Economic Analysis

Mexico Economic Outlook 2021 - 2022

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Improved growth dynamics; inflation will peak in April; Banxico will look through high inflation levels; the MXN has some room to further appreciate

We upwardly revised our 2021 GDP growth forecast to 4.7% from 3.2%; upward bias on probable larger boost from US dynamic growth

- A better-than-expected 4Q20 growth print along with the upwardly revised US growth forecast (to 6.2%) led our 1.5pp upward revision to our 2021 GDP forecast. The better than expected 1Q data (0.4% QoQ) points to a stronger start of the year (BBVA 0.2% QoQ). This figure significantly improved from the (-)0.8% QoQ previously expected estimate -consistent with the 3.2% previous forecast for 2021.
- By demand components, we anticipate a 4.2% annual growth for private consumption -reaching 93% of its pre-COVID level by the end of the year-, while we expect private investment to increase 3.5% YoY, reaching 83% of its pre-COVID level by year end. Exports would grow 14.0% YoY, exceeding its pre-COVID level by 4.0 pp.
- A context of uncertainty arising from bad policy decisions, particularly in the energy sector, has triggered time-inconsistency problems, and will continue to take a toll on investment and explain its underperformance.
- As to 2022, we downwardly revised our GDP growth forecast to 2.8% from 3.8% previous, amid the slow vaccination process, a gradual and slower return to normality than previously expected, and less optimism on the consumption outlook on the back of a still weak labor market, with concerning developments at the turn of the year (see below). Nonetheless, according to our new estimates, Mexico would reach its pre-COVID GDP level by 2Q23, three quarters before our previous expectation (1Q24).
- Private investment stalled from 2016-18 with value-chains in risk with Trump's anti-NAFTA rhetoric and the ensuing lengthy trade-deal renegotiating process. In 2019, investment dropped on an uncertainty spike due to the time-inconsistency problems arising from bad policy decisions, particularly related to the energy sector, taken by the new government. Afterwards, in 2020, investment plummeted on the pandemic.
- As a result, total investment now stands 15% below its January 2016 level. Almost two thirds (-9pp) of that drop are related to the pandemic. The persistent weakness of investment has effects not only on short-term economic growth, but also on the long-term capital stock and, therefore, on potential growth.
- We keep unchanged our recently downwardly revised potential GDP estimate at 1.5% on private investment weakness amid the persistent climate of uncertainty. Yet, cyclical factors, namely a post-pandemic rebound and much-stronger-than-previously-expected US growth, will likely boost growth in the next few years.

The outlook for formal job creation is improving with an upwardly revised GDP path; yet, we do not expect a return to pre-pandemic levels until 2022

- In spite of a (slow) recovery trend, the labor market is still showing elevated levels of contraction in YoY terms in 1Q21; besides, the gradual recovery has been marked by high levels of informality, underemployment, and critical employment conditions
- From January to March 2021, 252 thousand new formal jobs were created, below the median creation during the first three months of a year since 2010 in spite of being driven by a rebound associated with a gradual normalization of some sectors in the economy (eg, tourism). Nonetheless, we expect the job creation pace to gather momentum in coming quarters, and now anticipate that 564 thousand new jobs will be created in 2021.
- A concerning development in 2021 is the loss of higher-income jobs -i.e., those earning 5+ minimum wages- that started at the turn of the year. It is likely to take a toll on the recovery dynamics of private consumption
- Real wages growth have not been able to fully offset the loss of employment in the total payroll in the formal sector, which is broadly stagnant: the average YoY growth rates from June 2020 to March 2021 is -0.1%

FX: the MXN still has room to catch up with EM currencies' average performance since the start of the global pandemic (Feb-2020)

- Normalization hopes with the global vaccine rollout and a search for yield could appreciate the MXN to 19.70 by the end of the year. An expected surplus of 0.6% of GDP for the 2021 current account also supports some MXN appreciation.
- In the medium-term, the current account deficit will stabilize at around 1.3% as the economy gradually recovers to pre-pandemic levels.This current account level (% of GDP) by no means entails a balance of payments problem.

Banxico will likely look through the temporary rise in inflation, which mostly reflects a spike in energy prices

- Headline inflation has surged in 2021 -to 6.1% in the first half of April- largely due to the spike in energy prices and unfavourable base effects. We anticipate that inflation would have peaked in April, and as the transitory effects unwind, we think that the headline inflation rate will drop down to slightly above-4.0% levels in 3Q, before rebounding temporarily again in 4Q to above-4.5% levels. Core inflation is set to gradually fall to below 4.0% levels in the next few months. With above-target headline inflation and with core inflation close to 4.0% in the near-term Banxico will not resume the easing cycle, which we expect to have ended with the monetary policy rate at 4.0%.
- That said, Banxico is not thinking of hiking rates, which supports our view that market expectations, expecting rate hikes within a year, are an overreaction to both the end of the easing cycle and the temporary pressures on inflation. Banxico's Board will not be in a rush to start a hiking cycle i.e., there will be a high bar for Banxico to shift to a hiking mode in a context of weak demand and with the Fed on the sidelines for the foreseeable future. We think that policy rate will remain at 4.00% over the coming years. This is a more dovish view compared to market expectations.

The 2022 General Economic Policy Preliminary Guidelines released by the Finance Ministry anticipate an improved outlook for public finances in 2021

- The federal government has upwardly revised its GDP growth forecast to 5.3% from 4.6% for this year and expects GDP to grow 3.6% in 2022. According to the federal government, the expected average price for the Mexican crude oil mix in 2021 increased to USD 55 per barrel from the USD 42 previous forecast.
- Forecasts for the year-end primary balance, PSBR and the widest definition of public debt are 0.0%, -3.3% and 51.4% of GDP, respectively.
- In relation to 2022 forecasts, the Ministry of Finance expects a primary surplus of 0.6%, PSBR of -2.9% and public debt of 51.1% of GDP.
- Public debt (% of GDP) will remain stable in 2021-22 but could increase to a manageable 56% by 2026 if no fiscal reform were implemented in 2022. We believe that a fiscal reform can avoid further credit downgrades and can be achieved without increasing marginal tax rates.

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