ABN·AMRO

Mexico Outlook 2019

Group Economics
Emerging Markets & Commodity Research

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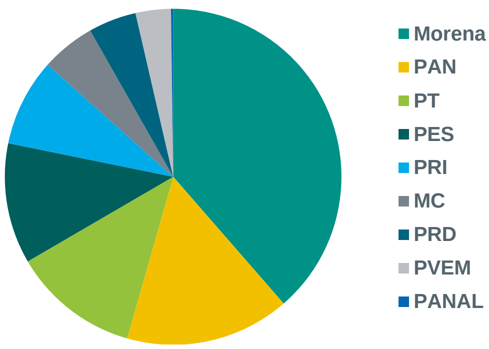
A new government and a new voice

- **The new Mexican government has grand plans...**
- **…with reinforcement of law and order a big priority.**
- **These plans will be difficult to implement without tax reforms.**
- **Investors fear the new government will steer its own course.**
- **We expect a less radical approach and that growth will remain on track.**

With 2019 just around the corner, it is time to look ahead. This applies in particular to Mexico which last weekend saw the installation of a new government led by Morena, a new party that wants to tear up the script and do everything differently. In the run-up to the elections, investors anxiously eyed the rise of Morena. Their unease briefly made way for cautious optimism, but this was short-lived. The government wants to organise referenda on all sorts of themes, often related to measures taken by the previous government. This puts the continuity of government policy at risk, which is an alarming prospect for investors. We think that the government will gradually seek to build good relations with the financial markets and do not foresee a sharp decline in GDP growth. The country is in good financial health and is resilient to setbacks.

Morena wins majority, both in parliament…

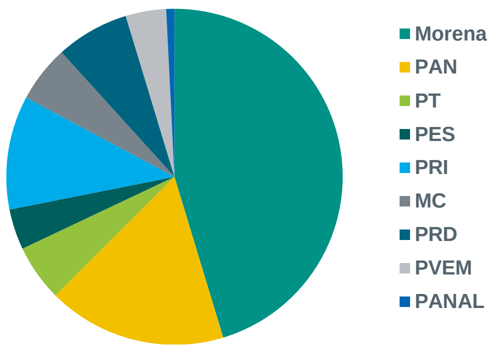
Share in total seats of 500



Source: IHS

… and in the senate

Share in total seats of 128



Source: IHS

Traditional political parties suffer defeat

The political landscape has undergone radical change. During the elections in July, the new Morena party defeated the traditional government parties PAN, PRI and PRD. Through alliances with other parties, Morena has managed to form a coalition that has a majority in parliament as well as in the senate. This makes it easy for the new government to implement budget changes. However, the government headed by President Andres

Manuel Lopez Obrador does not have the two thirds majority that is necessary for constitutional changes. In order to fulfil its wish to reverse some of the former government's educational, energy, telecom and financial sector reforms, the government must therefore make additional arrangements with the other political parties.

New government favours referendum-driven politics

As well as reversing reforms, the new government also wants to change the shape of politics. Notably by creating more space for referenda on all sorts of themes. Including public finances and public spending. The constitution currently forbids referenda on such issues. The new government recently held a vote on the construction of the new national airport, one of Morena's central election themes. Despite the low turnout and objections regarding the legitimacy of the referendum, the new government made grateful use of the result to stop the construction of the airport. A costly decision in view of the many investments already made and the expense of buying out existing contracts. In addition, it is now necessary to invest in airport capacity elsewhere.

Peso under persistent pressure versus USD

Source: Thomson Reuters Datastream

Yields on government bonds rise further

Source: Thomson Reuters Datastream

Cancellation of national airport worries investors…

Investors are monitoring the changes with a wary eye. If this form of direct democracy becomes the new standard, continuity in government decision-making is no longer assured. Following the cancellation of the construction of the airport, the peso fell in value, CDS premiums and interest rates on 10 year government bonds rose and share prices declined. Rating agency Fitch also decided to change the outlook for its A+ credit rating to negative. This market response did not stop the new government announcing more referenda. Among other things, citizens will be given a chance to vote on extra expenditures on grants and traineeships for young people, a doubling of pensions for over-68s, better access to healthcare, the building of an oil refinery and the construction of new rail links.

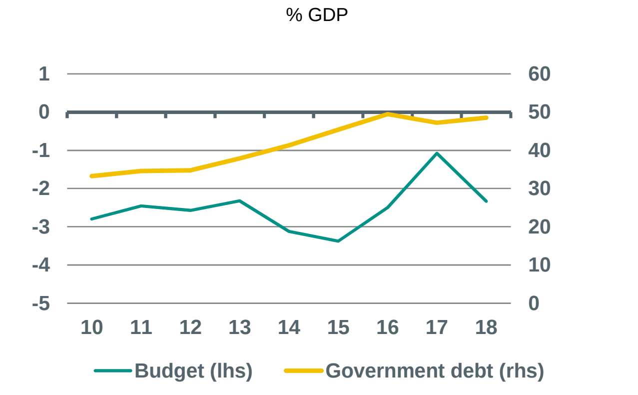
…though the government has also pledged to clean up the government apparatus

Investors can derive some comfort from the government's professed commitment to budget discipline. To prevent the public debt from rising further, the new government has set itself the task of restricting the primary budget surplus, i.e. the budget excluding debt-servicing and one-off costs, to 0.8% of GDP. To achieve this, it wants to reduce the number of administrative layers within government, fight corruption, merge social programmes and cut civil service salaries. The resulting savings are to be used to raise pensions for the elderly as well as expenditures on young people. On top of all this, more effective tax collection and efforts to bring the informal sector into the formal economy should lead to higher tax revenues.

Public oil revenues uncertain due to inefficiency of state oil company

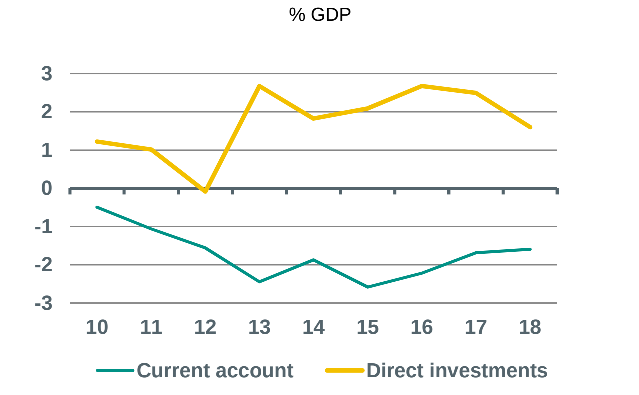
The government's oil income remains a source of uncertainty. In 2012 energy revenues still accounted for 40% of the public income. The share today is less than half that number. This shift was mainly attributable to the lower oil prices and a decline in production. Output from the Cantarell field is falling and too little is being invested in new exploration. State oil company Pemex is heavily indebted and a byword for inefficiency. Since 2014 reorganisations and large-scale redundancies have undermined employee morale. The government now wants to impose a salary ceiling for civil servants and possibly also for employees of state-run companies. The latter could spark an exodus of talented employees, possibly putting the envisaged production increase at risk.

Public finances weaken, but still healthy



Source: Thomson Reuters Datastream

Direct investments cover current account deficit



Source: Thomson Reuters Datastream

Broader tax base vital to fund spending plans

On balance, the government thinks its budget target is achievable without raising tax rates. In fact, it actually wants to reduce VAT and profit tax in the border regions in order to prevent profits migrating abroad as a result of the tax cuts in the US. The IMF doubts whether the budget target can be achieved without a broader tax base. Its advice is to introduce more progressive income tax, raise the VAT on food, reduce the number of exemptions and give local government greater powers to levy property tax. The new government is due to present its budget on 15 December. It will then be easier to assess whether the plans are realistic.

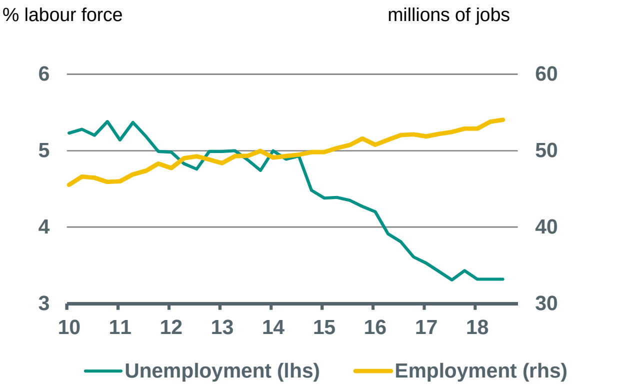
Structural GDP growth still far too low

Public revenues can rise if GDP growth improves. The Mexican economy should be capable of faster growth. The country has a young population, is mineral-rich and maintains close relations with the US. Despite these favourable conditions, GDP growth has averaged less than 2.75% since 1990. The main impediment is weak productivity growth. The previous government implemented reforms to remedy this problem. State monopolies were broken up and measures taken to promote competition. Despite giving the private sector better access to the oil industry, these steps only had limited effect on productivity.

Stronger law enforcement is a priority

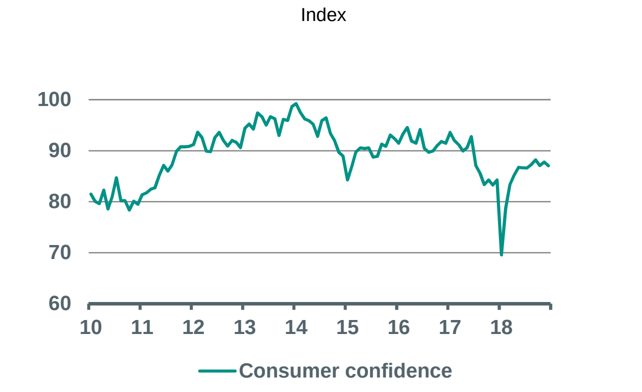
Endemic - and frequently drugs-related - crime is one factor that is dampening productivity. Pervasive criminal activity feeds insecurity and stifles entrepreneurial initiative. Reinforcement of law and order is understandably a priority. The new government has therefore launched a 'National Plan for Peace and Security' aimed at reconciliation and compensation, while also containing an amnesty programme for small criminals. But victims are reluctant to come forward. Human rights activists also have grave doubts about the proposals to merge army units and police forces into a national guard. They claim that this goes against the government's aim to abandon the repressive approach.

Unemployment historically low, job growth continues



Source: Thomson Reuters Datastream

Consumer confidence bounces back post-elections



Source: Thomson Reuters Datastream

Improving labour market supports consumer

The third quarter saw the economy grow by 2.6% annually. GDP growth in 2018 was supported by the pre-election increase in public spending. The high level of activity in the US is also helping. Growing demand north of the border is good for exports. Moreover, Mexicans working in the US are sending more money to their family at home. This contributes to higher consumer spending. Consumption is receiving a further impulse from the buoyant labour market. Unemployment has decreased to a mere 3.2% of the labour force. This is underpinning consumer confidence. Retail sales are trending up and the decline in car sales is flattening out.

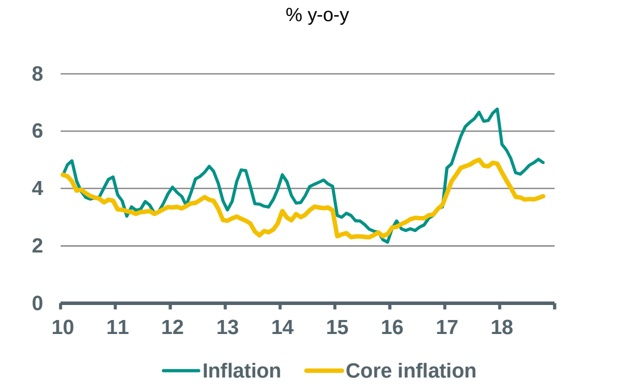
Uncertainty about the trade agreement is finally over

The low PMI index signals that business sentiment is subdued. The willingness to invest is extremely limited. But there is a good chance that business investments will gradually look up. The combination of elections and NAFTA trade negotiations kept businesses on edge. They postponed investments while awaiting more clarity. With the elections behind us and a new trade treaty on the table, businesses can finally put their plans into action. Mexico has had to make some concessions in the new USMCA trade agreement. The automotive industry, for instance, will be confronted with stricter rules of origin and higher minimum wage requirements. At the same time, the new agreement contains modernisations with arrangements in the field of services, e-commerce and data transparency. But the core of the original agreement has remained largely intact.

Current account deficit fairly easy to finance

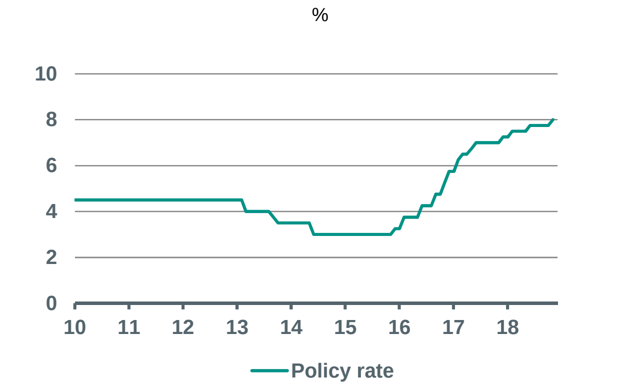
The contribution of trade to GDP growth will weaken. We foresee a slowdown in growth in the US, Mexico's main sales market. As a result, the current account deficit will widen marginally. But Mexico will encounter few problems financing this deficit. As in the past, this deficit can be largely covered by the direct investments. The foreign debt, which has run up to 39% of GDP in recent years, is still manageable, partly thanks to its long term nature. Mexico is thus less vulnerable to currency crises than Turkey and Argentina. The central bank allows the exchange rate to float freely. In an emergency, it can fall back on substantial currency reserves and, if need be, the credit lines at the IMF and the US.

Inflation stubbornly high due to low peso and oil price



Source: Thomson Reuters Datastream

Central bank raises official rate



Source: Thomson Reuters Datastream

Central bank pursues tight monetary policy

The central bank has repeatedly failed to get inflation within the targeted bandwidth of 2% and 4%. In September, y-o-y inflation was 5%, marking the 21st month above target in a row. One crucial factor is the increase in oil prices which impacts in particular on transport costs. Another is the volatile peso. The central bank wants to prevent these temporary factors having a long-term effect on prices. It raised the official policy rate to 8%, its highest level in ten years. Recent statements of the central bank suggest that a further rate hike is on the cards. We expect the impact of the rising energy prices to drop out of the inflation figures next year and that the Fed will end its series of interest rate hikes. The central bank can then step away from its tightening policy and start considering a reduction in interest rates.

Bank, business and household finances relatively healthy

The financial sector is healthy and stress-resistant. The banks are well-capitalised with an average tier-1 ratio of 14%. Their profitability is also favourable with a Return on Equity ratio of 21%. Moreover, the banks boast ample provisions and have few problematic loans. Despite the sharp rise in private sector lending in recent years, non-performing loans make up a mere 2.1% of the portfolio. At 16% of GDP, household debt is modest compared to other emerging economies, where the average is 40% of GDP. Stress tests also show that businesses have adequate capital buffers. So there is scope for further growth in lending to households and businesses. The banking sector is dominated by foreign parties. One advantage is the high efficiency of these players. A possible disadvantage is that they can withdraw more easily in times of stress.

Economic outlook for 2019 and 2020

We expect growth to stabilise at 2% in the coming years. Due to the growth slowdown in the US, exports will expand at a more moderate pace. This, however, will be compensated by domestic spending. Admittedly, public spending will rise less quickly now that the elections are behind us. Against this, however, businesses will invest more as the uncertainty over the trade treaty with the US and Canada has been removed, and consumer spending will hold up well. We doubt that the government can maintain sufficient budget discipline without broadening the tax base. If it sticks to its plan to leave the tax system intact, the financial markets will step up the pressure. We assume that the government will be sensitive to such moves and gradually become more mindful of the interests of investors. The result will be a stabilisation of the peso.

Key forecasts for the economy of Mexico

	2016	2017	2018e	2019e	2020e
GDP (% yoy)	2,9	2,0	2,0	2,0	2,0
CPI inflation (% yoy)	2,8	6,0	4,9	4,4	3,7
Budget balance (% GDP)	-2,5	-1,1	-2,3	-2,5	-3,0
Government debt (% GDP)	49	47	49	51	55
Current account (% GDP)	-2,2	-1,7	-1,6	-1,5	-2,0
Gross fixed investment (% GDP)	23,0	22,3	22,1	22,0	21,8
Gross national savings (% GDP)	21,6	21,4	21,3	21,0	20,3
USD/MXN (eop)	20,7	19,8	20,0	19,0	18,0
EUR/MXN (eop)	21,9	23,8	23,0	23,8	23,4

Economic growth, budget balance, current account balance for 2019 and 2020 are rounded figures
Source: EIU, ABN AMRO Group Economics