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Mexico Economic Outlook

Second quarter 2020

Extraordinary circumstances call for extraordinary measures

Mexico needs more fiscal and monetary stimulus

- **A false dichotomy between saving lives (with social distancing measures) and protecting the economy**
- **A sharp fall in economic activity; the current fiscal stimulus and monetary stance are insufficient**
- **The labor market is under significant pressure**, with losses of up to 1.5 million formal jobs and the deterioration of the market and higher levels of unemployment, informal employment and workers in critical conditions of employment.
- **As we expected, downward pressure on inflation is dominating; Banxico should accelerate rate cuts**
- **Long-term interest rates will continue to decrease**, although the slope of the curve will remain high given the higher risk premium
- **The negative differentiation of the peso will see some improvement**; we expect the peso to reach less depreciated levels by year-end
- **We expect public debt (in its broadest definition) to increase to 54.2% of GDP in 2020** as a result of the depreciation of the peso, the considerable fall in public revenues, and the negative nominal GDP growth.
- **The risk to the balance of payments in 2020 is very limited**. The expected reduction in portfolio flows, remittances and tourism will be more than offset by international reserves and the International Monetary Fund's (IMF) flexible credit line

Considering the recent performance of private consumption and the deterioration of the investment climate, we estimate that growth will stand at between -6% and -12% in 2020 (point estimate -7%). The magnitude of the recession will hinge on four factors. First and foremost: the length of the pandemic and, consequently, of the social isolation measures and restrictions on economic activity at local and federal levels. At present, it is unclear when the curve will begin to flatten and infection rates will begin to slow. The aggregate effect on the economy will be greater the longer the pandemic lasts and the number of cases continues to grow. Second, the eventual reopening of the US economy and the dynamics of its recovery, considering the strong link between the manufacturing sectors of the two countries. Third, the implementation and/or speed of counter-cyclical fiscal, monetary, credit, and liquidity economic policies that support businesses and households in the face of massive job losses. Lastly, it will hinge on the extent and longevity of the eventual lifting of isolation measures, given that it is still not possible to rule out the chance of new waves of contagion in the future.

Our point estimate of -7% is assuming that Mexico's strictest isolation measures remain in place for a period of around ten weeks, and that, albeit slowly, it ends up adopting an expansive monetary policy as of the second half of the year, while the US economy begins a gradual recovery from the third quarter onwards. Delays in the reopening of economies—or possible setbacks leading to further economic shutdowns—would imply a deeper recession. Failure to adopt an expansive monetary policy, or moving too slowly toward its adoption, would also have negative effects. It is the vast uncertainty of the situation that means that the range of our forecast is so broad. Moreover, the depth of the recession will also depend on the magnitude of measures implemented by the federal government in addition to the fiscal stimulus. We expect the fiscal stimulus to fall very short of the mark. Given these reasons, our point estimate is not at the center of the range. In other words, we believe that the most

likely risks tilt our estimate downward and that there is little room for a less negative scenario (only to -6%) because the probability of adequate fiscal stimulus is low and the monetary stance remains restrictive.

Meanwhile, the gradual deterioration of confidence resulting from contract disputes and consultations has raised further doubts about the government's decision-making process. This greater uncertainty will cause dynamic inconsistency problems with negative effects on investment across all sectors and shall be a deciding factor in terms of the extent of the damage to confidence and the overall strength of the eventual recovery. It would be advisable to enter into a dynamic to restore confidence so as to bolster the strength of the eventual recovery of economic activity. This would lead to an upward revision to the rate of bounce back in growth in 2021 and onwards. At present, we do not see this as the central scenario. As such, the recovery we foresee for 2021 is not as strong as we would have expected to see if the context for private investment had not been damaged.

The negative impact of the shocks to supply and demand arising from COVID-19 are starting to become evident. In this sense, in March, formal employment reported by the IMSS (*Instituto Mexicano del Seguro Social* — Mexican Social Security Institute) showed a loss of over 130,000 jobs compared to the previous month. Meanwhile, indicators in the National Occupation and Employment Survey (ENOE) in March reflect a year-on-year deterioration in working conditions, specifically a growth in underemployment (2.2 pp) and critical conditions of occupation[1] (3.7 pp), reaching levels of 9.1% and 23.2% of the total EAP, respectively.

Based on this scenario and given the characteristics of the economic downturn we are experiencing, we expect the impact on employment to occur more quickly. Given our point estimate of a 7% decline in GDP, we estimate a loss of 0.893 to 1.1 million jobs by the end of December, which could increase to 1.5 million in the event that the fall in GDP moves closer to the lower limit of our forecast of 12%. We estimate that the unemployment rate will be in the range of 4.6% to 6%; this would mean an additional 750,000 to 1.5 million unemployed workers.

Recent inflation has been in line with what we predicted both in qualitative terms—with dominance of downward pressure on prices—and in quantitative terms—with headline inflation falling rapidly and core inflation resuming a downward trend. As we expected, and contrary to the initial reaction of analysts' consensus expectations and those implicit in market instruments, inflation showed a strong downward trend in March and the first half of April. After reaching 3.7% in February, we expect headline inflation in April to be 2.2%, i.e. 1.5 percentage points (pp) lower and one point closer to the lower limit of the range of variability around the 3% target. In qualitative terms, all of the sub-indices have behaved as we expected, with falling energy prices more than compensating for the heightened pace at which fresh food prices are rising and the downward trend in the services sub-index more than offsetting the higher rate of increase in goods (due to processed foods) in the core component. We expect headline inflation to remain below 2.5% on average for Q2-Q3, before increasing slightly and closing at just under 3% in December, with core inflation slowing to 3%. We have a downward bias for inflation. Inflation is not a cause for concern.

There is plenty of room for Banxico to make more interest rate cuts and to accelerate cuts. On the one hand, the real rate remains surprisingly high and the environment remains restrictive. While the ex-ante real rate (i.e. with the inflation observed) from January to March fell from 4% to 3.3%, it is expected that it will have returned to levels near 4% in April (3.8% if we consider the interest rate of 6% and our forecast inflation of 2.2%). On the other hand, the spread over the federal funds rate remains at 5.75 pp, i.e. it has seen no reduction yet. A more aggressive approach to cutting interest rates and an expansive monetary policy are justified; market expectations have gradually converged toward our long-term forecasts in the downward cycle. We expect an expansive stance from

1: Percentage of the population that is employed and working less than 35 hours a week due to market reasons plus the percentage of the population working more than 35 hours a week with a monthly income below the minimum wage or working over 48 hours a week earning up to two minimum wages.

Q2 2020 onwards, with the interest rate reaching 3% by year-end. A lower monetary policy rate would boost the right liquidity measures announced by Banxico.

Long-term rates have declined moderately and, as we forecasted, Banxico has announced further cuts in rates, although there is still room for further cuts. The spread over US rates is now very large. We expect the M10 rate to continue its downward trend and reach levels of about 6% by year-end.

The negative differentiation in the peso during the ongoing episode of risk has been very pronounced (around 20 pp); so far it shows no sign of reversal. Once global risk aversion declines, we expect the current degree of overreaction in the exchange rate to be partially reversed. As such aversion declines, the hike in the exchange rate will fade gradually and partially. We expect to see an appreciation of the peso, reaching levels of 20.80 and 20.20 MXN/USD by December 2020 and 2021, respectively.

SHRFSP (*Saldo Histórico de los Requerimientos Financieros del Sector Público* — Historical Balance of Public Sector Borrowing Requirements), the broadest indicator of public debt, will increase from 44.7% of GDP in 2019 to 54.2% of GDP in 2020 (even without a significant fiscal stimulus). This considerable increase of 9.5 pp of GDP can mainly be explained by the following reasons: (i) the depreciation of the peso; (ii) the considerable decrease in public revenues; and (iii) the nominal fall in GDP.

According to the SHCP (*Secretaría de Hacienda y Crédito Público* — Ministry of Finance and Public Credit), the depreciation of the peso against the USD will be approximately 20% by the end of 2020. This will be reflected in an increase in the value in pesos of public debt denominated in foreign currency, which represents about 34% of total public debt. Meanwhile, the local and global economic downturn associated with the effects of the COVID-19 will spark a significant fall in the country's public revenues. The SHCP has acknowledged this adverse impact on public sector borrowing requirements (PSBR) for 2020, estimating that they will be 4.4% of GDP instead of the 2.6% of GDP that was approved by Congress. Lastly, our forecast of a contraction of 7% in real GDP (using a GDP deflator of 3.5%) means a fall of 3.5% in nominal GDP.

While significant investment portfolio outflows have been observed so far this year and a sharp fall in foreign currency revenue from remittances and tourism is also expected, we do not foresee significant risks to the balance of payments in 2020. This is due to the relatively large amounts represented by the country's international reserves and the possibility of accessing the IMF's flexible credit line. These resources currently total around USD 248 billion, while the expected reduction in flows from portfolios, remittances and tourism is approximately USD 28 billion. We also expect the current account to run a deficit of 0.5% of GDP in 2020.

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