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Mexico Economic Outlook

3Q21

2021 growth forecast revised upward from 4.7% to 6.3%

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- **INEGI has revised the growth estimate for 1Q21 upward to 0.8% QoQ (from a preliminary estimate of 0.4%),** setting a strong starting point for GDP growth in 2021.
- **Private investment grew 8.5% in 1Q21, reaching 95% of the 1Q20 level,** following the delay in its recovery during 2H20.
- **Private consumption gained momentum in 2Q21** thanks to increasing mobility and the reopening of the economy.
- **Manufacturing will also gain momentum as bottlenecks dissipate** along with supply constraints in the US industrial sector.
- **The growth estimate for 2022 has been revised upward to 3.0% (from 2.8%)** given the improved investment outlook and higher consumption dynamism in 1H21.
- **Recovery in IMSS formal employment was slow in the first half of the year, but the outlook is improving for year-end.** 639,000 jobs are expected to be created by the end of December 2021, but pre-pandemic levels will not be reached until 2022.
- **Headline inflation is expected to decline in the coming months but return to 6.0% at the end of the year** and is not expected to return to the target range until 2Q22.
- **Banxico indicated that it will continue to raise the monetary rate unless inflation decreases more than expected;** it therefore anticipates three additional increases of 25 basis points that would bring the rate to 5.0% by year-end.
- **Tapering and the conversation surrounding the Federal Reserve's rate hike** will take the exchange rate to 20.7 pesos per dollar by the end of 2022.
- **We forecast a current account deficit of 0.5% of GDP for 2021** in view of a better-than-expected economic recovery. Mexico does not have any problems in terms of external imbalances.

We have revised the 2021 growth forecast upward to 6.3% (from 4.7%) in view of the economy's strong momentum in 1Q21 (0.8% QoQ, vs. the National Institute of Statistics, Geography and Informatics [INEGI] preliminary forecast of 0.4%), driven by higher-than-expected growth in investment and consumption. Private investment saw a quarterly variation of 8.5% in the first quarter of the year, reaching 95% of its 1Q20 level, after an initial delay in recovery in 2H20. Private consumption grew 2.5% QoQ over the same period.

According to BBVA Consumption Indicator data, private consumption gained momentum in 2Q21 thanks to increasing mobility and the economy reopening, recording monthly variations of around 5.0% in April and May, with seasonally adjusted figures. The BBVA Consumption Indicator also shows restructured demand for services, given the lifting of travel restrictions in said period. Although consumption will remain strong in 2Q21, it is expected to slow down toward the end of the year as the momentum driven by reopening fades and savings accumulated by families during the pandemic decrease. Despite this, in annual terms, variation in private consumption is estimated to amount to 7.7% in 2021.

Private investment saw a stronger upturn than expected in 1Q21, with the imported machinery and equipment segment recording the best performance, while the construction sector lagged behind. While the BBVA Investment Indicator points to enhanced total investment in the coming months, it will take until 2023 to reach its 4Q19 level and will remain below its 1Q19 level for the next five years. This is a result of the persistent weakness recorded by this variable since the beginning of 2019 due to the uncertainty generated by certain public policy decisions. We estimate that private investment will grow 15.1% YoY in 2021, following a drop of -20.2% in 2020.

With regard to the supply components of GDP, we anticipate that supply bottlenecks and shortages will gradually ease in the coming months, boosting the US manufacturing sector further and, in turn, having a positive effect on the Mexican export sector. The US ISM Manufacturing Supplier Deliveries Index already points to a reduction in input delivery times, which would allow the country's manufacturing industry to remain strong, while the June IMEF (Instituto Mexicano de Ejecutivos de Finanzas — Mexican Institute of Finance Executives) manufacturing index remains expansionary at 52.4 (the same as in May).

GDP is expected to return to 4Q19 levels in 2Q22, and 1Q19 levels in 3Q22. At the end of 1Q21, GDP was still 8% below its pre-pandemic level, but it is now expected to grow 3.0% in 2022 (compared to an initial estimate of 2.8%), driven by a better investment outlook.

The IMSS (Instituto Mexicano del Seguro Social — Mexican institute of social security) formal job creation outlook has improved for the end of 2021, but it still falls short of reaching pre-pandemic levels. We anticipate that 639,000 jobs will be created by the end of December, representing growth of 3.2% YoY as of December 2021 — 0.4 percentage points higher than the previous forecast.

During the first half of the year, recovery in the labor market varied, with signs of weakness and slow recovery. Based on the National Job and Employment Survey, we estimate that the working conditions of 5.4 million people over the age of 15 in the labor market were still affected as of May 2021. As such, the participation rate was 1.4 percentage points lower than in February 2020, which is equivalent to 628,000 fewer people, an additional 219,000 people unemployed, 2.4 million more economically inactive people available for work, and 2.2 million more underemployed.

On the other hand, formal employment, as recorded by the IMSS, showed slow recovery during 1H21 with an average monthly growth rate of 0.3% since August 2020—a trend that boosted job recovery—in contrast with a more dynamic GDP recovery. From January to June 2021, 402,000 new jobs were created, 7.6% below the median job creation level since 2009 (for years with positive growth), meaning that there are still 438,000 fewer jobs than before the pandemic. Closing this gap would therefore require 2.2 times more jobs to be generated in the second half of the year than have been since 1997, which we believe is unlikely despite the improved job creation outlook.

By income level, new jobs paying up to twice minimum wage have been recovered and created (+157,000). On the other hand, the decrease in the loss of jobs paying two-to-five times minimum wage and more than five times minimum wage has slowed, but there is still a combined deficit of 594,000 jobs. Despite the recent rise in inflation and job losses, the real average wage has increased by 3.6% in real terms compared to February 2020. Meanwhile, the total wage bill remains close to pre-pandemic levels, but given the dynamics expected for inflation, this is expected to remain stagnant with moderate growth.

Greater economic dynamism and a faster recovery in the services sector are expected in the second half, which will allow employment to pick up to near pre-pandemic levels, though this is not expected to be achieved consistently until the first quarter of 2022. It should be noted that job creation remains 1.5 million jobs below pre-pandemic levels, which indicates that job creation needs go beyond job recovery. Job creation, and therefore investment, should thus be prioritized to boost the total wage bill and, consequently, consumption and economic growth.

We also note that headline inflation has slowed less than anticipated due to the rise in core inflation. Within core inflation, goods inflation is not falling as expected due to the significant increase in non-food goods, while the reopening of the economy has resulted in higher service prices. Within goods, both components have seen sharper increases in recent months. As such, the average cumulative increase in goods inflation in June from 2010 to 2019 was slightly higher than 2.0%, while this figure was greater than 3.0% in 2021. The change in relative demand due to the reopening of the economy is having a strong impact on service prices. The average cumulative increase in service inflation in June from 2010 to 2019 was 1.5%, while this figure was greater than 2.0% in 2021.

We expect that the factors behind the uptick in core inflation will persist in 2H21, so downward rigidity is forecast for the second half of the year. Core inflation will remain above 4.0% for the rest of the year. Meanwhile, headline inflation will decline in the short term but will return to 6.0% at the end of the year and will not return to the target range until 2Q22. In general, there are no widespread pressures on aggregate demand, meaning that the inflation increases observed this year will be transitory, explained by base effects, bottlenecks and changes in relative prices. Inflation in Mexico will remain controlled.

Banxico suggested that it will continue to increase the monetary rate unless inflation declines more than expected. While the rise in inflation is transitory, following the latest monetary policy decision and discussion by members of the Banxico Governing Board, there is a sense that for the majority that voted to raise the monetary rate in response to a temporary trend, the inflation observed will dictate upcoming monetary policy decisions, even though the high levels respond to a change in relative prices, as paradoxically recognized by the central bank itself. We therefore expect that Banxico will raise the monetary rate to 5.0% over its next three meetings, since it forecasts that headline and core inflation will exceed 5.0% and 4.0% respectively for the rest of the year.

The peso has performed better than other emerging-economy currencies in recent weeks, especially with the surprise increase in the Banxico reference rate. We therefore predict that the exchange rate will fluctuate within a narrow range in the coming months. Nevertheless, tapering and the conversation surrounding the US Federal Reserve's interest-rate hike will put pressure on the peso in 2022. The exchange rate is expected to stand at around 19.70 and 20.70 pesos per dollar in December 2021 and 2022 respectively.

We anticipate that the current-account deficit will stabilize at around 1.5% of GDP in the medium term. It is also expected that this deficit will be around 0.5% of GDP in 2021, thanks to a better-than-expected economic recovery.

In the period from January to May, the primary balance of the public sector recorded an amount of MXN 74.3 billion vs. MXN 39.9 billion in the same period of 2020. For this year, the federal government's target for this balance is MXN 268.5 million (0% of GDP). Government revenue increased by 6.7% in real YoY terms from January to May, while public spending grew by 4.0% and tax revenues increased by 0.3% over said period, also in real YoY terms. We expect there to be a modest real YoY increase in tax revenue in 2021 as control efforts have already made up for last year.

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