MEXICO

Economic activity has been resilient to sharply lower oil prices, weak world trade growth and monetary policy tightening in the United States. Domestic demand remains the main driver of economic activity, supported by recent structural reforms that have cut prices to consumers, notably on electricity and telecoms services. Growth will be held back in 2017 and 2018, mostly through investment and consumer confidence, following uncertainties about future US policy, although the economy could benefit from stronger import demand from the United States.

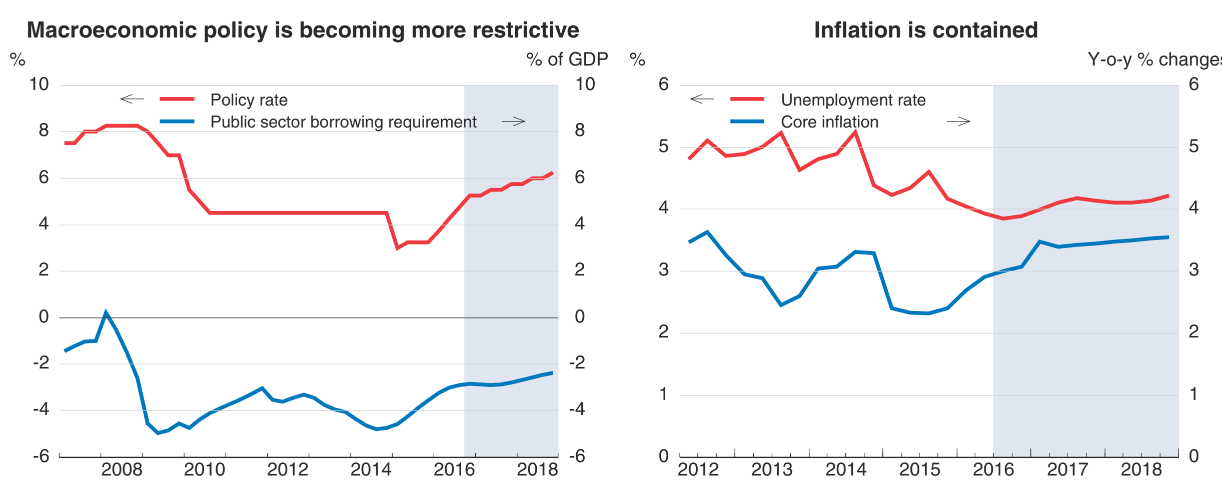
Macroeconomic policy is being tightened. Banco de Mexico raised policy rates to counter inflationary pressures and keep inflation expectations anchored near the inflation target and more recently in response to heightened uncertainty in the wake of the outcome of the US presidential election. In order to meet the consolidation path and ensure debt sustainability, the 2017 budget includes expenditure cuts, with the objective of returning to a primary surplus.

The government laid down a consolidation path two years ago to reduce the budget deficit (measured by the public sector borrowing requirement) by 2 percentage points of GDP over 4 years. However, there is scope for reallocating expenditures and further limiting tax expenditures to raise spending on programmes conducive to inclusive growth for Mexican families – such as child care, health, poverty reduction, and infrastructure.

Economic activity is being held back by external headwinds

Despite being hit by several external shocks, the Mexican economy has been resilient. The external environment is difficult, with the global economy remaining in a low-growth trap and poor expectations depressing trade, investment, and wages. Headwinds specific to Mexico include collapsing oil prices, which decreased government receipts, cutbacks in energy sector investments, and the sharply depreciating Mexican peso following market

Mexico



Source: OECD Economic Outlook 100 database; and Banxico.

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Mexico: **Demand, output and prices**

	2013	2014	2015	2016	2017	2018
	Current prices MXN billion	Percentage changes, volume (2008 prices)				
GDP at market prices	16 114.5	2.2	2.5	2.2	2.3	2.4
Private consumption	11 048.0	1.8	3.1	2.8	2.4	2.4
Government consumption	1 962.5	2.1	2.4	0.6	-0.1	0.0
Gross fixed capital formation	3 400.7	2.8	3.9	2.0	1.9	2.2
Final domestic demand	16 411.2	2.0	3.2	2.4	2.0	2.1
Stockbuilding[1]	- 150.9	0.0	-0.1	0.0	0.0	0.0
Total domestic demand	16 260.3	2.1	3.1	2.4	2.1	2.1
Exports of goods and services	5 119.4	6.9	9.1	2.6	4.3	4.9
Imports of goods and services	5 265.2	5.9	5.1	3.2	3.9	4.1
Net exports[1]	- 145.7	0.3	1.2	-0.3	0.1	0.2
Memorandum items						
GDP deflator	_	4.7	2.5	3.7	3.3	3.2
Consumer price index	_	4.0	2.7	2.8	3.5	3.6
Private consumption deflator	_	4.2	4.0	3.7	3.6	3.7
Unemployment rate[2]	_	4.8	4.3	3.9	4.1	4.1
Public sector borrowing requirement[3,4]	_	-4.6	-4.1	-3.0	-2.9	-2.5
Current account balance[4]	_	-2.0	-2.9	-3.5	-3.4	-3.1

1. Contributions to changes in real GDP, actual amount in the first column.
2. Based on National Employment Survey.
3. Central government and public enterprises.
4. As a percentage of GDP.

Source: OECD Economic Outlook 100 database.

StatLink http://dx.doi.org/10.1787/888933439127

expectations of US Federal Reserve tightening, and policy uncertainty in the United States. Domestic demand remains the main driver of growth thanks to the strong expansion of credit combined with gains in real wages, employment and foreign remittances. Unemployment remains low. The large depreciation of the peso has further increased the competitiveness of Mexican non-oil exports, with associated inflationary pressures being offset by reform-driven price reductions of several services.

The government is on track to meet its Public Sector Borrowing Requirements (PSBR) deficit target. The deficit was cut by 1.1% of GDP from 2015 to 2016, although this largely reflected a one-off profit remittance from the central bank. The loss of budget revenue following the collapse of global oil prices posed a challenge and an opportunity for Mexico, which it successfully met by implementing a reform to raise taxes by 3% of GDP since 2014, thereby significantly reducing fiscal dependence on oil. The central bank has raised its target interest rate by 225 basis points to 5.25% since end-2015 with the objective of countering inflationary pressures resulting from the significant depreciation of the peso and keeping inflation expectations anchored close to the 3% target.

Reforms are paying off and should be continued

There are signs of early benefits from the structural reforms, especially on productivity growth, which has picked up recently. Trade openness, foreign direct investment, integration into global value chains and incentives to introduce innovative technologies have boosted selected activities, such as auto production. However, many other activities lag behind and more needs to be done to motivate people to participate in the formal labour market, while ensuring satisfactory work-life balance, and equipping workers with the necessary skills to be productive. Further reforms are needed to address the misallocation of productive resources, due to overly stringent local regulations, weak legal institutions, high rates of corruption and insufficient financial inclusion. Reforms should also aim at eradicating extreme poverty, reducing income inequality and informality, raising female participation, and encouraging more responsible business practices.

The outlook is linked to external developments

Despite benefitting from stronger US import demand, the expansion of the Mexican economy is projected to be affected by policy uncertainties in the United States. However, the economy will continue to be supported by a competitive exchange rate, solid credit expansion, and continuing improvements in the labour market aided by the government's structural reforms and the low inflation environment. On the other hand, declining oil production and public spending cuts weigh on the economy.

Risks to the projections include uncertainty about external policy developments, additional reductions in oil production, and softer business confidence and private investment. Inversely, an increase in oil prices could bring positive developments for both the current account and fiscal deficits. Domestically, full implementation of structural reforms, in particular education, is key to support longer-term growth.