BANK OF AMERICA

Global Liquidity Speaker Series
Mexico – From Pandemic to Outlook
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START OF RECORDING

Attendance List:	Jack Moncarsz Carlos Capistran
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Hosted By:	Sharon Hawkins

Coordinator

Good day, and welcome, everyone, to the Bank of America Global Liquidity Speaker Series [indiscernible - 36:05], hosted by Jack Moncarsz. My name is Lily and I'm your event manager. During the presentation, your lines will remain on listen only. [Operator instructions]. I would like to advise all parties that this call is being recorded for replay purposes.

Now I would like to hand it over to you, Jack. Please take it away.

Jack

Thank you, Lily. Hello, everyone. My name is Jack Moncarsz. I'm head of liquidity for Latin America for Bank of America. I have the privilege and honor to host this call with Carlos Capistran, our chief economist for Canada and Mexico.

Carlos, thank you for joining us this morning. In a few words, how would you describe the situation of the Mexican economy, in December of 2009 [sic], I mean, right before the pandemic struck? And then, how would you compare that situation to what's happening today, to how Mexico is looking today?

Carlos

Hi, Jack. Thank you very much for having me here. It's a pleasure to be with you guys here today.

Look, the Mexican economy was already in a recession last year. It was a small recession but it was a recession nonetheless. It was kind of a surprise here because if you remember 2019 the US was growing and Mexico is very much linked to the US. So, it's not usual that if the US is growing, Mexico grows into a recession.

But, what happened is that there is a relatively new president and that's Manuel Lopez Obrador. Everybody calls him Amlo. He has a different agenda in economic terms than previous administrations, and in particular previous administrations were very market and investor-friendly whereas

Amlo's administration is not. He wants to give more money to poor people in Mexico. He wants to reduce inequality, fight corruption and that's all good of course. But, policy uncertainty, especially for businesses, increased a lot with US President-Elect, the council airport [ph] outside Mexico City. And therefore, his presidency [ph] then has been going down and the country was struggling a little bit to adapt to this new administration, and that basically sent the country into a small recession. That was before the pandemic.

And then, of course, as we all know, the pandemic hit us. It's a large, large shock. For Mexico, it's a very important shock because it's a global shock and Mexico is a very open economy. It's one of the most open economies out there. If you add exports plus imports it's more than 70% of GDP. Of course most of that trade is with the US, but initially global supply chains were disrupted when China shut down. That affected Mexico, but then the US also shut down. The first was the Mexican supply side; the second affected Mexico on the demand side. But, then of course, we lived through the huge financial shock. Mexico, an emerging market, also suffered because it depreciated. So, it was a massive shock for the Mexican economy.

And of course that sent the Mexican economy into quite a big recession. But then, the problem is that this administration that was trying to change a lot of the—did not respond in the best way to the pandemic, both on the health front and on the economic policy front. The response has been different in other places and I think that has hurt growth. As a result, Mexico this year is going to fall close to 10%, and sterling is going to be maybe 9% but it's going to go down significantly more than the US. At this point, we're thinking the US is going to go down between 3% and 4% this year, where Mexico is going to be between 9% and 10% so quite a shock.

That's the situation today. Just to give you a little bit more color on why the Mexican policy has amplified this, this shock on the health side, the government decided to limit testing so Mexico is one of the countries out there that is doing very, very few tests. It's just very difficult to get a test and they're expensive. And of course if you're not testing, then you don't where the virus is and it's very difficult to have a good strategy to contain it, and as a result, the number of cases remain high. They are increasing from high level. So, basically Mexico is waiting for vaccines so this is going to take a toll for some months.

And then on the economic side, the other thing that Mexico has been different than other countries is that instead of providing large fiscal stimulus as we saw in other countries, even in emerging markets such as Brazil, Mexico decided to provide very little fiscal stimulus, less than 1% of GDP. You can look at the charts from the IMF and the fiscal stimulus that each country provided and Mexico is the one with the smallest fiscal stimulus. [Overlapping voices - 42:19].

Jack

That was my next—yes, that was my next question, sir. As everyone knows, the US government took several measures to push in the impact of COVID-19 on the US economy and businesses. The Fed cut its target rate to a range of 0% to 0.25%, a stimulus package was implemented, and this resulted in increased liquidity with US banks holding more deposits that they could lend and this drove the rate paid on those deposits to very, very low levels, banks paying almost 0% on deposits.

Can you talk about any similar measures that the Mexican government took to support the financial system? You mentioned that they did very little. Whatever they did, was that effective and was there any impact from those measures on the liquidity in the market? Were banks impacted in any way?

Carlos

Look, Mexico did very little on the fiscal front. On the monetary front, Mexico did a little bit more. Rates were very high so the central government was able to cut rates a lot, more than 400 basis points in total. Rates are still relatively high to other countries but at least I mean Mexico did cut a lot and that certainly helped.

But, really, the best response was on the financial side. And on the financial side, very early on I mean in April the central bank took a lot of measures to actually help liquidity. Of course being a very open economy, linked to the US, I mean dollar liquidity is important so one of the actions that the central bank took is to provide US dollar auctions using Fed swaps. So that helped a lot.

But there were other measures to help with the domestic liquidity. The central bank reduced monetary relation [ph] deposit that deducts [ph] for bank, so the money that the banks need to keep at the central bank they reduced that requirement. Then they also lowered cost of credit and repos through one facility that is the ordinary additional liquidity facility, and also, extended the securities that are accepted as collateral. So, this was a very important mechanism early on to make sure that banks had adequate liquidity.

There were other programs, too, but it turns out that they were not as needed. For instance, there was a new corporate securities repo but this was initially used a little bit but not much.

The good thing is that the central bank opened all these facilities. So initially the banks used some of these facilities but the truth is that after a couple of months they were not using these facilities that much because there was ample liquidity in Mexico. So that was never really a big issue. [Overlapping voices - 45:45]

Jack

Would you say that Mexico benefited a little bit from whatever the Fed was doing? I mean, the amount of liquidity in the US market, did that help Mexico in any way and how about the remittances? How would you compare the remittances? Were people sending more money to Mexico this time around?

Carlos — Yes, that's a very important point. So, on the financial side, there was help and so there was no problems except for the very beginning from the banks in Mexico. But, of course the country as a whole was struggling because the lack of fiscal support and of course the big virus and shock. So, with no domestic help on the fiscal front, what actually ended up helping Mexico was the US. Some of the large support measures in the US, both on the fiscal and on the monetary side, find their way through Mexico, to Mexico. And, one important channel was remittances.

This year, remittances are going to be probably around $40 billion and this is going to be the single largest source of dollars for the Mexican economy. It's going to be larger than FDI [ph], for flows and oil exports. So, again, $40 billion, that's a lot in one year and that has helped consumption.

But, the other ways the US helped Mexico is for instance all these [indiscernible - 47:28] in the US as you know helped rebuild sales, helped sales of goods like cars. Mexico of course is one very important source of these kind of goods for the US economy, so exports from Mexico to the US are back to pre-pandemic levels. And so if you look at the data, the exports and remittances certainly those are some of the few things that year-over-year are already showing positive rates of growth in Mexico. [Overlapping voices - 48:02].

Jack — Would you say then that the US government's drive to restart the engine of the US economy that in a certain way also pushed the Mexican economy? Did they have to assert some pressure? How is that dynamic between the US opening and then Mexico restarting its own factory, its own production?

Carlos — Well, that's one of the advantages of Mexico when you compare it to other Latin American countries. Right? Mexico is very much linked to the US. Mexico has these very important and comprehensive trade agreements. Remember that Trump wanted first to withdraw from that agreement, from NAFTA, but the three countries, between Canada, ended up renegotiating this agreement and the new updated agreement went into effect in July this year and is good for at least another 16 years. So this is an important agreement because you have fewer ties [ph] to move products between the three countries but also you have a lot of investment protection. And this is a good basis for trade and car production between Mexico, the US, and Canada. So, with the US, but also Canada, providing large fiscal stimulus that they could get at basically zero rate that's something that ended up helping Mexico, which cannot get that kind of help because remember Mexico peso is much higher international rate. So, the cost of capital for Mexico is much more expensive.

At some point Mexico could only get money in dollar terms, at 6% rates for instance, versus the US and Canada can get money in their own currencies at fewer rates basically. So that explains in part why Mexico decided not to provide large fiscal stimulus but certainly Mexico has benefited from the fiscal stimulus in North America and that sets it apart from other countries in Latin America. Right? That makes a big difference.

So, today, for instance, the market is quite excited with the news that we may get a larger fiscal package going forward. In the US there is some bipartisan support. If that is the case, then that's going to help Mexico next year. Again, it's through the same channels, remittances and exports from Mexico to the US. So, even if there are some policy uncertainty, there are policies that Mexico is pursuing, the fact that it's so much linked to the US is always something that puts a floor [ph] I would say to what happens in Mexico and that's good.

Jack

Great. First of all, I have a question. I remember last time Mexico had a cycle where rates were going down. Those rates reached as low as 3% in 2014. And, this time around, I've seen several countries reaching record lows. Yes, the US reached 0% to 0.25% which it did before but even the rates that the US is paying banks now is 10 bps, interest on excess reserves. And, I mean, rates have been pushed down. Brazil is at a record low of 2% and Mexico seems still a little bit stuck at 4.25%. Why hasn't Mexico been able to go down further and what is the outlook in your view of the interest rates in the Mexican market?

Carlos

Yes, that's an important difference that Mexico has with other countries. So Mexico is up 4.25%. In the last monetary policy decision, the central bank decided to take a pause, to stop for now so they're likely to stay there for some time. This means that the real rate is positive. It's around 0.6%, and this is the highest real rate across markets with investment grade. So that's the reason by the way explains why everybody is like you—the peso now, a lot of investors want to go long the peso and take advantage of the carry because again this is very high interest rate. This is for countries that has investment grade.

What's going to happen—so two things, why rates are higher than in other countries? What's going to happen in the future? Rates are higher because despite the large contraction economic activity, inflation remains high in Mexico in the sense that it's above the target of the central bank. And the central bank in Mexico is an inflation target. It doesn't have a dual mandate. It's only inflation targeted. So if inflation is above the target for whatever reason, then this leaves the room that the central bank has to cut so because inflation is stuck at close to 4%, both [indiscernible - 53:45], then the central bank cannot cut because the rate is already in expansion or in territory but inflation is still above the target. So, they cannot cut much more. They are currently waiting for inflation to come down. In the most recent print, inflation surprised to the down side and it came down and many analysts, many economists in Mexico and the central bank are expecting that with large [indiscernible], so with a large recession in Mexico, inflation is eventually going to come down so this is going to open more room for the central bank to cut next year.

That's not what we think. We think that inflation is pretty sticky in Mexico. There are a lot of incremental costs that are preventing inflation to come down. The president there wants to increase minimum wages. They're talking about 15% increase per year. So that's something that's going to push inflation up. There are other costs, especially labor costs, and therefore we believe that inflation is just not going to keep growing for the central bank to cut more. In any case, nobody is talking about the central bank cutting 200 basis points or anything like that. I mean, even people that see that the central bank are going to cut more are already talking about maybe 100 basis points more and that's it. Again, we are more on the hawkish side. We believe that the central bank is going to remain here with rates at 4%, 4.25% the whole year.

And if you ask me, actually the risk is on the other side. The risk is that once a vaccine is widely available, as we saw with the encouraging news of vaccines in recent weeks, prices of commodities, prices of metals globally can increase, activity can increase, prices of services can increase, and actually it may be the case that inflation starts to move up and then central banks not only in Mexico but in Brazil and in other countries have to start hiking rates and not cutting rates. Right? So I see that there is not a lot of room for the central bank of Mexico to cut anymore. So, I'm not expecting cuts from here, not many.

Jack — Got it. Last time you and I spoke, and we spoke about Mexico's investment grade, you told me that Mexico, the risk of Mexico losing its investment grade that it was not a question of if but a question of when. People really felt that it was going to happen. Now, I saw some news November 11 that Fitch rating for Mexico's long-term foreign currency is [indiscernible - 56:47] rating with a stable outlook. I read the comments and they had some positive comments in there. Do you still feel that Mexico eventually losing its investment grade is something that it's inevitable or do you think that maybe that will not happen?

Carlos — I still see that it's a high priority event. This is the thing. In many countries, they just opened the door to more government expenditures to help with the pandemic. So, the fiscal balance has increased a lot and debts are increasing a lot. So people are looking at that, a fiscal deterioration. Right?

And in contrast, Mexico, as I mentioned, is not expending a lot so when you look at the balance, the fiscal balance it is small. And even though debt has increased, it has not increased as much as in other countries. So, people then, investors, tend to think that Mexico's fiscal position is solid, but that is wrong. And it's wrong because basically Mexico, due to the lack of fiscal help, is not growing. As I mentioned, it is going to collapse, probably close to 9% or so this year and then we believe it's not going to grow much next year.

So, the problem when you look at debt to GDP as rating agencies do is that this is a ratio and it's not only there but it's debt to GDP so this can deteriorate on two fronts, either debt increases or GDP decreases. So the problem that Mexico is facing is exactly that one which is I mean growth is just not there.

Jack But, particularly compared to other countries, Mexico kind of looked good because it didn't spend as much money, and then Mexico also benefited from the US. But then what you're saying right now is that okay all this will pass and then Mexico will continue spending in its social programs and eventually people will come to realize—I mean we are in the same situation as before where Mexico will be headed towards probably losing its investment grade. That's what you're saying. Yes?

Carlos Yes. Not only spending in terms of products, it's also spending through payer mix [ph] but loses a lot of money and the president wants to keep investing in payer mix. And, payer mix already lost investment grade. So, that's already happened and Mexico keeps investing in payer mix. But then, the real problem is growth. So, it's like a low cooking [ph] type of thing so that is why I was saying that a lot of people think that Mexico is going to end up losing investment grade but the timing is the question because it seems like it's in slow motion. So, some people think that we are two to three years away from Mexico losing investment grade whereas I think that at the end of next year we may be there.

Regarding the one comment regarding what Fitch said, at some point Fitch was saying that they were expecting Mexico to do a large fiscal reform so that they can collect between two and three percentage points of GDP in extra revenue by 2022. That's not a given. On the contrary, the president doesn't want to increase taxes and in fact he just signed an executive order like a couple of days ago lowering VAT and lowering income tax from some municipalities that are close to the borders in Mexico, the north and the south. So, he's actually doing the opposite of what Fitch was expecting so I think that eventually Fitch is going to have to say okay, this fiscal rebound that we were expecting is not happening and therefore we have to downgrade.

The last comment there is that the problem is that Mexico is already too close to the border of losing investment grade. For instance, Fitch has a stable outlook but Fitch only needs to downgrade once to send Mexico to [indiscernible - 61:03]. So, that's why they are trying to be more careful but eventually I think it's going to happen.

Jack I understand. Look, to finish in a positive note, I mean Mexico was hit hard by the pandemic as most countries. Everyone in every country has probably complained about how their government handled the pandemic. You see the news in every country. But now, the pandemic also created some opportunities for Mexico. Right? You uncovered weaknesses on companies that depend too much on supply from Asia and there is this

	thought about companies maybe creating other sources for their supply chain even if it might be a little bit more expensive than Asia but more reliable. So do you see there an opportunity for Mexico?
Carlos	Sure. Look, Jack, I mean, this is the big opportunity that Mexico has. So, Mexico is a country that structurally has a lot of advantages. As I mentioned it's close to the US; it has the renewed trade agreement with the US. It's already exporting, a manufacturing powerhouse. Wages are low when you look at them in dollar terms, so if you have a [indiscernible - 62:35] exchange rate that accommodates any shock. So, it really has a lot of advantages. It's just that right now between the change in the administration and the pandemic and all that, Mexico's growth is suffering a lot. But with the US-China trade war with globalization broadly speaking, and with the need of moving supply chains closer to the consumer, now especially with the pandemic and all that, we are seeing, as you know that China is losing market share in US imports in a very important way. And, Mexico is an excellent position to take that opportunity and to gain market share in US imports. So this is something that is going to play over the next five, ten years. It's not something that's going to help Mexico growth today but it is something that over the medium term it keeps people constructive on Mexico. So, the opportunity is there. I know about many of the Asian players that are looking at Mexico trying to move supply chains to North America. Part of that is going to go to the US or maybe Canada, part of that is going to be with [indiscernible - 64:01], but at least some of that is going to go to Mexico or is looking to go to Mexico. So, medium term we believe that Mexico does have very good opportunity that's there with all these re-shoring topic and this is going to benefit all the industries that are already linked to the US, especially manufacturing. So, that's good. The only problem again is just it's not going to happen overnight and for now there are other things that have growth suffering a lot. The medium term, it looks good as long as Mexico is able to take this opportunity. It's working hard trying to do that. I mean, the government has some programs to incentivize this type of investment and again these US NAFTA trade agreement is already in effect so that's good.
Jack	Well, thank you very much, Carlos. This has been really insightful and hopefully Mexico will take advantage of the opportunity. We are over the hour and again thank you very much for your time and thank you, everyone, for participating in today's call. This concludes the call for today. Thank you very much.
Carlos	Thank you, Jack, and thank you, everyone.
Coordinator	Thank you. That concludes the call for today. You may now disconnect. Thank you all for joining and please enjoy the rest of your day.

[END OF CALL]