Mexico Sees Stronger 2018, NAFTA Challenges

By Jesus Cañas

Mexico's economy expanded in 2017 at its slowest pace in four years—growing 1.5 percent in real (inflation-adjusted) terms following a 3.3 percent gain in 2016.[1]

Trade policy uncertainty following the U.S. presidential election weakened the peso, which led to higher prices for imported goods and boosted inflation. A reduction of gasoline price subsidies in January 2017—part of an energy reform agenda in place since 2014—also contributed to higher inflation. Overall price increases peaked at a 6.8 percent annual rate in December.

Banco de México responded with five interest rate increases, taking the policy rate from 5.75 percent to 7.25 percent by year-end. Higher interest rates not only increased borrowing costs, but also likely slowed economic activity.

Meanwhile, the U.S., Mexico and Canada entered North American Free Trade Agreement (NAFTA) renegotiations which, after a year, have made little apparent progress.

Amid these challenges, there is hope that a strong, expanding U.S. economy and a bright global outlook will support brisk Mexican growth in 2018. Additionally, domestic consumption is expected to increase as inflation decelerates and wages catch up to prices.

Fiscal Discipline

Slowing economic activity during the year also reflected less government spending, declining investment and imports growing faster than exports—all helping curtail gross domestic product (GDP) growth. In particular, government expenditures, including public investment, fell mainly due to ongoing fiscal consolidation aimed at bringing spending in line with government revenue.

Declining oil production has provided urgency to the government's fiscal discipline attempts. Private investment also declined, perhaps reflecting the trade talks.

Finally, despite a rebound in export growth in 2017—aided by the depreciated peso—the expansion was insufficient to move the trade balance into positive territory. Mexico's trade deficit totaled $11 billion in 2017, about 1 percent of GDP. By comparison, the U.S. ran a $796 billion trade deficit, about 4 percent of GDP.[2]

Labor Market Strength

The consumer provided support to Mexico's economy last year. Consumption, backed by a strong labor market, expanded at a steady pace despite elevated interest expense, lower real wages and a higher cost of credit.

Employment in the formal sector—where people work "on the books" (unlike the informal economy)—grew 4.3 percent in 2017 (*Chart 1*). The overall unemployment rate, covering all workers, dropped to 3.4 percent in December, the lowest since 2007.

Some of the growth in formal-sector jobs is likely due to the labor market and tax reforms that have made the informal sector less attractive for firms and workers. The large and inherently inefficient informal sector, which employs 57 percent of Mexico's workers, has been a longstanding obstacle to economic development. Nevertheless, there are mounting signs that the labor market as a whole has tightened.

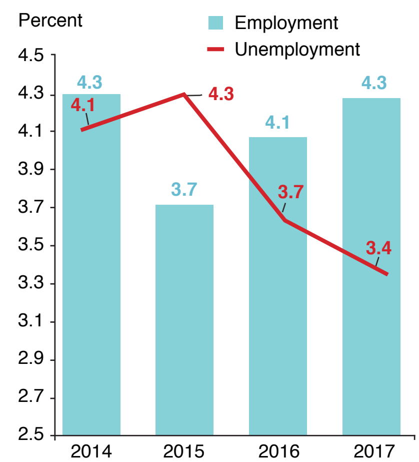
Continuing Uncertainty

The Mexican economy faces several sources of continued uncertainty—notably the NAFTA renegotiation and the presidential election in July. While political headwinds abound, there is reason for optimism.

Inflation is expected to drop to 3.6 percent by year-end, according to a Banco de México consensus forecast.[3] Labor markets are likely to remain tight. Unfortunately, investment is unlikely to recover absent clarity on NAFTA and the election. Public investment may contract further as fiscal consolidation continues.[4]

The Banco de México consensus GDP growth forecast for 2018 calls for a slight acceleration in activity to 2.3 percent annual average growth.

CHART 1 Jobs Grow in 2017; Unemployment Falls



NOTES: Unemployment rate captures entire labor force, including informal sector. Chart shows rates as of December of each year. Annual employment growth rate shown over each bar is the December-over-December change.

SOURCES: For unemployment, INEGI's Encuesta Nacional de Ocupación y Empleo (National Institute of Statistics and Geography's National Employment Survey). For formal employment, Instituto Mexicano del Seguro Social (Mexican Social Security Institute).

Notes

[1] Growth is based on the percentage change in gross domestic product (GDP) in fourth quarter 2017 relative to fourth quarter 2016. Mexico typically reports growth as the change in the annual average GDP. Annual 2017 average GDP growth was 2.1 percent, down from 2.9 percent in 2016.

[2] Trade balance for both countries excludes services.

[3] Source of consensus forecast: Banco de México's Encuesta sobre las Expectativas de los Especialistas en Economía del Sector Privado: Febrero de 2018 (Survey of Private Sector Specialists' Expectations, February 2018).

[4] Mexico started a five-year fiscal consolidation plan in 2013 aimed at bringing spending in line with government revenue and reducing public debt.