Mexico

Disappointments

Mexico's economic growth prospects are deteriorating: slower growth in the US, fiscal austerity and low investment levels have dragged down growth in the last two quarters. The slowdown is likely to continue, despite support from consumer spending. The threat of trade tensions with the United States and the lack of clarity in Mexico's economic policy, as shown by the troubled implementation of its energy reforms, are adversely affecting the investment outlook. The increase in Mexico's medium-term sovereign risk has been recognised by Fitch, which has cut its sovereign credit rating. Fortunately, external vulnerability is limited.

Slower economic growth

The upturn in confidence inspired by the election victory of Andrés Manuel López Obrador (AMLO) and the signature of the new trade agreement with the USA has quickly ground to a halt. The government's policy hesitancy and the slowdown in global growth have already affected growth in Mexico, with the year-on-year increase in GDP falling from 2.6% in Q3-2018 to 1.7% in Q1-2019. Consumer spending continued to underpin growth in the first quarter of 2019. However, the contribution from net exports was barely positive, and those of investment and public spending were negative for the second straight quarter.

Growth is likely to slow substantially in 2019 and remain weak in 2020. Survey results are sending some fairly pessimistic signals for the next few quarters. Although consumer spending is set to continue supporting economic activity, consumer confidence has been falling steadily since the start of the year. Most importantly, business confidence is down significantly in 2019, with investment expectations showing a particularly steep decline, and has been lower than the average seen in the last five years. Growth forecasts collated by the central bank every month from a broad panel of analysts have also been downgraded since the start of the year. The average GDP growth forecast for 2019 was a mere 1.1% in June, down from 1.8% in December 2018.

Confusion about energy reform is increasing sovereign risk

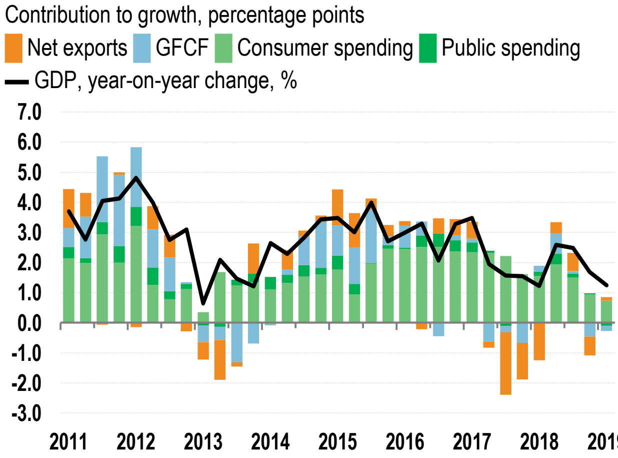
As exemplified by Mexico's attempts to reform its energy sector, the lack of clarity in economic policy is likely to remain a drag on investment. When he was elected, AMLO was planning new reforms in the energy sector, aiming to increase oil production to 2.4 million barrels per day (bpd) by the end of his term of office in 2024 (up from around 1.7 million today). Mexico's production peaked at 3.4 million bpd in 2004. The new administration is planning to upgrade existing refineries, build a new one, and provide greater support to two state-owned companies (oil producer Pemex and electricity producer CFE). Finally, whereas measures taken since 2013 were aimed at promoting the involvement of private-sector investors (foreign and domestic) in the sector, that involvement is likely to be very limited in the next few years. Auctions of oil blocks have also been stopped (the fourth round was due to begin in February 2019) and the private-sector companies that won the previous auctions will have to carry out the promised investments within three years or lose rights to their blocks.

1- Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	2.1	2.0	1.5	1.0
Inflation (CPI, year average, %)	6.0	4.9	4.1	3.9
Budget balance / GDP (%)	-2.2	-2.1	-3.2	-3.7
Public debt / GDP (%)	54.3	53.8	53.5	54.0
Current account balance / GDP (%)	-1.7	-1.8	-1.6	-1.5
External debt / GDP (%)	37.6	36.5	37.0	39.6
Forex reserves (USD bn)	170.5	171.4	171.7	173.0
Forex reserves, in months of imports	4.1	3.8	3.5	3.6
Exchange rate USDMXN (year-end)	19.7	20.0	18.6	18.0

e: BNP Paribas Group Economic Research estimates and forecasts

2- Slower growth



Source: National accounts

So far, several measures have been announced, including a recapitalisation and lower taxation for Pemex, but overall they have been deemed to be "one-offs" and insufficient to arrest the sector's decline. The development plan for Pemex has still not been unveiled and, more broadly, structural measures for the sector as a whole have yet to be announced (and financed).

Tensions with the United States

Investor sentiment has also been affected by the recent trade tensions with the US. The US government has for the moment given up on its plan to impose customs duties on all Mexican goods, and the Mexican government has promised to help the US combat illegal immigration. However, the threat of trade tensions will continue to drag down Mexico's growth outlook in the coming quarters.

The Mexican government's desire to maintain good relations with the US was strengthened in late June by the Mexican Senate, which comfortably ratified the new North American free-trade agreement with Canada and the US (USMCA). This makes Mexico the first of the three countries to ratify the agreement.

Question marks over fiscal discipline

Mexico's economic policy has remained tight since the start of AMLO's term of office. He has reiterated his campaign promises on several occasions: maintaining the fiscal discipline of the last few years (particularly by cutting spending), while introducing measures to reduce both inequality and corruption and to stimulate growth. However, the firm grip on spending since the start of 2019 results more from the need to shore up Pemex and by the difficulties involved in setting up certain projects than from genuine fiscal austerity.

Mexico's spending overshoot is likely to be limited again this year. However, sovereign risk is increasing. In early June, rating agency Fitch cut its sovereign rating on Mexico and Moody's placed its rating on watch with negative implication. Both agencies also cut their ratings on Pemex.

The resources allocated to Pemex and CFE are likely to prove insufficient. According to Moody's estimates, Pemex's funding requirement is between 1% and 2% of GDP per year. If Pemex's financial position does not improve in the next two years and if government transfers become a regular occurrence, Mexico's budget deficit could double between now and 2021, pushing up the public debt/GDP ratio even with nominal growth of 5%.

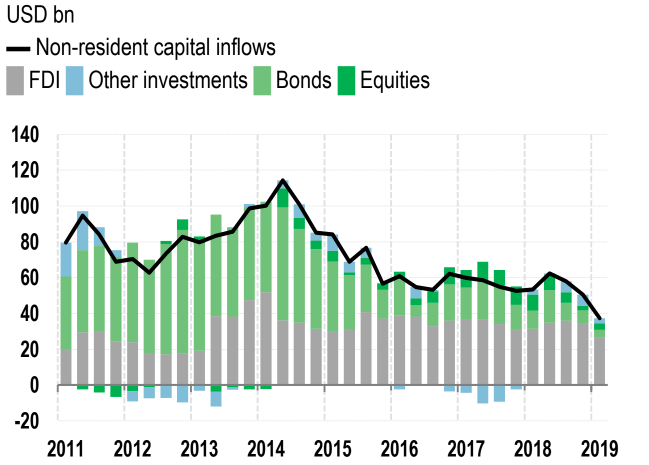
In addition, in early May ALMO ended the private-sector tender process relating to the plan to build a new refinery. The government now wants Pemex to handle the entire construction process. In early June, the Energy Ministry announced that the project would be completed by May 2022. Given Pemex's lack of experience (and that of the Energy Ministry) in this area, it is more than likely that the construction timeframe will be much longer and the cost much higher than anticipated, putting additional pressure on the public finances.

These recent announcements further highlight the contradictions in the government's stated priorities. Simultaneously achieving all of its targets—including a deficit target of 2.5% in 2019 and 2.1% in 2020 after 2.1% in 2018—seems to be impossible, especially since the government has promised to do so without increasing taxes or introducing new ones in the next three years.

No short-term threats to financial stability

Mexico remains exposed to a downturn in investor sentiment, but the short-term consequences in terms of its external vulnerability remain limited. In the last four quarters, foreign capital inflows have diminished, but they remain comfortable (Chart 2). Most importantly, FDI flows have remained broadly stable during the period. Mexico also has solid macroeconomic fundamentals: its monetary policy is credible and its current-account deficit and external debt are moderate, with the current-account deficit averaging less than 2% of GDP since 2010 and being fully covered by FDI inflows. The country has substantial currency reserves (almost USD 180 bn in June 2019, equal to around 4 months of imports). Even if investor sentiment were to deteriorate rapidly, Mexico has the resources needed to meet its external obligations.

3- Limited external vulnerability



Source: IIF

Hélène Drouot
helene.drouot@bnpparibas.com