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Economics Group

Special Commentary

Eugenio J. Alemán, Senior Economist
eugenio.j.aleman@wellsfargo.com • (704) 410-3273

Mexico: One More Thing to Worry About in 2018

Executive Summary

The Mexican economy is facing a very tough environment in 2018, with still high inflation and interest rates, combined with a weak investment environment and several risks on the political front. As the country approaches the July 1st presidential election, where most polls today suggest Andres Manuel López Obrador will come out the winner, risks of isolationist economic policies are on the rise, which could bring economic reforms back several decades.

Although economic activity strengthened somewhat in the final quarter of 2017, we are still concerned that the increased uncertainty in the country's political future, and the unfinished renegotiation of the North American Free Trade Agreement (NAFTA) could continue to put downward pressure on economic activity this year.

Despite strengthening economic activity, economic and political uncertainties remain.

Q1 GDP Improves a Bit, but Concerns Remain

According to the "flash" release of the performance of the Mexican economy in Q4-2017, the economy improved a bit in the last quarter of the year, up 1.0 percent, sequentially and not annualized. On a year-earlier basis, the economy grew 1.8 percent non-seasonally adjusted (Figure 2). This means that the Mexican economy grew 2.1 percent for the whole of 2017. We had forecasted growth of 2.0 percent in 2017, after reversing our original call which accounted for a slight recession due to the increased risks of the United States abandoning the NAFTA, among it Canada and Mexico.

Figure 1

Figure 2

Source: IHS Global Insight and Wells Fargo Securities

However, the details of the Q4 release were relatively weak with the economy being driven by the service sector, up 1.2 percent sequentially and not annualized, and by 2.6 percent on a year-earlier basis, not seasonally adjusted. For the year as a whole, the service sector increased a strong 3.1 percent. That is, economic growth continues to be driven, fundamentally, by domestic consumption. As this was a preliminary release, we do not have full details on the supply side or information on the demand side; however we are able to make inferences based on where the weakness resided during 2017, something that we believe did not change as the year came to a close.

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The all-important industrial sector was weak at year-end, driven by a very soft mining sector. The industrial sector managed to grow 0.1 percent sequentially and not annualized in the last quarter of the year, but was down 0.7 percent on a year-earlier basis, not seasonally adjusted. This sector, however, declined 0.6 percent for the year as a whole. Meanwhile, the primary sector, which is a highly volatile one and includes agriculture, cattle and fisheries, saved the day for fourth quarter GDP as it increased 3.1 percent on a sequential basis and not annualized, and by 4.2 percent on a year-earlier basis, not seasonally adjusted. For the year as a whole, the sector grew a strong 2.8 percent. Thus, even if the Mexican economy improved in the final quarter, it remains weak. We are not expecting much change regarding the economy's performance this year as it continues to navigate a still risky NAFTA renegotiation process and a contentious presidential election slated for July.

Figure 3

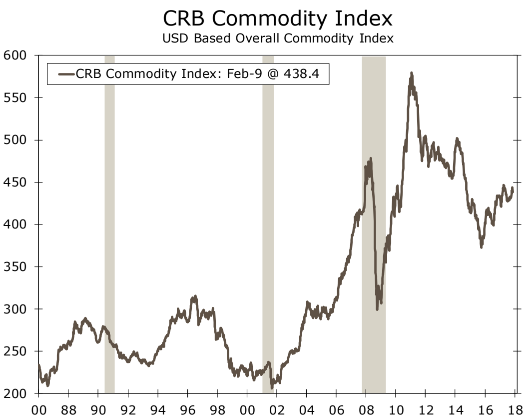
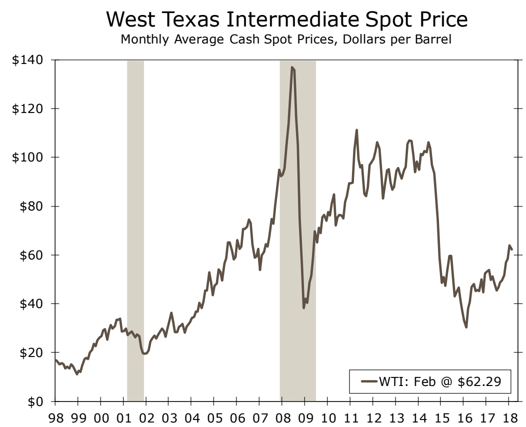


Figure 4



Source: Bloomberg LP, IHS Global Insight and Wells Fargo Securities

On the positive side, we have recently heard better-than-expected comments from Canadian and Mexican officials involved in the NAFTA negotiations compared to what we have heard over the past year or so. We still do not know much about the U.S.'s position in the negotiations, other than that it is asking Canada and Mexico for many tough-to-swallow changes to the agreement. However, the negotiations are scheduled to continue over the next several quarters, pointing to probable good news for the future of a revised NAFTA and for the survival of the economic integration of these three economies. Furthermore, the recent increase in the price of petroleum will likely also help the Mexican economy in 2018, especially as it increases investor interest in the new petroleum-producing zones that the government has been opening to international bids (Figure 4).

Then Came the U.S. Tax Reform

The newly passed U.S. tax reform indirectly takes a hit at the Mexican economy.

Just when you thought that all of what could go wrong for the Mexican economy was over, the successful passage of the U.S. tax reform occurs. This package indirectly takes a hit at the Mexican economy, as it reverses one of the competitive advantages Mexico had vis-à-vis the U.S. economy in terms of its corporate tax rate. Mexico's corporate tax rate stands at 30 percent today while, before the U.S. tax reform in December, the U.S. corporate tax rate was 35 percent. That is, the newly passed tax reform in the United States reduces the 35 percent corporate tax rate to a flat 21 percent, and gives U.S. corporations, and perhaps even Mexican corporations, an incentive to move to the United States rather than remain in Mexico.

It is still too early to know how this change in relative corporate tax rates will play out for U.S. and even Mexican firms because the advantage in terms of relative wages between the two countries is still one of the major advantages U.S. firms have for conducting the labor-intensive part of the production process south of the border. Furthermore, some large U.S. corporations pay much less than the 35 percent corporate rate already; that is, their effective corporate tax rate is much lower than the nominal rate. This means that firms will need to decide on the feasibility of keeping production south of the border, and those type of decisions are not short-or even medium-term in nature. Thus, we expect this process to take some time and for this type of effect to start manifesting itself during a period of several years rather than immediately.

2018 Will Remain a Volatile Year for the Mexican Economy

Even though the International Monetary Fund recently upgraded the growth outlook of the Mexican economy in 2018, arguing that better U.S. economic growth will benefit economic growth south of the border, the truth is that the Mexican economy has slowed, burdened by the uncertainty that the renegotiations of NAFTA with the United States and Canada is generating. This uncertainty has been magnified with the recent passage of U.S. tax reform, which turns Mexican tax policy into turmoil especially during a presidential election year. Traditionally, Mexican presidents are more or less lame ducks during their final years in office and we do not expect anything will happen to counteract this change in relative corporate tax rates between the two countries.

The Mexican economy has been burdened by uncertainty regarding the renegotiation of NAFTA.

As we said before, it is clear that corporate tax rates are not the only consideration companies use in deciding where to open or move their operations. However, it is also clear that this decrease in the U.S. corporate tax rate will give companies good reasons to revise their investment plans, further increasing the uncertainties that have affected the Mexican economy during the past year or so.

Figure 5

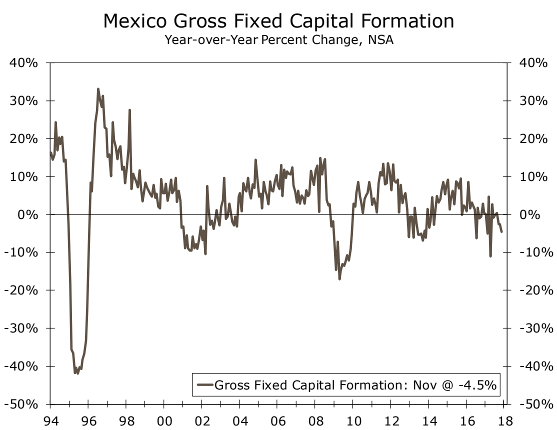
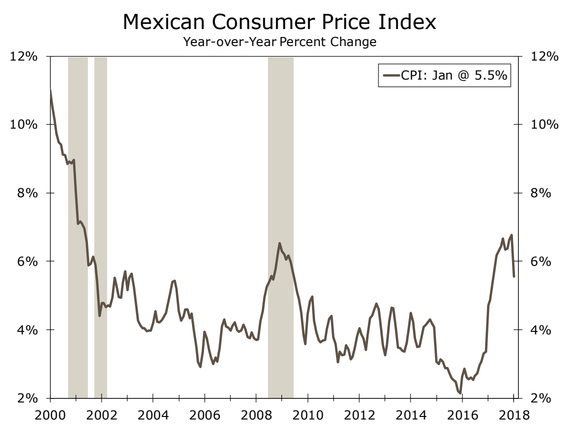


Figure 6



Source: IHS Global Insight and Wells Fargo Securities

One of our biggest concerns regarding the Mexican economy lately has been related to the investment in productive capacity in the country, which normally determines the ability of the economy to grow over time. According to the monthly estimate on gross fixed capital formation, investment declined 0.8 percent during the third quarter of the year compared to a year earlier. This is the third consecutive year-over-year quarterly decline for this index and a sign that firms in the country remain concerned with what is happening at the NAFTA renegotiation table. The index extended its loss by declining 2.6 percent in October and by 4.5 percent in November compared to the same month a year earlier (Figure 5). Gross fixed investment increased only 1.1 percent in 2016 and is probably going to show negative growth during this year. Even the recent success in the petroleum sector bids have not been enough to prop up investment in the country.

The level of the consumer price index increased 0.6 percent in December, registering a year-over-year rate of 6.8 percent, which is the highest rate since May 2001 (Figure 6). Mexican prices increased roughly 6.0 percent on average during the whole of 2017. In January, consumer prices increased 0.5 percent with the year-over-year rate declining more than a full percentage point to 5.5 percent. The Mexican central bank's target rate of inflation is 3.0 percent, however going forward, our expectation for inflation is that it will remain close to 5-6 percent this year. That will be enough to keep the Mexican central bank on edge during the rest of the year. The latest move from the Mexican central bank came in February when it increased its policy rate to 7.50 percent from 7.25 percent. Interest rates are also a risk for Mexican economic growth in 2018 as the U.S. Federal Reserve continues to raise its own rates.

The Mexican central bank is likely to remain on edge as inflation remains at elevated levels.

This Year Is Not Politics as Usual

Another big risk for this year is political. Mexico has presidential elections on July 1, 2018 and the front runner in the race is the ex-Mexico City mayor, Andrés Manuel López Obrador (or AMLO). AMLO is a leftist politician that grew up politically in the Partido Revolucionario Institucional (PRI), the party that governed Mexico for more than 70 consecutive years.

AMLO comes from the left wing of the PRI as was the case for his mentor, Chautemoc Cárdenas, who ran several times for the presidency of Mexico. Cárdenas was the presidential candidate for the Frente Democrático Nacional in the July 1988 election. He lost the election on a disputed vote-counting process after the government said that the "system went down;" that is, the computer counting the votes had an issue and when that was resolved, the government said that the PRI had won the election. In 1989, Cárdenas founded the Partido de la Revolución Democrática (PRD) and AMLO was one of the most important leaders of that party. Cárdenas was the son of an ex-President Lázaro Cárdenas from the PRI.

The 1988 presidential election was probably the starting point for the demise of the PRI's monopoly power in Mexican presidential elections. After several attempts by Cárdenas as a presidential candidate from the PRD, the party elected AMLO as its new president. He had been elected mayor of Mexico City from the PRD. During his tenure as mayor he developed what Mexicans call the "second floor," which was the construction of elevated expressways above the traffic-jammed and burdened Mexico City road system. However, in 2012, AMLO resigned from the PRD and founded a new party called Morena. This is the current party with which he is leading in the presidential polls. Perhaps Morena and AMLO's biggest issues today are that, while he is a leading political figure in the Mexican left wing political movement, Morena is a relatively new party and may lack the national representation he needs to finally capture the presidency.

That said, the fact that the opposition (and one of the largest parties), the Partido Acción Nacional (PAN), is also divided, is helping make Morena's problems regarding national representation seem smaller than what they would normally be.

However, the biggest issue markets have with AMLO is that he is a left-wing candidate who wants to redistribute income; he is, in general, against free trade and NAFTA, and he is against the opening of the petroleum and energy sector, among other relatively coveted advances made over the past several decades by the Mexican political system. Furthermore, the current political climate north of the border is helping push his image as a leftist nationalist with strong populist undertones, which frightens the business community, in Mexico as well as the United States.

If Mexico becomes more nationalistic it will hurt the Mexican economy more than that of the United States.

Of course, in theory, it is much easier for the Trump administration and the United States to become more protectionist vis-à-vis Mexico and/or abandon NAFTA because the United States is not a very open economy. That is, Mexico needs more from the United States in terms of production and trade than the other way around. If Mexico becomes more nationalistic and inward looking, it will hurt Mexico more than the United States.

It is also possible that AMLO could be playing both sides of the coin, one for national consumption and another for external consumption as he realizes that he has to moderate his rhetoric to be successful in his bid for the presidency. Furthermore, some analysts argue that due to his party's lack of a strong representation on a national level, ALMO will probably have very little sway in the Mexican Congress and that this will ultimately limit his ability to make the "radical" changes he is seeking.

Conclusion

Perhaps what remains clear, in any environment, is that 2018 will remain a very uncertain year for the Mexican economy, which likely will hurt economic growth even if the U.S. economy grows at a faster pace than in previous years. The recent performance of gross fixed investment is a clear indication that economic growth will continue to suffer in 2018. Furthermore, higher-than-target inflation will keep the Mexican central bank on edge with interest rates remaining high.

Wells Fargo Securities Economics Group

Diane Schumaker-Krieg	Global Head of Research, Economics & Strategy	(704) 410-1801 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 410-3275	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Jay H. Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Currency Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Eugenio J. Alemán, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Eric Viloria, CFA	Currency Strategist	(212) 214-5637	eric.viloria@wellsfargo.com
Sarah House	Economist	(704) 410-3282	sarah.house@wellsfargo.com
Michael A. Brown	Economist	(704) 410-3278	michael.a.brown@wellsfargo.com
Jamie Feik	Economist	(704) 410-3291	jamie.feik@wellsfargo.com
Erik Nelson	Currency Strategist	(212) 214-5652	erik.f.nelson@wellsfargo.com
Michael Pugliese	Economic Analyst	(704) 410-3156	michael.d.pugliese@wellsfargo.com
Harry Pershing	Economic Analyst	(704) 410-3034	harry.pershing@wellsfargo.com
Hank Carmichael	Economic Analyst	(704) 410-3059	john.h.carmichael@wellsfargo.com
Ariana Vaisey	Economic Analyst	(704) 410-1309	ariana.b.vaisey@wellsfargo.com
Abigail Kinnaman	Economic Analyst	(704) 410-1570	abigail.kinnaman@wellsfargo.com
Shannon Seery	Economic Analyst	(704) 410-1681	shannon.seery@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com
Dawne Howes	Administrative Assistant	(704) 410-3272	dawne.howes@wellsfargo.com

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