



LATIN AMERICA ECONOMICS UPDATE

Is a stronger peso harming Mexico's economy?

- **Mexico's exports have fared well recently and the current account deficit remains small. But a closer look suggests that the strength of the peso is causing dynamics in the balance of payments to worsen.**
- The Mexican peso has been one of the best performing major currencies this year, appreciating by 16% against the dollar and is now at its strongest level since 2015. This has earned it the moniker 'super peso'. One consequence is that the peso is now looking like one of the most overvalued currencies that we cover (see our forthcoming [FX Valuations Monitor](#)).
- **The headline data suggest that this overvaluation hasn't yet done any economic harm.** If anything, the peso's appreciation appears to have helped the economy by reducing [inflation](#). Exports have fared well, with the country becoming the largest exporter to the US. (See Chart 1.) And the current account deficit remains small – it stood at 1.3% of GDP in Q1, in line with pre-pandemic levels. (See Chart 2.)
- **But there are some more worrying trends under the surface.** For one thing, the goods trade deficit is already running at a wider level than before the pandemic, by around 1% of GDP. The overall current account deficit hasn't widened further because remittance inflows (recorded under 'secondary income' in the balance of payments) have risen. (See Chart 3.)
- **What's more, net trade has been a drag on real GDP growth over the past year. For all the optimism about Mexico enjoying a [near-shoring boom](#) that will drive exports, export volume growth has actually been pretty disappointing.** Exports contracted in y/y terms in Q1. And import growth outpaced export growth in the four quarters to Q1 of this year (the latest data point).
- The exchange rate appears to be playing a role here. The negative contribution to GDP growth from net trade is broadly consistent with moves in Mexico's real (i.e. adjusting for inflation differentials) effective exchange rate. (See Chart 4.) That suggests that the strength of the peso may have weighed on export competitiveness and encouraged Mexicans to purchase more imported (rather than domestic) goods.
- **And the trade deficit would be wider than its current level were it not for an improvement in Mexico's terms of trade.** Based on figures compiled by the Mexican central bank, the price of the country's exports has risen relative to the price of its imports over the past year. (See Chart 5.) Were it not for this, we estimate that the trade deficit would be some 1% of GDP wider – and would be widening quickly. (See Chart 6.)
- One likely explanation for the improvement in Mexico's terms of trade is that the prices of refined energy products and gas (which Mexico imports) have fallen further than the price of crude oil (which Mexico exports). Another is that the prices of Mexico's main manufactured goods exports – autos and parts – have continued to increase, even though the prices of most other manufactured goods have fallen back.
- **Irrespective of the precise cause, the key point is that this improvement in Mexico's terms of trade has masked what appears to be an underlying deterioration in external competitiveness.** As a result, the current account deficit could widen to more worrying levels if the factors that have supported it recently – higher export prices and remittances – reverse. In both cases that seems quite plausible.
- Auto inflation in the US is likely to moderate further which, in turn, is likely to stop Mexico's export prices from rising. (See Chart 7.) To compound matters, the mild recession that [we expect](#) in the US economy will drag on Mexico's export volumes. (See Chart 8.) And the accompanying deterioration in the labour market will probably weigh on remittance inflows from the US to Mexico.
- **The upshot is that net trade is likely to drag on GDP growth and Mexico's external position is likely to deteriorate in the coming quarters.** To be clear, Mexico isn't going to fall into the same risk category as Chile and Colombia were last year (both of which ran current account deficits in excess of 5% of GDP). Nonetheless, **the peso could find itself in a more vulnerable position. Indeed, our view is that the currency will depreciate to 20/\$ by year-end, from 16.8/\$ now.** (For more, see our [FX Update](#).)



Chart 1: US Imports by Trading Partner (\$bn, SA)

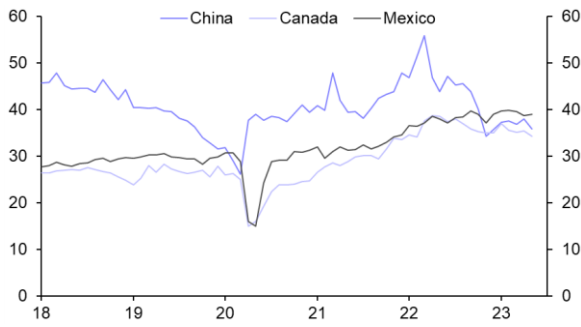


Chart 2: Current Account Balance (% of GDP, 4Q Sum)

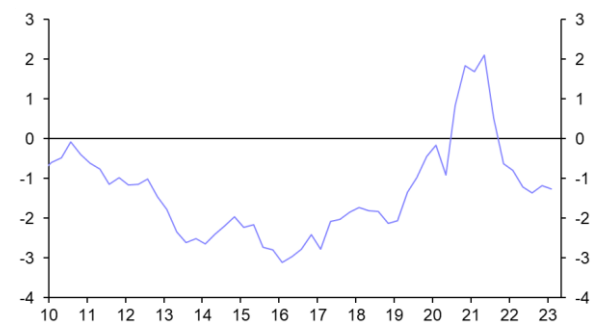


Chart 3: Contribution to Change in Current Account Balance (%-pts of GDP, 2019 to Q1 2023)

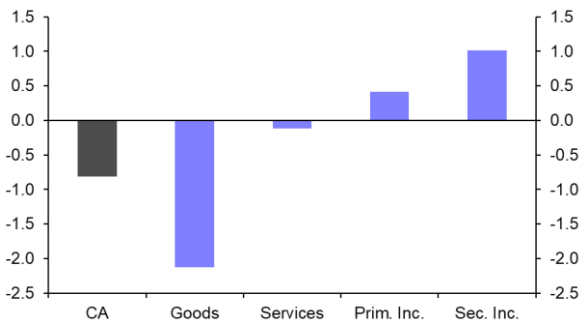


Chart 4: Real Exchange Rate & Net Trade Contribution to GDP Growth

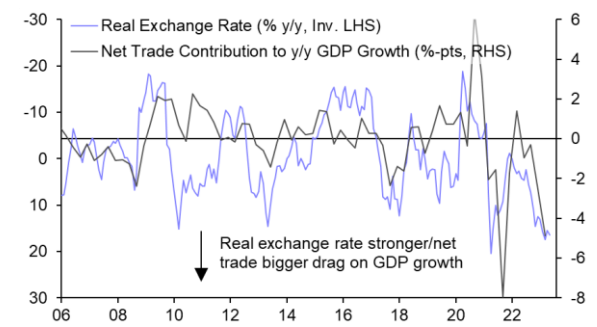


Chart 5: Mexico Terms of Trade (2019 = 100)

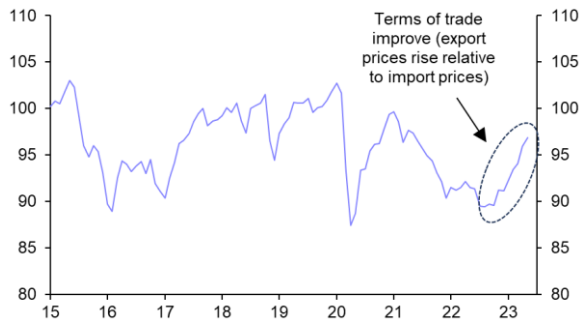


Chart 6: Trade Balance (% of GDP, 12m Sum)

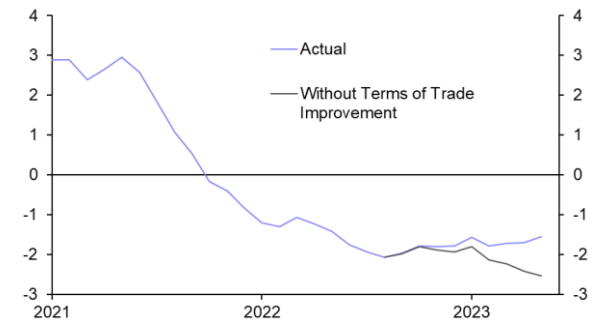


Chart 7: US New Auto CPI & US Manufactured Goods Import Prices from Mexico (% y/y)

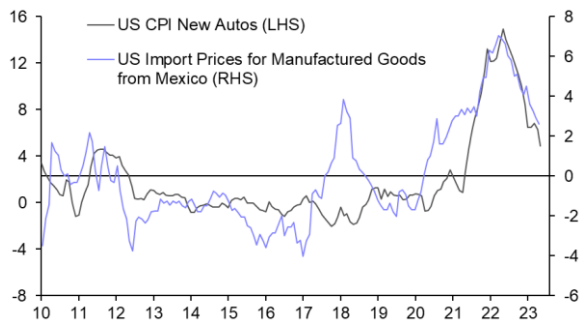
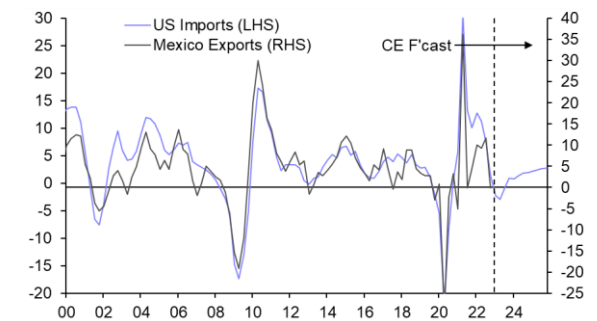


Chart 8: US Real Imports & Mexico Real Exports (% y/y)



Sources: Refinitiv, BLS, Banxico, Capital Economics



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