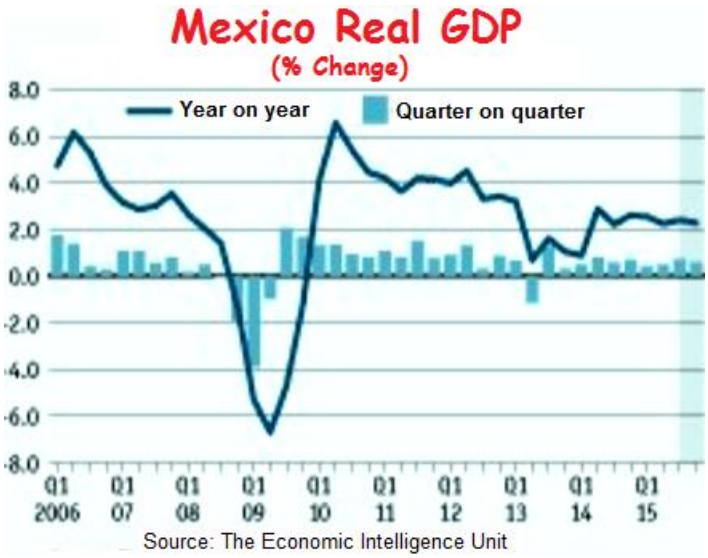
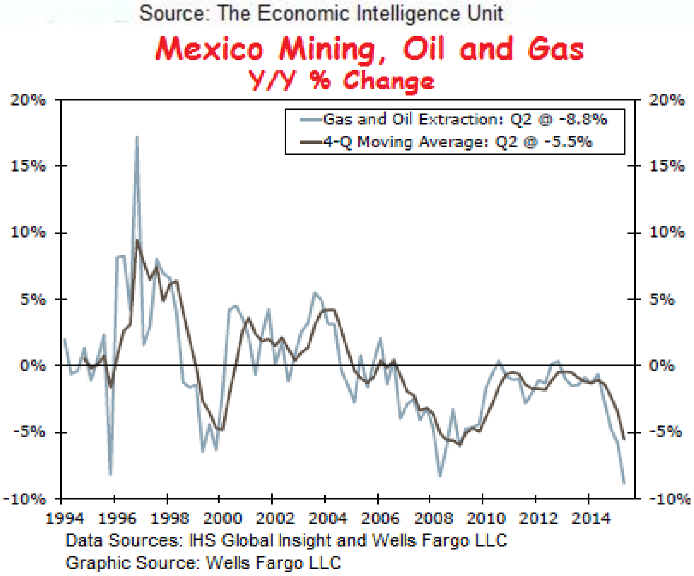
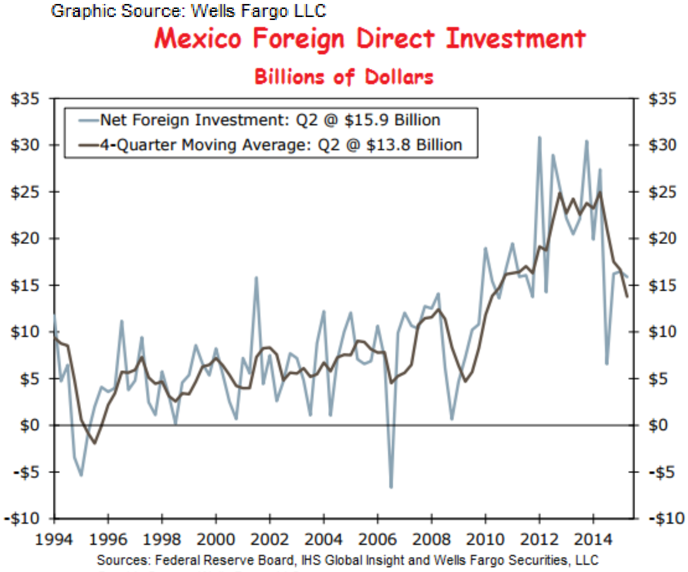
Mexico's Economic Outlook



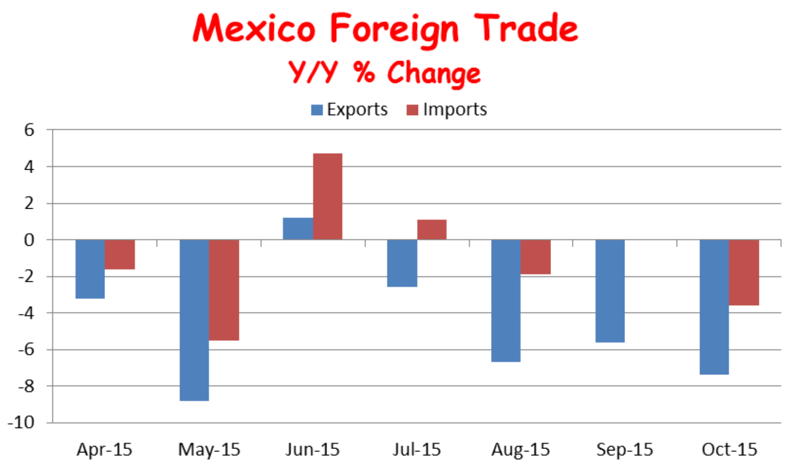




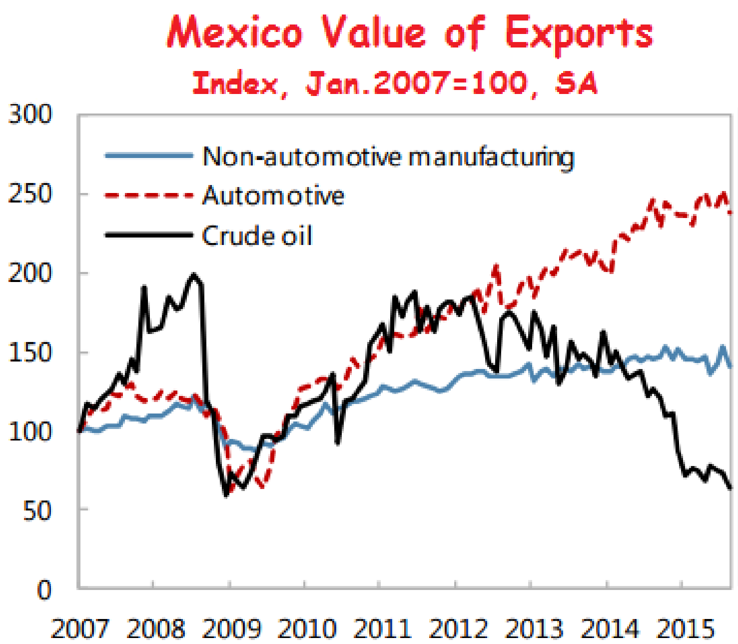
The Mexican economy is struggling to recover from a slowdown that began two years ago. Growth has fallen below 3% since 2013, the first year with Enrique Peña Nieto as president. Conditions are expected to remain lackluster in the near term, with growth reaching around 2.2% this year, half the rate of those experienced in the early 2010s.

The main culprit of Mexico's faltering economic recovery is weaker investment spending. Investment plummeted in 2013 due to the negative effects of transitioning to a new administration. New taxes on investment and the uncertain economic environment caused firms to continue to retrench in 2014. Meanwhile, lower oil prices over the last year have significantly reduced oil-related fiscal revenue, the source of almost a third of the federal budget. As a result, public investment spending has weakened, along with investment by private sector firms that rely on the federal budget.

Reduced investment spending is crimping Mexico's production capacity, with oil production by the national oil company Petroleos Mexicanos dropping by almost a third compared to 2004 levels. The combination of lower production and falling oil prices has created major concern and prompted the government to re-open the industry to foreign investment after 77 years. The historic change is the core of President Nieto's energy reform efforts to raise production. Although large international energy companies have been reluctant to engage in these investments, recent contractual term improvements by the government have sparked foreign investors' interest. As a result, three of five drilling blocks were sold at the latest auction, compared to only two of 14 at the first auction.

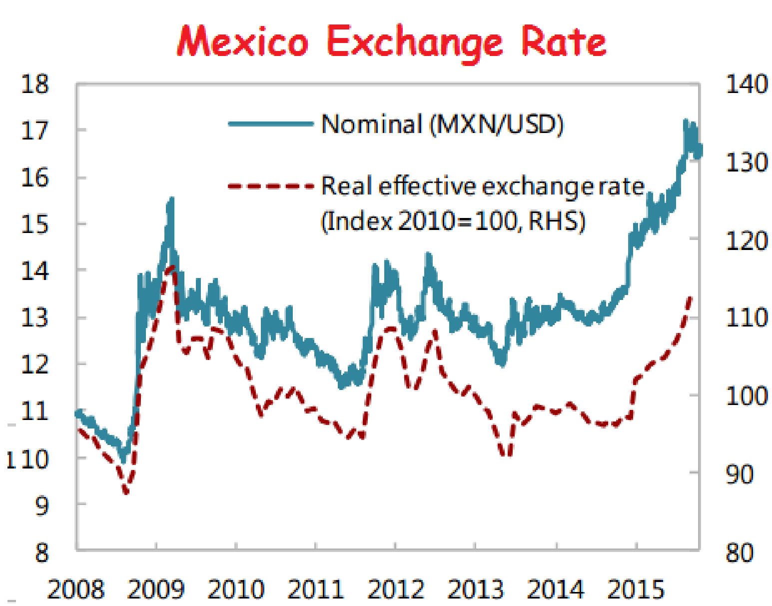


Data Sources: Banco de Mexico, INEGI, SAT and SE, Moody's Analytics



Graphic Source: IMF Country Report No. 15/313

Data Sources: National Authorities, Haver Analytics, Dealogic, and IMF Staff Calculations



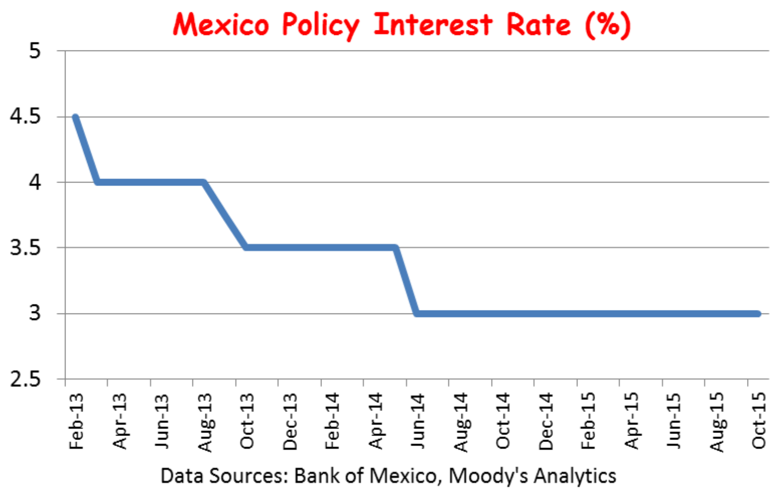
Graphic Source: IMF Country Report No. 15/313
Data Sources: Bloomberg; National authorities; and Haver Analytics

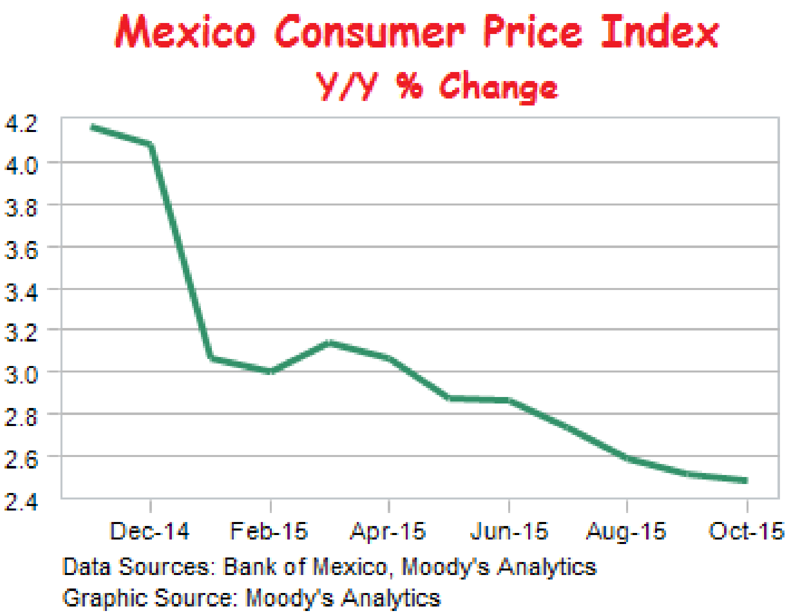
While the recent auction results have given hope for the government's reform efforts, activity in the energy market will most likely remain restricted in the near term due to the downward trend in oil prices. Tepid global economic conditions resulting from China's slowdown and uncertainties in Greece have caused the price of oil to drop significantly. Given that a strong recovery in oil prices is not expected any time soon, significant improvement resulting from the government's reform efforts will most likely not occur for a few years.

Thankfully, the negative effect of lower oil prices on Mexico's exports has been partially offset by steady nonoil exports growth. The anticipated monetary tightening by the Federal Reserve, along with lower oil prices and China's slowdown, has significantly increased risk aversion among foreign investors and caused the peso to depreciate sharply over the last year. The weaker peso is boosting nonoil exports by increasing the price-competiveness of Mexican goods in the global market.

In addition to the weak peso, nonoil exports are also being lifted by improving economic conditions in the U.S., Mexico's principal trading partner. Manufacturing exports, particularly those relating to autos, have experienced the strongest gains. Mexico is now the fourth-largest exporter of cars, exporting around 80% of its auto production.

Nonoil exports growth is expected to strengthen in the near term as the U.S. growth engine gains momentum and peso faces additional downward pressure from lower oil prices and China's slowdown. Nevertheless, the negative impact of lower oil prices on Mexico's energy sector will continue to outweigh the improvement in nonoil exports growth in the near term.





Meanwhile, Mexico's imports are also faltering, particularly those relating to intermediate goods. Unfortunately, this is bad news because it suggests that business confidence in Mexico is deteriorating. Imports of consumer goods are also stalling due to reduced purchasing power from the weak peso. Although imports are expected to pick up in the near term as a result of the recent increase in consumer demand caused by the government's expansionary policies, growth will remain restricted until business confidence improves.

The Bank of Mexico has left the policy interest rate unchanged since June 2014 at 3%, a record low, boosting consumption. Household spending is also being supported by falling inflation, as tax hikes on some food staples in 2014 have resulted in lower inflation this year due to a higher comparison base.

Overall, we see that Mexico's economy is stalling and giving mixed signals of recovery. The decline in oil prices will continue to weigh on the nation's energy sector and prevent a strong recovery in investment and production in the near term. Although the falling peso and improving economic conditions in the U.S. will boost exports in the coming months, the negative impact of lower oil prices will continue to outweigh these benefits. Meanwhile, significant improvement from the government's reform efforts is not expected to occur for a few years. The economy will therefore remain restricted in the near term, with growth reaching around 2.2% this year, below its potential.