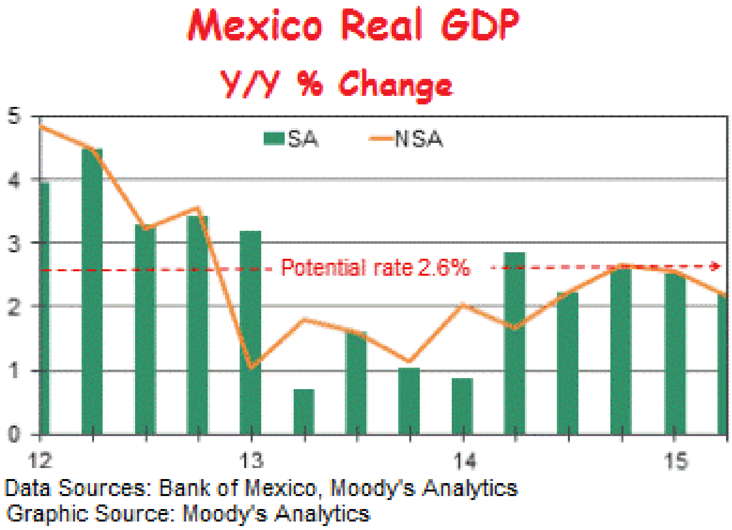
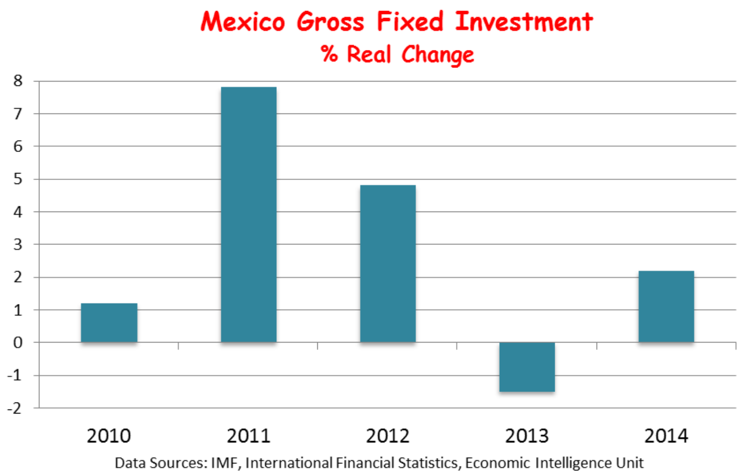
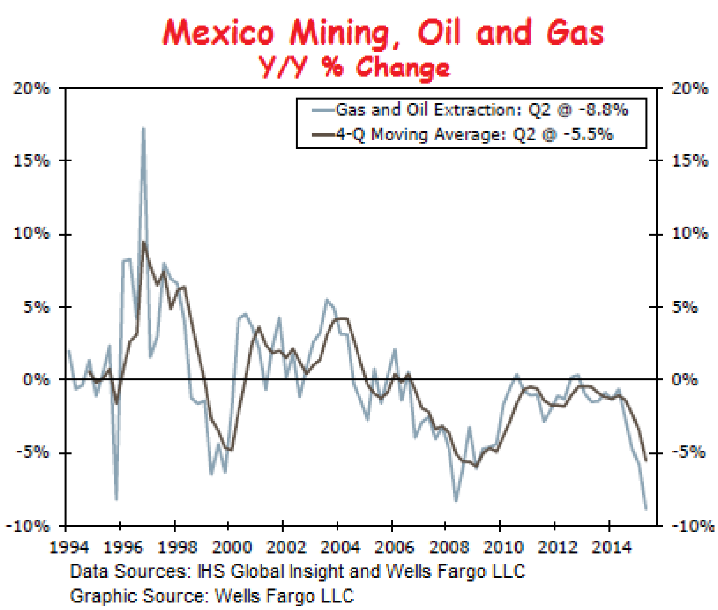
Mexico's Economic Outlook



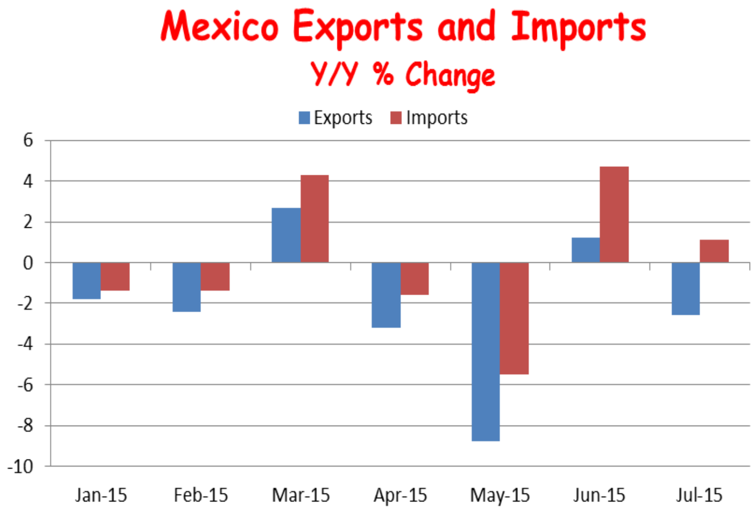




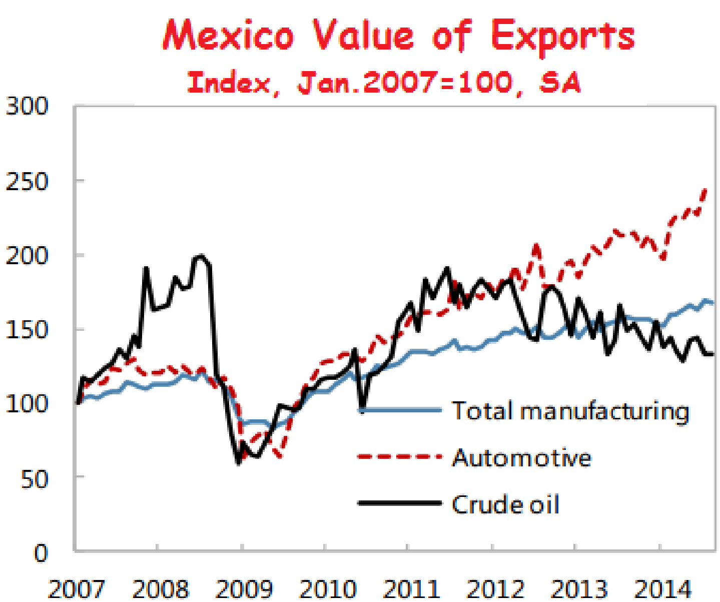
The Mexican economy is struggling to recover from a slowdown that began two years ago. Growth has fallen below 3% since 2013, the first year with Enrique Peña Nieto as president. Conditions are expected to remain lackluster in the near term, with growth reaching around 2.3% this year, half the rate of 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. Unfortunately, however, lower oil prices have made large international energy companies reluctant to engage in these investments and only two of the 14 drilling blocks were sold at the first auction. The disappointing results, along with frenzy caused by the recent prison escape of the nation's most-wanted drug lord, Joaquín "El Chapo" Guzmán, has shattered confidence in the administration and its reform efforts.

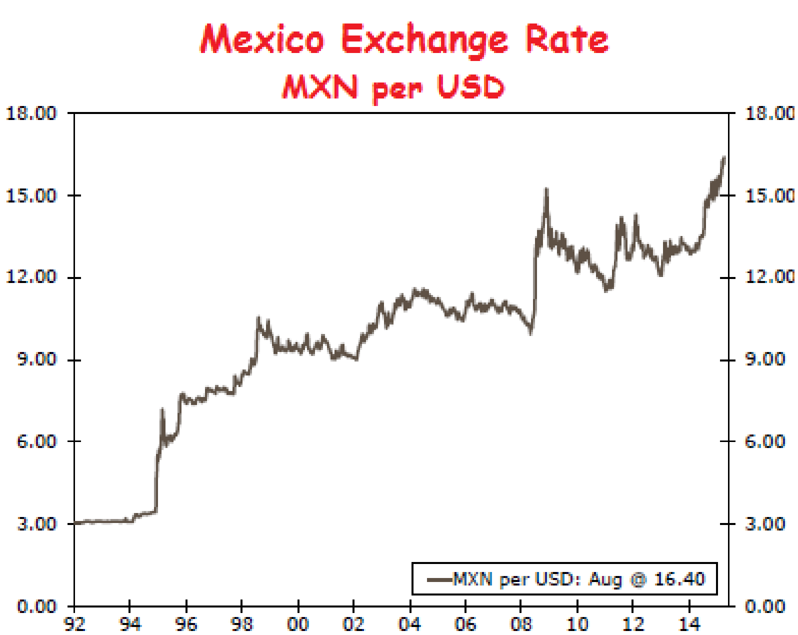


Data Sources: Banco de Mexico, INEGI, SAT and SE, Moody's Analytics



Graphic Source: IMF Country Report No. 14/319

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



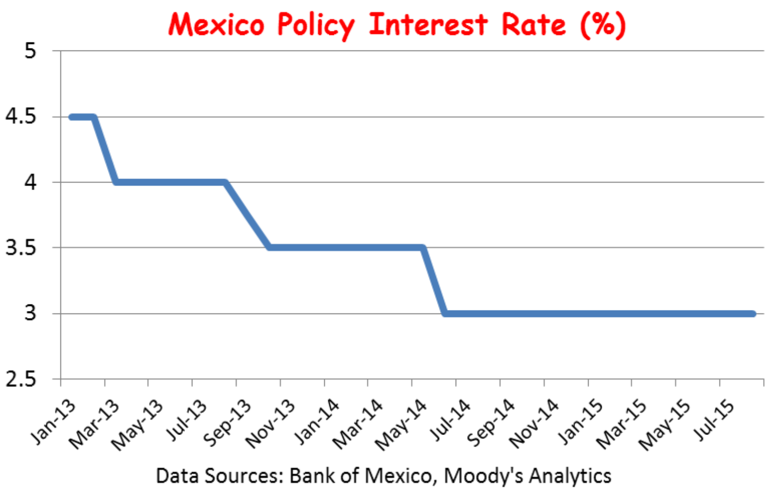
Data Sources: IHS Global Insight and Wells Fargo LLC
Graphic Source: Wells Fargo LLC

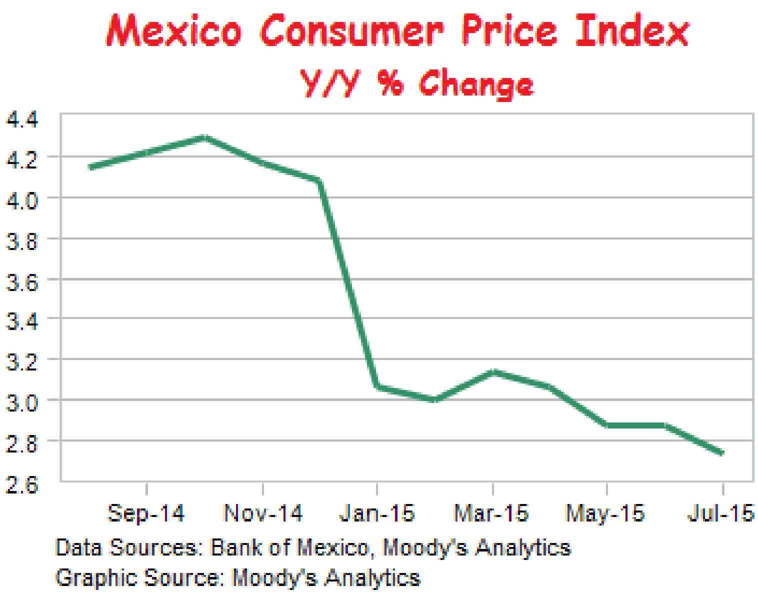
Although the government is attempting to make contractual terms more favorable to foreign investors, activity in the energy market will likely remain suppressed in the near term due to the downward trend in oil prices. Tepid global economic conditions resulting from China's slowdown and uncertainties in Greece have driven the price of oil to a 6-year low. 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 rising 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 peso is now at a record low against the U.S. dollar, increasing the price-competiveness of Mexican exports.

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, are experiencing 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 remain strong 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.





Despite reduced purchasing power from the weak peso, Mexico's imports are rising. The Bank of Mexico has left the policy interest rate unchanged since June 2014 at 3%, a record low, which is boosting consumer spending by reducing the return on saving. 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.

Although household consumption will continue to be supported by low interest rates in the near term, Mexico's inflation rate is expected to experience upward pressure in the coming months as the higher base effect from last year's tax hikes dissipates and the weak peso increases imported inflation. As inflation pressures rise, households will experience reduced purchasing power and the central bank may need to raise the policy interest rate, crimping the outlook for consumer spending.

Overall, we see that Mexico's economy is stalling and giving mixed signals of recovery. The renewed decline in oil prices will weigh heavily on the nation's energy sector and prevent a 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 2.3% this year, below its potential.