



Global



Quality

A changing Mexico: Perspectives 2019

December 2018



Introductory Letter

C.P.C. Mauricio Brizuela Arce
Socio Director



I am pleased to welcome you to the third edition of our analysis document “A Changing Mexico: Perspectives 2019”.

In our last publication, we had said that 2018 would be a year in which various significant changes adjustments would arise in both domestic and global scenarios. The effects of the changes have begun to have an impact on the world economy. However, economic indicators have not necessarily shown the depth of the changes yet.

Some of the changes posed materialized in 2018 and others did not completely materialize. In this publication, we offer a brief account of the events that set the course in both the global and domestic setting in this 2018. Moreover, we strive to contribute to the need for information and caution our clients and friends as to the possible risks, scenarios, and recommendations that the Salles Sainz - Grant Thornton team deems significant for the next year 2019.

During the next year, there will be many distractors. However, there are 3 issues that should draw out utmost attention: the approval of the T-MEC, trade war between the US and China, and the new Government in Mexico.

Constant oversight of the performance of these three matters will be significant.

Times of changes such as those that are being lived open opportunities and generate specific risks. At Salles Sainz - Grant Thornton, we hope to help our clients find the way to take advantage of the former and mitigate the latter.

Mexico and the world will continue to undergo a stage of big changes. Being observant of the events occurring in Mexico will help to foresee possible scenarios.

Contents

Section	Page
Executive Summary	1
Prior considerations	3
Retelling the events	5
Global setting	5
Domestic scenario	6
Politics	7
Economical	8
Socially	12
Risks, scenarios and perspectives for 2019	13
Risks	13
Signature and approval of the USMCA	13
Trade war between US and China	13
New Government in Mexico	14
Probable scenarios of a changing Mexico	14
With USMCA and economic continuity	15
With USMCA and a policy of change	15
Without USMCA and economic continuity	15
Without USMCA and a policy of change	16
Recommendations	17

Executive Summary

2018 started as a year in which protectionist trends and threats, limitations on world migration, terrorism, and possible armed conflicts were the risks that seemed likely to arise. However, some of them were mitigated.

The world is living an era of significant adjustments and changes. The effects of the changes have begun to have effects on the world economy. However, economic indicators have not necessarily shown the depth of the changes yet.

The context of transition and change is due to the displeasure of societies, brought about mainly by the following reasons:

- Democracy has not solved the problems of distributing wealth among peoples, which has led to displeasure with politics and politicians.
- Migratory flows have not been stopped and they generate distortions in the economy and social coexistence of the countries affected.
- Protectionism continues to make itself felt in various modalities, trade wars, imposition of tariffs and trade restrictions.
- Social networks have become sources of power and influence in the everyday life of societies.

This has led to an intense search for new political and economic options. In 2018, Mexico has found itself in a moment of historical, relevant changes highlighted by two elements: internationally, the renegotiating of the NAFTA (lately named USMCA), and the other of an internal nature that has been the result of the 2018 elections and uncharted period of transition. These two issues have brought about a period of instability and political uncertainty.

An era of world change is being experienced in which it seems that emotion is placed over reason for decision-making. Economic agents react in dealing with this panorama by adversely impacting the economic performance of countries.

Notwithstanding the foregoing, the world continues with a process of moderate expansion. According to World Bank data, world growth is estimated to be 3.1% for 2018 year end. Economic growth seems to weaken for the following years.

According to data from the same source referred to above, 3.0% economic growth is estimated for 2019. Another example of this lies in the growth projections for 2018 and 2019 of leading economies, such as the United States and China, in which decrease in growth rates is forecasted, due primarily to two factors:

- Trade disagreements that generate uncertainty on markets.
- High interest rates that are experienced worldwide.

An environment of high interest rates limits growth and breeds inflation in some cases.

The national setting in 2018 has shown two moments: a first semester where there was economic stability in spite of the presence of political campaigns; and a second semester in which the results of the election unleashed events that have generated instability and volatility in variables and financial markets.

Unsolved social problems such as insecurity, corruption, and little progress in eliminating marginalization have contributed to the era of change that is being lived.

Elections for President of the Republic, Mexican Congress, various State Governments, and a large number of Mayorships and popular vote positions were conducive to a very intense 2018. Even though the polls projected it as such, the victory of MORENA candidate, Andres Manuel Lopez Obrador, was surprising due to the wide margin which he was victorious. In addition, the same party obtained a majority in Congress.

Economically, Mexico showed light and dark parts due to the external setting, as well as internal aspects previously described. Nevertheless, it has also shown signs of strength and stability.

In spite of the economic slowdown the country and the world are going through, there are certain factors in Mexico that contribute to maintaining stability in the domestic economy, such as employment, the tourist sector, the upswing of the agricultural sector, the performance of foreign investment, and the flow of international remittances to Mexico.



There will be many distractors for 2019, but three will be matters of major relevance and impact for Mexico, which merit constant observance and analysis:

- Approval of the USMCA
- Trade war between the US and China
- New Government in Mexico

Constant oversight of the performance of these three matters will be significant.

This document is intended to put forward the possible risks, scenarios and recommendations derived from the studies and analyses performed by the Salles Sainz - Grant Thornton team, applied to the business world and reality that Mexico will experience throughout 2019.

Based on the performance of economic variables and expectations with respect to the signature and approval of the USMCA, as well as the handling of the economy, how the new Government performs, we have drawn up four scenarios which we consider to be representative. There are different projections in each one of the economic variables.

At any rate, we estimate that Mexico will experience economic growth for 2019, inflation and, therefore, interest rates will remain at high levels similar to current levels.

By the same token, the exchange rate will be a variable with high levels of volatility, and it will be subject to the reactions of economic agents, in accordance with the result of the approval of the USMCA, and the actions of the new Government.

Moreover, as we have stated in the past, times of changes such as those that are being experienced open opportunities and generate specific risks where it is necessary to find how to take advantage of the former and mitigate the latter.

Prior considerations

Various matters of high transcendence remained on world work desks throughout 2018, which included, among other things, economic growth, migration, protectionism, terrorism, and the possible existence of wars.

In the document that we published toward the end of 2017 **“Mexico and the world in 2018”**, we anticipated that 2018 would be a year in which uncertainty and instability on the markets would be a trend due to the political and social scenarios that the world was undergoing.

Some of the trends, risks, and opportunities presented for 2018 were shown as a mixed panorama in the global setting, such as protectionist trends and threats, limitations on world migration, terrorism threats, and the possibility of armed conflict. Had these scenarios occurred, effects could have been expected in the world economy, above all, in trade, flow of people, possible acts of terrorism, and harm to world peace.

Fortunately, some risks were mitigated and regrettable events did not take place. However, it is evident that economies and societies are at a time of adjustment and significant changes, which have been conducive to diverse decisions being made that begin to have a bearing on the world economy.

That is why before embarking upon a more detailed analysis of the economic data and perspectives for the future, it is necessary to make certain previous considerations to be able to frame the information in a context of transition where economic indicators do not necessarily show the depth of the changes yet, but they do outline a course that is necessary to identify for business decision-making. In particular, some trends and indicators thereof are beginning to show strength:

- Democracy has not solved the problems of distributing wealth among peoples, which has led to displeasure with politics and politicians;
- Migratory flows have not been stopped and they generate distortions in the economy and social coexistence of the countries affected;
- Protectionism continues to make itself felt in various modalities, trade wars, imposition of tariffs and trade restrictions;
- Social networks have become sources of power and influence in the everyday life of societies.

As a consequence of the foregoing, societies are changing their way of acting searching for a new direction. This explains the decisions of some countries up to a point, of making radical changes in the forms of organization and Government.

Options that have already been surmised with examples such as BREXIT in the United Kingdom or the arrival of a disruptive governing person such as Donald Trump to the White House. The world will continue to experience and search for new options; recent examples such as the radical changes in the Governments of Sweden in Europe or Brazil in the Americas confirm it.

The displeasure of societies has led to an intense search for new economic and political options.

For Mexico, its trade opening, geopolitical position, and internal conditions bring about a definitive influence in the process of events.

Together with the conditions of the international environment, the displeasure of Mexican society with regard to unsolved chapters such as the distribution of wealth, lack of growth and, in these last years, issues that hurt society such as corruption, drug trafficking, delinquency, and the lack of the rule of law, have been conducive to institutions and society as a whole, are also searching for new economic and Governmental options, with a clear objective of making changes that bring about an improvement in the well-being of the population.

2018 has become a moment of reflection, underscored by two elements: one of an international nature that is the result of the renegotiating of the NAFTA, and the other of an internal nature, which is the result of the elections in Mexico and the uncharted transition of Government.

This is why the analysis of the performance of the Mexican economy in 2018 must be addressed considering two periods within the same year.

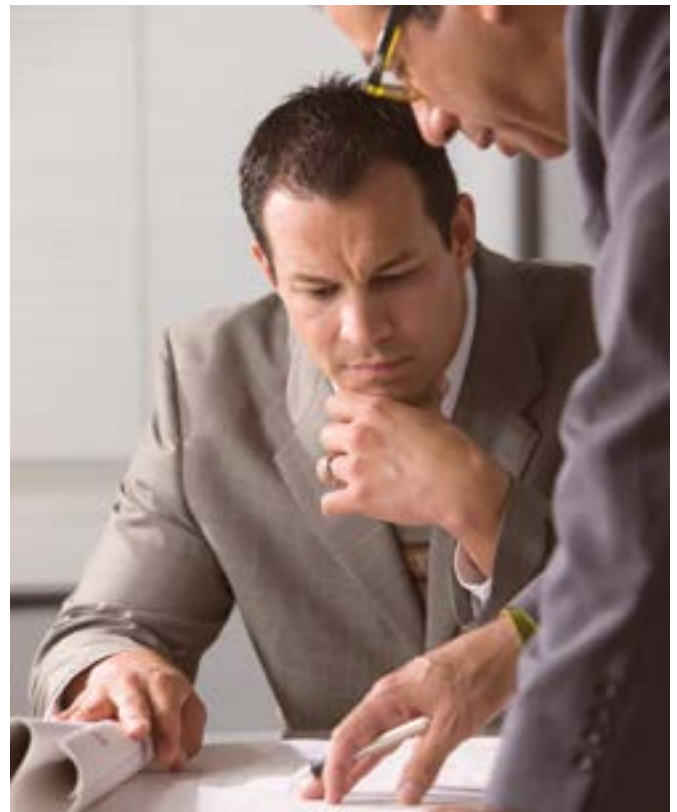
Mexico is living a time of historical and relevant changes in 2018.

On one hand, the first semester was characterized by negotiations of NAFTA and competitive electoral campaign processes that generated continuity in the economic activity of the country.

On the other hand, a second semester where the risks of the renegotiating of the NAFTA (recently named USMCA) are compounded and have raised doubts in the completion of the process, beginning with the risk of the failure to have it approved by the Congresses of the three countries. Politically, the result of the elections have given the triumph to an option of a profound political change in the country.

At the same time, consideration of the uncharted process of transition of Government where the new political actors announce future decisions that raise the doubt of the continuity of economic policy.

The scenario described has a significant bearing on the certainty of the decisions made by persons, companies, institutions, and Governments, which certainly leads to uncertainty and instability that impacts the performance of the economy of countries.



Uncertainty and instability have become one of the characteristics of the current era.

Retelling the events

Throughout 2018, the performance of economies has been affected by conditions of world change and by the evident, profound changes within the country.

A present is being experienced where the displeasure of societies described above in which a higher value is placed on emotion over reason for decision-making. In dealing with these new realities, economic agents react confusingly in trying to adhere to traditional schemes and protecting the economic, political, and social interests of its members, which breeds instability on various markets.

To be able to draw up possible, likely scenarios, it is always necessary to analyze past circumstances and current performance. In this line of ideas, reviewing what has happened in the world and inside of Mexico prepares the bases for estimating future behaviors and estimations.

Global setting

Two positions found have been developed in the world: on one hand, the protectionist trends expressed by countries such as the United States and the United Kingdom in the West and, on the other hand, promoting and insisting on maintaining trade opening and globalization in the Orient.

In dealing with these disagreements and a mixed panorama in the global setting, economic agents take their precautions. Consequently, trade has been reduced and experienced little dynamism.

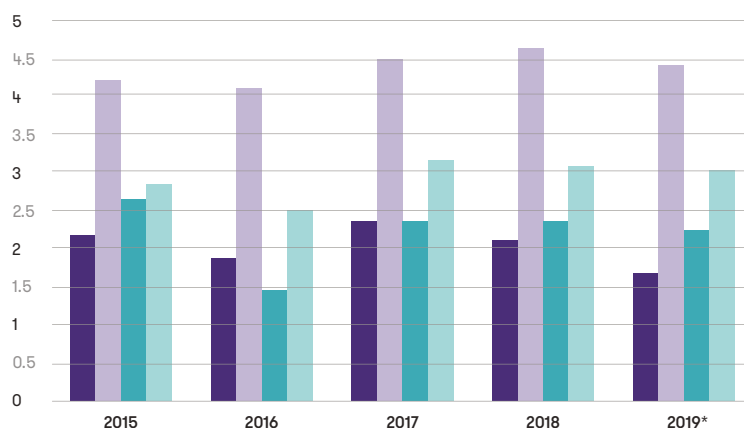
The trade war undertaken by the United States against China not only affects trading conditions between them, but also in the countries that maintain close trading relations.

The reality is the world growth of the Gross Domestic Product has maintained positive growth, notwithstanding its scant dynamism. On the other hand, the trade war in which the United States and China are embroiled, inflation, and rise in interest rates have affected world economic growth.

Notwithstanding the foregoing the world continues with a process of moderate expansion. According to World Bank data, world growth is estimated to be 3.1% for 2018 year end. Economic growth seems to weaken for the following years. According to data from the same source referred to above, 3.0% economic growth is estimated for 2019. We found another example thereof in the growth projections of economic powers such as the United States and China for 2018 and 2019.

Regional GDP Annual Growth Rate %

Units: percentage/year



*Estimated data. Source: own preparation with World Bank data.

Interest rates with an upward trend and inflationary pressures will continue to be present.

Growth rates are dropping due mainly to two factors. The first factor refers to uncertainty on the markets, brought about by trade disagreements. A clear example is the trade war existing between the United States and China. The second factor is due to the environment of high interest rates that are being experienced worldwide.

Meanwhile, leading interest rates on the market continue to rise, and dependent countries will have to do the same. In the United States, the interest rate has shown an upward behavior for several years. The increase is not lower, since it has risen from 4.2% to 5.2% in just a single year.

An environment of high interest rates limits economic growth and breeds inflation in some cases. In the forthcoming years,

increases are expected in inflation by going from 2.1% in 2017 to 2.6% at the end of 2018 and 2.8% for 2019.

The economy of the region has been influenced by political events, such as the mid-term elections in the United States, which sent messages that were confusing and aggressive at times, with the idea of influencing the American electorate.

Domestic scenario

Many events have taken place in Mexico in 2018, in the political environment as well as in economic and social matters, which undoubtedly represent a point of inflection in the future of the country.

Politics	Economical	Socially
Intense electoral processes	Slow, insufficient growth	Insecurity and delinquency that have been unable to be controlled
Alternation in power	Sectors that perform well: tourism, agriculture; and others that do not, automotive	Unsolved corruption
Majority and control in Congress	Inflation that decreases, but does not ease off	Scandals
Uncharted political transition	Rising interest rates	
High impact Government decisions before being sworn into office (NAIM and others))	Volatile exchange rate	
	Renewed NAFTA, but unsigned	

The duration of these events marked significant changes in the perception and economic performance of the country toward the second semester of the year, which generated greater uncertainty in the future by economic actors and, therefore, greater volatility of variables.

Politics

2018 was a very intense year in political issues for Mexico. During this year, elections were held for President of the Republic, the Chambers of Deputies and the Senate, various State Governments, and a large number of Mayor ships and positions by popular vote.

The political campaigns that took place during the first semester of the year were fluid in general and without serious incidents. The Federal Government and electoral authorities guaranteed a clean process and acted responsibly and there was a broad network of communication.

In most cases, the day of the elections were held in a normal, mature and responsible exercise of Mexican society.

Even though the polls already forecasted the anticipated triumph of the opposing candidate of the Government in office, Andres Manuel Lopez Obrador, candidate of MORENA for the Presidency of Mexico, his triumph was surprising, above all, due to the wide margin which he gained the triumph, over 30 million votes that represented 53.1% of the electoral preferences.

Not only was it surprising, but also the fact that this same political party obtained an absolute majority in the Chamber of Deputies with 51% of the votes and 63%, taking into account those of the Encuentro Social and Partido del Trabajo (PT) parties, which belong to the same coalition. By the same token, MORENA reached 46% in the Senate and 55% with the parties of the same coalition.

This situation had not happened in Mexico in many years, and evoked opinions found among those who thing that it facilitates Government action, and those who consider that the lack of political checks and balances leads to mistaken, authoritarian decisions in favor of groups of interest.

Beyond the winning party, MORENA has been strongly criticized for its trend toward a leftist ideology, based on populism as part of its action and Governing program. What is true is that the result of the vote reflects the process of exhaustion and disagreement of society in coping with Governments that have been unable to solve problems entailing corruption, insecurity, and lack of the rule of law in society,

on one hand, and a desire to achieve significant changes in economic results and well-being of the population.

Beginning with the election, an uncharted process of transition in the history of Mexico began due to various reasons, highlighted by:

- Political activism by the President-elect with proposed actions prior to being sworn into office.
- The appointment and advance communication of the cabinet and heads of various agencies who also started with public arrangements and proposals.
- The restraint of the Government in roles in dealing with the media.
- Holding a citizen referendum concerning the location of the new international Airport of Mexico City, despite the percentages of completion in the construction thereof in the Texcoco area and which, upon fail to meet the constitutional legal requirements, brought out major criticism and lack of confidence.

This scenario has brought on extensive discussions and disagreements among political leaders, business people and social leaders where there is no point of convergence among the parties, which generated significant distortions in the economy toward the end of 2018.

The electoral results of 2018 more than a political alternation represent a change of regime. The economic changes and consequences pose a great challenge.

MORENA represented a change that even when it obtained an electoral majority, it fails to achieve the consensus of domestic and foreign economic.

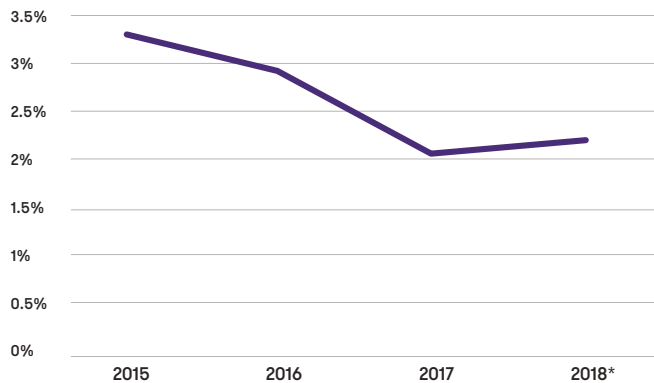
Economical

The economic performance of Mexico in 2018 showed light and dark parts due events derived from the external setting, as well as internal aspects previously described herein. Nevertheless, it has shown signs of strength and stability.

From the perspective of the real economy, Mexico continues to grow. However, it grows below what was expected and necessary for the economy of a developing country, and it has not surpassed the 3% barrier. Consequently, expected growth of the Mexican Gross Domestic Product is set at 2.2% for 2018.

GDP México

Units: percentage/year



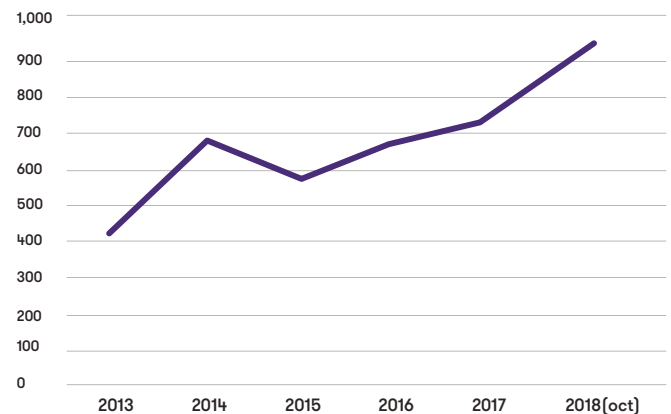
*Estimated Data. Source: Own preparation with World Bank data

In spite of the economic slowdown the country and the world are going through, there are certain factors in Mexico that contribute to maintaining stability in the domestic economy, such as jobs, the tourist sector, the upswing of the agricultural sector, the recovery of oil prices, the performance of foreign Investment, and the flow of international remittances to Mexico.

Even when growth of production has not had the expected dynamism, jobs continue to be created in the formal economy, which contributes to maintaining sound levels of consumption and internal activity.

Employment

Units: thousands of people/year



Source: Own preparation with INEGI data.



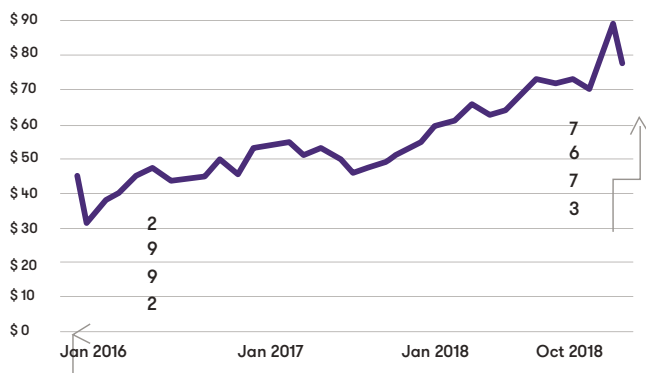
Moreover and thanks to the multinational oil production agreements that have been entered into in these last year and the world demand for oil, the price of crude oil on the market showed an upward trend in 2018. This represents a factor that contributes to economic growth, and represents additional revenues for the domestic economy.

Throughout 2018, Mexico has dealt with big economic challenges, brought about mainly by the 2018 elections and the renegotiation of NAFTA. However, direct foreign investment and international remittances continue to strengthen the economy of the nation.

Foreign investment has continued to flow to our country in the order of 30 billion dollars annually, and it is expected to achieve a similar amount in 2018.

Oil - Petroleum

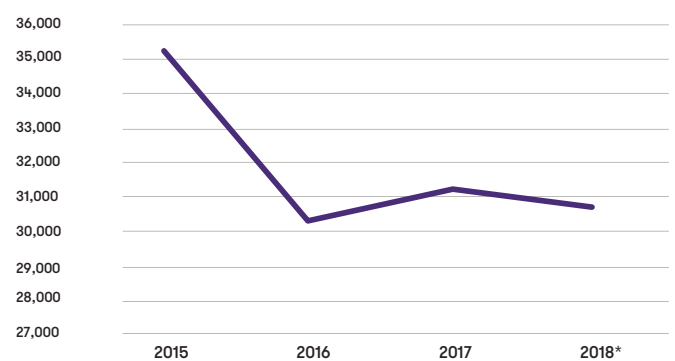
Units: dollars/year



Description: Crude oil, an average of three prices, Brent (dated), Intermediate West Texas and Dubai Fateh, U.S. Dollars per barrel. Source: Own preparation with World Bank data.

Foreign Direct Investment

Units: millions of dollars/year



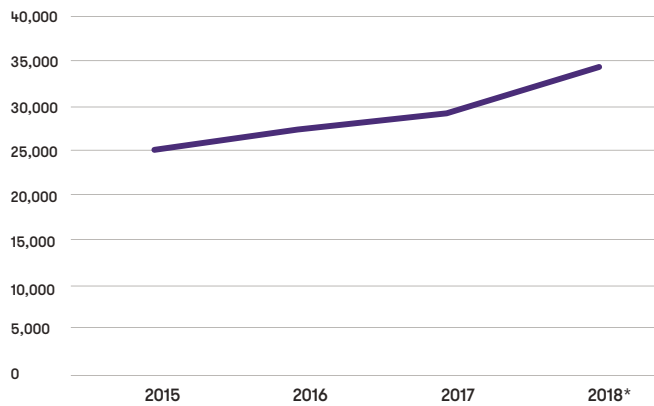
*Estimated Data. Source: Own preparation with data from Banco de Mexico (BANXICO).

The risk of a tax assessed on sending international remittances by the Government of the United States did not happen and that is why the flows of international remittances from that country continue to increase. These revenues have become a significant buffer of the income of Mexican families, which have shown consistent growth, and it is estimated that they will reach about 34 billion dollars for 2018 year end.

Many efforts and actions have been undertaken by the Banco de Mexico and the tax authority of Mexico to successfully reduce price levels. But the forecasts made by our firm in 2017 were true. Even when a process of reduction of inflation was started in 2018, it will not be possible to attain the levels expected by the financial authorities of the country, above all, if an environment of rising interest rates is considered.

Remittances

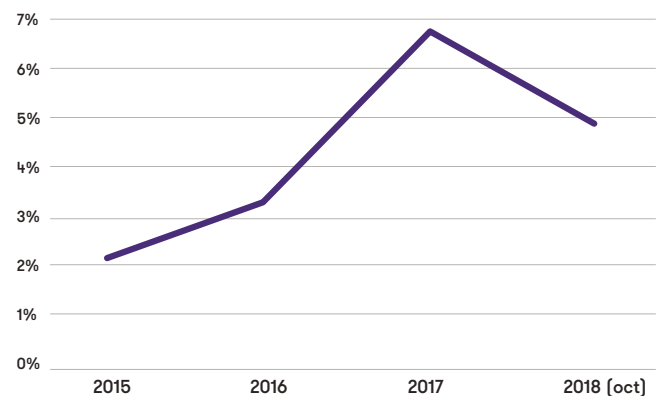
Units: millions of dollars/year



*Estimated Data. Source: Own preparation with data from Banco de Mexico (BANXICO)

Inflation

Units: percentage/year



Source: Own preparation with data from INEGI

The economy of Mexico continues to show signs of strength and stability in spite of an aggressive international environment and changes that are being experienced. In this line of ideas, it has been necessary to manage public finances responsibly. To achieve this, it has been necessary to make use of financial variables in order to maintain stability and discipline in public finances.

The economy of Mexico continues to show signs of strength and stability.

Inflationary indexes and interest rates have been affected by the reactions of the economic agents in dealing with decisions made by the incoming Government.

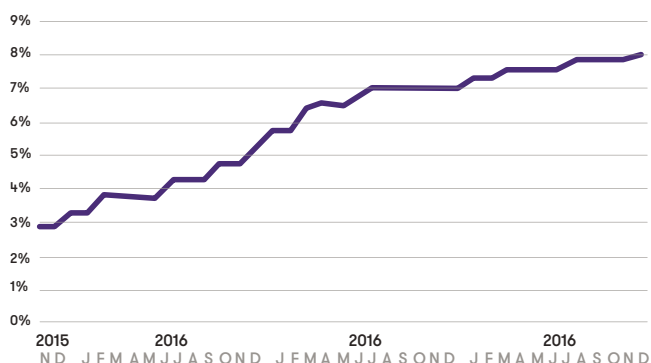
In dealing with a level of inflation close to 5% for 2018, as well as taking into account the need to maintain a positive flow of foreign currency toward Mexico, and in dealing with a world environment of rising interest rates, it becomes necessary to maintain positive real interest rates.

For such purposes, the interest rate in Mexico has shown congruent behavior with this objective, and it has been set at 8% at November month end. That does not necessarily mean good news for the economy.

It is important to note that an high interest rate also leads to undesirable effects, by reducing available income of persons and, therefore, it affects consumption, investment and, in general the economic activity. As time elapses, it becomes a brake on economic growth.

Interest Rate

Units: percentage/year



Source: Own preparation with data from the Banco de Mexico [BANXICO].

Mexico has experienced an uncharted period of transition, in which decisions of great importance such as that of the new international Airport of Mexico City have impacted different economic variables.

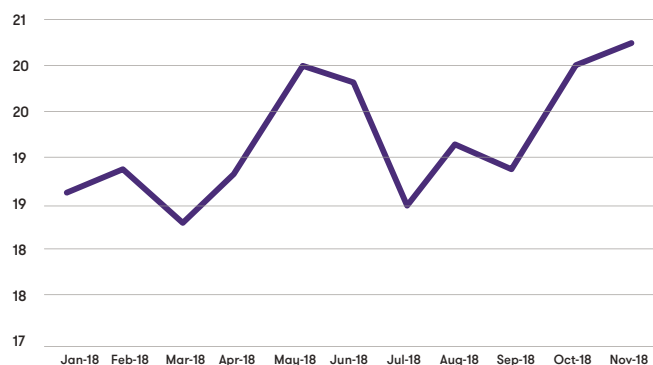
In particular, the variable in which short-term uncertainty is reflected is in the exchange rate. Market anxiety generates movements of capitals and stock markets that impact the exchange rate.

By the same token, it must be born in mind that the Mexican peso is the most significant currency of emerging countries; therefore, it is affected by transactional movements in Mexican pesos that are carried out on international markets.

Forecasts by specialists have been surpassed in the last months of 2018 that have carried the Mexican pesos to values that exceed \$20 pesos per US dollar, which place it on a band ranging from \$20.00 to \$21.50 at year end.

Exchange Rate

Units: pesos per dollar/month



Source: Own preparation with data from the Official Daily Gazette (DOF).

Taking into account the behavior of economic variables of the first semester and end of the second semester of 2018, the economic scenario nationwide reflects uncertainty and anxiety on the markets, which results in scaled effects in financial variables such as the exchange rate and interest rate.

Socially

The events recorded in Mexico in both politics and performance of the economy that have been presented in this document are derived from feedback from how society and its members feel and act. The mood and perception of society is finally what spurs political decisions and provide guidance in economic matters.

One of the tasks pending continues to be the social issue, and even though this document is not intended to perform an exhaustive analysis of social issues, some comments are necessary to be able to understand the performance of the economy. Estimates indicate that the cost of corruption in Mexico can represent up to 10% of the Gross Domestic Product, an excessively high amount.

The existence of high levels of corruption leads to a process of a lack of confidence, inefficiency and in doing so, higher operating costs that are reflected in many sectors of the economy. The fight against the phenomenon of corruption has not been efficient, since legislation has not been sufficiently analyzed and defined.

In spite the efforts in the economy and in political issues, there are still big social matters pending.

As long as there is no solid legal framework, on one hand, and a firm authority in the enforcement of the rule of law on the other hand, Mexico will continue to pay the costs of this phenomenon economically and in resentment and social division.

Insufficient economic growth in Mexico over decades and the poor application of social policies have not allows for overcoming the big lag in the distribution of wealth.

According to the last results of the Income-Expense of Homes Survey of 2016, the quarterly average current income is \$46,521 pesos per home. However, there are big differences in how income is distributed, since income of homes was \$168,855 in the highest decile, it barely recorded \$8,166 in the lowest decile.

Thus, income of the tenth decile exceeds the income of the first decile by nearly 21 times, which accounts for the high disparity in the distribution of income, and the wide percentage of marginalization with the resulting economic and social effects generated.

Other data that are worth recovering are those that help improve the quality of life and development of the Mexicans. This issue is no less a social problem that that which is presented since Mexican homes barely allocate 12.4% to education and 2.7% to health care. This shows the high degree of importance that both the educational public and health care sectors represent for Mexican families.

As part and consequence of this environment of social lags, delinquency expressed through high impact activities such as illegal drug trafficking, kidnapping, and organized crime generate high levels of uncertainty, social anxiety and personal security.

There is a big challenge in social issues in Mexico, the strengthening of institutional functioning, and the institutions themselves as sources of social prosperity and firm law enforcement are unavoidable elements for achieving improvement in these matters. In addition, good performance of the economy and good application of economic policy become a large complement for reaching the objective.

Risks, scenarios and perspectives for 2019

2018 ends as a very singular year for Mexico with unexpected events and results that bring about modifications in domestic strategic plans which, at the same time, will demand adjustments in how businesses act.

In domestic matters, the beginning was defined of what is estimated to be a profound political change, starting with an uncharted period of transition that has generated high levels of uncertainty and volatility on the markets. The way of governing and engaging in politics changes.

Some risks have dissipated in the external scenario, but trends have been confirmed at the same time, such as trade protectionism that will surely intensify rivalry and the trade war. The year ends with the signing of the USMCA, and awaiting the legislative confirmation process to be able to consider it valid. Trends of rejections are confirmed of countries to migratory flows that affect the good performance of some economies.

Risks

As we have stated in the past and in these times with greater emphasis, times of changes such as those that are being experienced open opportunities and generate specific risks where it is necessary to find how to take advantage of the former and mitigate the latter.

There will be many distracters for 2019, but three will be matters of major relevance and impact for Mexico, which merit constant observance and analysis:

- Signature and approval of the USMCA
- Trade war between the US and China
- New Government in Mexico

Constant oversight of the performance of these three matters will be significant.

Signature and approval of the USMCA

Long negotiations as well as due to the distinct positions of some countries, the USMCA has not been completed at this time, thereby generating speculation and uncertainty. Some of the relevant changes are:

- Definition of quotas for the automotive and auto parts industry
- “Sunset” clause that allows for reviewing the conditions of the Treaty every 6 years
- The elimination of chapter XIX on the solution of disputes

The effects will be different in accordance with the sector involved and they will have their consequences.

By the same token, there is still the issue of duties on steel and aluminum imposed unilaterally by the United States, which have not been eliminated in contrast to the negotiations of the USMCA, which represent significant effects for the economy.

The course of the USMCA in the following months will have to be reviewed and approved by the legislative branches of the signatory countries, which must approve the terms thereof. Some concessions and negotiations must be made in order to be successfully approved with which moments of instability may be experienced due to this cause in the first months of 2019.

It must be considered that there is still a real risk that the USMCA may not be approved by the Congresses. Consequently, there would be a panorama of temporary high volatility and additional negotiations would be required to determine the future of the current NAFTA, which is what governs regional trade at this time.

Whether or not the USMCA is signed and finally signed generates different economic scenarios for Mexico and regional trade. At the same time, it affects economic growth, the external sector, and financial variables differently.

Trade war between US and China

We have already given an account in prior documents of the risks that can change future scenarios. In this line of ideas, the protectionist trend in the West that opposes the idea of globalization and opening of markets in the Orient has unleashed a trade war between the US and China, beginning with the imposition of tariffs of a significant magnitude.

The effects do not seem to be felt in the economies. However, it has to be considered that the effect of measurements such as these does not have an immediate impact, but rather over the

course of time; therefore, some of them are expected to appear in 2019. The expected effects and harm are:

- Increase in prices
- Being prone to subsidies and protection of special sectors
- Smuggling and illegal activities
- Reduced trade

The effects are not only shifted between the countries that are part of a trade war, but rather regional markets. It is not a coincidence that the United States, China, and the world currently experience economic slowdown processes in general, as well as increased inflation, and rising interest rates.

New Government in Mexico

The entry of the new Government is one of the highly significant issues in the economic performance of Mexico. Everything seems to indicate that how the issues of the country are addressed will change in the perspective from which actions are analyzed and presented.

The change of Government brings a more political orientation with it along with emphasis on social matters; therefore, it is to be expected that political thought is above reason in the analysis of problems, which represents a fundamental change in exercising power and economic policy.

The assignment of priorities and budgets can change their justification toward a social nature that does not necessarily respond to productivity factors, performance, and efficiency.

Toward that end, it will be important to oversee the direction taken by reforms in terms of energy, telecommunications, and education, as well as the how quickly Government spending is activated for 2019.

Various Government actions have already been announced that respond to this new orientation: cancellation of the new International Airport of Mexico City, construction of refineries, construction of the Maya Train, a significant budget increase in social programs such as senior citizen adults and promoting jobs for young people, and many others that confirm this orientation.

In many of these projects and initiatives, the related economic

agents have reacted with dissatisfaction and rejection, year end exchange rate volatility, a strong drop of indicators and securities on the Mexican Stock Exchange, reduction in the rating of the debt and Mexican papers by international raters and the flight of capitals that evidence it.

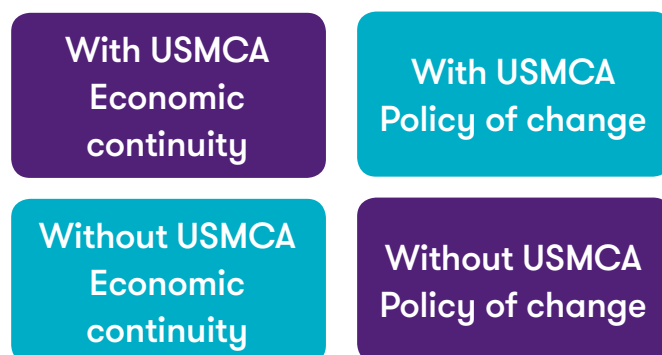
The implied risk in this new way of acting is to have the economic resources necessary to deal with those programs without sacrificing issues concerning productivity and generation of wealth.

Probable scenarios of a changing Mexico

There will be two issues that mark the course of the country for 2019. The first issue in the internal aspect will address the signature and ratification of the USMCA. The second issue in the internal aspect corresponds to the economic policy that the incoming Government decides to carry out. Under these premises, 4 will be the possible scenarios for Mexico in 2019:

Indicators and economic variables vary significantly, depending upon each scenario and the reactions of the various economic agents, both regional and abroad. At the same time, the world environment of protectionism, trade wars, and rejection of migration will be risk factors concerning growth and economic performance.

With USMCA and economic continuity



The formalization and ratification of the USMCA by the member States, together with a policy of continuity, represent the best of scenarios for the future of the country. However, that scenario seems rather unlikely. After the mid-term elections of the United States, the Democratic Party won the majority of the House of Representatives, thereby opening the possibility of reopening negotiations of the USMCA at the request of the democrats.

On the other hand, the incoming Government has made multiple statements concerning the implementation of an economic policy other than that which has been applied in the country.

Should this scenario materialize, Mexico would be able to reach 2.7% economic growth, showing signs of strength and economic stability, driven largely by foreign investment, remittances, and job creation.

By the same token, financial instruments would reflect stability with an exchange rate between \$18.80 and \$19.80 pesos per dollar, and contemplate that other external factors can affect its stability. The certainty and stability of the country would have a positive effect on the interest rate of the country, placing it between 6.5% and 7.5%.

With USMCA and a policy of change

In a mixed scenario, there is the possibility that the USMCA is signed and ratified in the terms already agreed upon, but internally the new Government will not favor continuity in the economic policy of the country. The possibilities for this scenario are not remote, since we have brought to light that the new Government has shown a line of change through which the economy of the country will be conducted. The results are not favorable in dealing with this possibility.

Mexico would present a decrease in Foreign Direct Investment, due to a lack of confidence of the financial agents in how the incoming Government acts. Incoming direct foreign investment could range from 26 to 26 billion dollar for 2019, which would represent 3 billion dollars less than that forecasted for 2018.

The financial instruments that should be used to try to offset the

uncertainty discussed above. The behavior of the peso would be volatile and could range from \$19.50 to \$20.50 pesos per dollar.

Within this mixed scenario, the signing of the USMCA contributes to continued job creation ranging from 840 to 850 thousand formal jobs and remittances would remain stable. These two factors would help the economic growth of the country from not being so affected by the change in the internal policy of the country, thereby achieving maximum economic growth of 2.0%.

Without USMCA and economic continuity

Another mixed scenario that could arise for 2019 is a Mexico that has an economic policy of continuity, but the USMCA fails to materialize. This would represent a hard blow to the domestic economy, since it would affect all economic sectors of the country. The main economic instruments would react negatively toward this assumption.

Job creation would be highly affected since with formally created jobs would range from 780 and 790 thousand, due mainly to the absence of a free trade agreement that facilitates the retention of foreign investments that were in Mexico as a result of the advantages offered by NAFTA.

The lack of a trade agreement would also affect the financial variables of the country, insofar as the interest rate would rise and range between 7.5% and 8.5%. In addition to the behavior of the peso against the dollar would be very unstable, eventually going up to \$21.5 pesos per dollar with inflation ranging between 3.8% and 4.8%. It is important to note that notwithstanding that the scenario is possible, the probability is low.

Without USMCA and a policy of change

Finally, there is the worst case scenario for the stability and economic growth of Mexico. That scenario would arise in the event that the free trade agreement with the United States and Canada is unable to be formalized and the threats of the United States to leave NAFTA materialize, in connection with the implement a policy of change. These two factors would represent a high degree of speculation and economic uncertainty.

All the economic sectors of the country would be affected in this scenario. The economic agents would react immediately and external capital flight would be imminent. Interest rates could rise as high as 8.5% and impact consumption of persons and generate inflation up to 5.5%. The behavior of the peso against the dollar would be unstable and volatile, and reach an exchange rate of up to \$22.50 pesos per dollar.

The economic growth of the country would be limited in this scenario, reaching a maximum of 1.7% for 2019 year end. Factors such as job creation and remittances could make the immediate effects not have such an impact on the economic stability of the country, but the effects could be greater in the long-term.

Thus, we are faced with 4 possible scenarios for 2019 that depend mainly upon 2 premises; the formalization of the USMCA together with the ratification process of each one of the Legislative Branches of the member States, and how the new

Government will conduct the economic policy of the country. Monitoring the decisions made on these two issues will be significant, in order to be able to guide our decision-making for facing the challenge as best as possible.

The behavior of the economy in each one of them varies since actions and reactions would have various effects.

2019 Forecasts

Variable	Unit	With USMCA Economic continuity	With USMCA Policy of change	Without USMCA Economic continuity	Without USMCA Policy of change
GDP Growth	%	2.7	2.0	2.0	1.7
Employment	Thousands	790-800	840-850	780-790	790-800
Remittances	Millions of USD	32,000-33,000	32,000-33,000	32,000-33,000	32,000-33,000
Foreign Investment	Millions of USD	29,000-30,000	26,000-27,000	26,000-27,000	24,500-25,500
Mexican Petroleum Mix	per barrel	60-66	60-66	60-66	60-66
Inflation	%	3.5-4.5	4.0-5.0	3.8-4.8	4.5-5.5
Exchange Rate	peso per dollar	18.80-19.80	20.20-21.50	20.50-21.50	21.50-22.50
Interest Rate	%	6.5-7.5	7.0-8.0	7.5-8.5	7.5-8.5

Source: Own preparation.

Recommendations

On the other hand, we conclude that thanks to the strength and stability achieved by the economy of the nation in these last years, Mexico is far from being bankrupt. On the contrary, Mexico will continue to grow in the 4 possible scenarios for 2018, even though at a slower pace in some scenarios than in other more favorable scenarios.

From our perspective, we consider it important to carry out the following actions to be successful in organizations:

- Have an attitude of accomplishment
- Information and technology
- Quality human resources
- Market oriented
- Prudence and talent in decisions

Mexico and the world will continue to undergo an era of big changes. In dealing with this, one should be alert for events that arise in both the global and internal environment in order to be able to foresee the possible scenarios and make the best decisions in a future that seems a little uncertain up to now.



Salles Sainz

Grant Thornton

An instinct for growth™

<http://www.grantthornton.mx/>

© 2018 Grant Thornton International Ltd. All rights reserved.

'Grant Thornton' refers to the brand under which the Grant Thornton member firms provide assurance, tax and advisory services to their clients and/or refers to one or more member firms, as the context requires. Grant Thornton International Ltd (GTIL) and the member firms are not a worldwide partnership. GTIL and each member firm is a separate legal entity. Services are delivered by the member firms. GTIL does not provide services to clients. GTIL and its member firms are not agents of, and do not obligate, one another and are not liable for one another's acts or omissions.

EPI191