1 2018-Q3 2018 (on a year-on-year basis). This would bring average GDP growth to -0.3% in 2018. Lastly, under worst-case scenario S3, real GDP would remain in negative territory until early 2019. It would increase at an average annual rate of 1.1% in 2017 before contracting 0.5% in 2018.

Hypotheses for explanatory variables

	Y_US	IR_US10	Spread	RER	IR_MEX
			Scenario 1		
2017 Q1	2.2	2.6	232	729	6.8
2017 Q2	2.4	2.8	232	729	7.8
2017 Q3	2.2	2.9	232	656	8.0
2017 Q4	2.4	3.0	232	656	8.0
2018 Q1	2.6	3.2	232	656	8.0
2018 Q2	2.8	3.3	232	656	8.0
2018 Q3	2.8	3.4	232	656	8.0
2018 Q4	2.9	3.5	232	656	8.0
			Scenario 2		
2017 Q1	2.2	2.6	232	729	6.8
2017 Q2	2.4	2.8	232	729	7.8
2017 Q3	2.2	2.9	280	510	8.0
2017 Q4	2.4	3.0	280	510	7.8
2018 Q1	2.6	3.2	280	510	7.5
2018 Q2	2.8	3.3	280	510	7.5
2018 Q3	2.8	3.4	280	510	7.5
2018 Q4	2.9	3.5	280	510	7.5
			Scenario 3		
2017 Q1	2.2	2.6	232	729	6.8
2017 Q2	2.0	2.8	232	729	7.8
2017 Q3	1.9	2.9	280	510	8.0
2017 Q4	2.1	3.0	280	510	7.8
2018 Q1	2.2	3.0	280	510	7.5
2018 Q2	2.3	3.0	280	510	7.5
2018 Q3	2.3	3.0	280	510	7.5
2018 Q4	2.1	3.0	280	510	7.5

Table 2 Source: BNP Paribas

Mexico's GDP growth projections

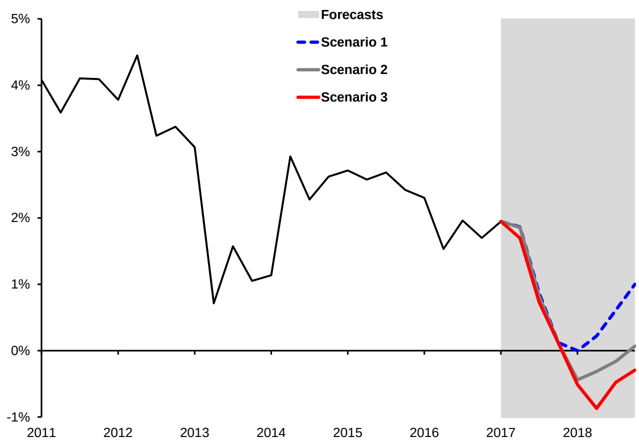

Chart 1 Source : BNP Paribas