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Mexico Economic Outlook

1Q22

Challenging outlook for the Mexican economy in 2022 due to contagions, high inflation, and higher interest rates

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- **Downward revision to our 2021 GDP growth forecast to 5.3% (6.0% previously)** due to the weakness of demand and the lower GDP growth reported by the National Institute of Statistics and Geography (INEGI) in 1Q21-3Q21 (vs preliminary figures).
- **The latest BBVA Research Big Data Consumption Indicator figures show** weak private consumption in 4Q21.
- **Bottlenecks and supply shortages are hampering the recovery of manufacturing;** the automotive industry has been operating at 60% of its installed capacity in recent months.
- **Downward revision to our 2022 GDP growth forecast to 2.2% (3.2% previously)** due to 2021 weakness, bottlenecks extension, higher prices, and a tighter monetary policy with downside risks caused by Omicron.
- **We are reducing our formal employment forecast to 618 thousand new jobs for 2022;** there is still significant slack in the labor market.
- **We expect core inflation to continue to rise in 1Q22,** and to decelerate more slowly than headline inflation. The latter will start a downward trajectory in 1Q22 but remain above 4.0% throughout the year.
- **We expect Banxico to increase the monetary rate to 7.0% by the end of the year.**
- **The increase in the federal funds rate and the reduction in the Fed's balance sheet** will be reflected in an exchange rate that will reach 22.00 ppd by year-end and show higher levels of volatility.
- **The 10Y bond yield presented an upward adjustment,** mirroring the one experienced by US Treasury bonds amid the more restrictive stance of the Federal Reserve.
- **We forecast a current account deficit of 0.8% of GDP for 2022** as a result of the modest growth forecast for 2022. Mexico does not have an external imbalance problem.
- **The forecast stability of public debt (% of GDP) and the expectation of higher tax revenue** mitigate the risk of losing the investment grade status in the next two or three years.

We downwardly revised our 2021 GDP estimate to 5.3% (6.0% previously) in view of the weakness of the economy in 2H21, and factoring in the lower growth of economic activity in the first three quarters of the year, compared with the preliminary figures released by the INEGI (1Q21-3Q21). In 3Q21 the business support sector contracted (-)50.8% QoQ as a result of the deadline for the implementation of the new outsourcing law. This change represented the disappearance of (or reduction in) the number of economic units that provided this service, and the corresponding loss of their aggregate value to production. We think this event is likely to have affected economic activity exclusively in 3Q21.

With regard to the components of demand, the latest BBVA Research Big Data Consumption Indicator figures point to weakness in consumption in the second half of 2021, remaining as a risk the persistently high prices with impact on disposable income and household spending, as well as the wave of infections being caused by the Omicron variant. On the supply side, the supply shortage owing to bottlenecks in global supply chains has hampered the growth of manufacturing, in particular in the automotive industry (which has been operating at 60% of its installed capacity in recent months). The latest figures from the ISM Manufacturing New Orders Index in the US point to a continuation of bottlenecks, for which the Omicron variant represents the greatest risk in view of factory closures, labor shortages and port delays. Investment remains 15% below its January 2019 level as a result of the uncertainty stemming from some public policies and the ongoing impacts on value chains.

It is important to note that the recovery in Mexico has been slower than in other comparable Latam countries; economic activity remains sluggish and is still 3% below the pre-pandemic level. The weak growth in 2021, the persistent impacts on value chains and the ongoing slowdown in consumption in the face of higher prices have prompted us to downgrade our growth forecast for 2022 to 2.2% (3.2% previously), with downside risks caused by Omicron and the consequent extension of bottlenecks. In addition, there is the risk of less gradual movements in the Federal Reserve benchmark rate than expected.

Twenty three months after the start of the COVID-19 lockdown, the labor market continues to show signs of weakness and a worsening of general conditions. One of the latent risks to the labor market remains COVID-19 and its variants, which continue to hamper economic activity. Another factor is the low level of investment, which plays a key role in job creation.

Figures to December from the National Survey on Occupation and Employment show that the labor market participation rate remains static and stood at 59.5%, just 3pp higher year on year, but 0.7pp below the pre-pandemic level (February 2020). In addition, we can identify four key factors in the reactivation of the labor market: 1) a faster recovery in labor market informality levels (56.2%, similar to the pre-pandemic level), 2) underemployment levels, which have been falling slightly (11.1%) but remain 2.2pp above the February 2020 level; 3) stubbornly high unemployment levels (4.0%, practically unchanged from 4.2% in December 2020) and 4) a recovery of employment with critical occupation conditions where almost a quarter (24.3%) of the employed in the country are classified with this status.

With regard to formal employment and in line with our forecast, the number of workers affiliated to the Mexican Social Security Institute (IMSS) grew by 846 thousand in 2021, the largest number of jobs created since 1998. This is largely due to the economic upturn, which enabled workers to return to the labor market following the economic shutdown that caused the loss of over 1.1 million jobs. Another contributory factor to job creation in 2021 was the reform to eliminate outsourcing which mainly helped create permanent jobs. As a result, the labor market reached the pre-pandemic level. Although this is good news, when compared with the job creation trend prior to the pandemic, the result is less positive, since it is 1.5 million jobs lower, and given the job creation outlook for the coming years, the impact on the labor market will be long term.

It should be noted that despite the reform to eliminate outsourcing, we were still expecting a negative seasonal adjustment in employment in December 2021 of around (-)319 thousand jobs, which virtually occurred with (-)313 thousand jobs, according to IMSS figures. This confirms that the seasonal employment adjustment is due to other factors that may be related. For example, jobs that need to be temporary because of their characteristics or jobs that have specific production cycles with budget closures with specific deadlines.

Following on from this and based on our economic growth scenario, we have reduced our employment forecast and now expect 618 thousand new jobs to be created in 2022 and a slight fall in the seasonally-adjusted unemployment rate, which will continue to show downward resistance and reach around 3.4% at the end of 2022.

It should be noted that increases in the minimum wage have played a key role in the recovery of the purchasing power of those workers who receive it, but it continues to lag behind in real terms and in comparative terms as the lowest among the OECD countries. Also, the minimum wage increases have not affected the salary distribution of workers affiliated to the IMSS; in fact, what is observed is that salary distribution has been compacting and in recent years there has been a greater concentration of workers in jobs of up to two minimum wages while jobs with a salary range of more than 18 minimum wages have disappeared. Which is to say that there has not been a lighthouse effect. The fact that lower-paid jobs are being generated, and the recent inflation dynamic, has meant that in real terms wages have stagnated at pre-pandemic levels, which directly implies an impact on real disposable income and therefore on consumption. So despite the temporary gains in real wages and employment, the employment market is still showing significant levels of slack.

With regard to inflation, the headline rate stood at 7.4% at the end of 2021, while core inflation stood at 5.9%, both the highest annual levels since Banxico established its inflation targeting framework in 2001. Inflationary pressures became more widespread and intensified in the second half of the year, with all the main subindices increasing in this period, with the exception of the energy subindex, which slowed in the second half of the year but still ended above the headline inflation rate at 8.7%. Inflation is still being driven by global factors, i.e.: i) supply-side bottlenecks against a backdrop of higher demand for goods, ii) higher prices for services amid the reopening of the economy and increased mobility following the easing of restrictions to contain infections, iii) the transfer of higher costs and even increase in profit margins in some sectors, and iv) in the first half of the year, the sharp rise in energy prices.

Looking forward, we forecast an easing in inflation, faster and more pronounced for the headline than for the core. We expect headline inflation to show a slower pace of yoy increase each quarter to 4.1% at the end of the year. Meanwhile, we expect core inflation to trend higher in the first quarter of the year, and to then fall more slowly over the following three months, ending the year at 4.5%. In 2023 we expect inflation to return to more modest levels and close at 3.5%.

Against this backdrop, Banxico increased the pace of its hiking cycle at its final meeting of last year, raising the monetary policy rate by 50bp to 5.50%. In doing so, we think it indicated that the cycle of pre-emptive hikes was behind, and that the Board thought that a more restrictive stance of monetary policy was warranted to avoid high levels of inflation to become entrenched with higher risks of second round effects and a de-anchoring of inflation expectations. Although the higher monetary policy rate is ineffective in mitigating the factors that have pushed inflation higher - i.e., global bottlenecks and higher energy prices-, we expect Banxico to maintain the higher rate of increase of the monetary policy rate at its first meeting of the year, taking the rate to 6.0% in February. Further ahead, in a context of rate hikes by the Federal Reserve, we expect Banxico to increase the monetary policy rate four more times, easing the pace, with increases of 25bp, taking the rate to 7.0% at year-end. This restrictive monetary stance will have a negative impact on activity this year and in 2023. In 2023, with inflation within the target range, we expect Banxico to initiate an extended pause against a backdrop of a steady increase in the federal funds rate.

The 10Y bond yield presented an upward adjustment, mirroring the one experienced by US Treasury bonds amid the more restrictive stance of the Federal Reserve. In light of the new scenario for the monetary policy rate and inflation trajectories, we are revising our forecasts for interest rates. With the expectation that Banxico will continue with a relatively aggressive normalization stance over the coming months, and in line with the faster global process of monetary stimulus withdrawal, we forecast that the yield on three-month CETES will be around 7.0% at the end of 2022, while the yield on 10Y fixed-rate government bonds will be 8.1%.

We expect the current account deficit to stabilise at around 1.3% of GDP in the medium term. We forecast that this deficit will be around 0.8% of GDP in 2022 in view of the modest economic growth expected this year. This suggests that the Mexican economy does not have a balance of payments problem.

In the January-November period, the public sector primary balance stood at MXN 74.8 billion vs. MXN 145.7 billion in the same period of 2020. For this year the government has a target of MXN -83.6 billion (-0.3% of GDP). Public revenue increased by 5.1% in real annual terms during the January-November period while public spending rose by 5.3% in this timeframe. Tax revenue increased by 0.6% year on year in the aforementioned period.

Economic growth and tax revenue will be two important factors that affect the sovereign credit rating awarded by the three leading rating agencies. Although the federal government has refrained from proposing a fiscal reform that would yield higher tax revenue through the elimination of VAT payment exemptions and higher income tax rates, the expectation of higher tax revenue in the coming years is based on collection improvements and administrative and technological simplification measures, with greater tax inspection authority to ensure payment of taxes. Achievement of the above and a stable public debt (% of GDP) would mitigate the risk of losing the investment grade status in the next two or three years.

In our view Pemex is unlikely to receive similar financial support packages over the coming years like those offered in 2020 and 2021. To improve its finances on a longer-term basis, the state-owned oil company will have to achieve greater control over its operating expenses and focus on more productive oil fields. In addition, the resumption of its associations with the private sector (farmouts) would enable Pemex to attract capital and know-how to explore and exploit new fields, in particular in deep waters. Pemex would also benefit from optimizing its refinancing activity before thinking about expansion, and allowing more imports of gasoline, which is less costly than producing internally. Looking ahead, Pemex will find it harder to obtain financing on competitive terms due to the growing number of global investors incorporating sustainability criteria into their investment decisions. Therefore, we expect the federal government to secure the financing and award it to Pemex via equity contributions.

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