Mexico Economic Outlook

2Q22
Global Economic Outlook
2Q22
Main messages

Ukraine-Russia conflict

The military conflict between Ukraine and Russia and the severe sanctions recently implemented represent a significant supply shock, with negative effects on both growth and inflation through the commodities, financial volatility, confidence and supply chains channels. In the current context, uncertainty is exceptionally high.

Activity

The global economy will slow down more than expected. After expanding 6.1% in 2021, global GDP is expected to grow 4.0% this year and 3.6% in the next (-0.4pp and -0.2pp, respectively, compared to previous forecasts). The downward revision of growth is significant in Europe and moderate in the rest of the geographies.

Inflation and central banks

Inflationary pressures continue to increase, most of all due to commodity prices and supply bottlenecks. Central banks are expected to keep their focus on inflation and move forward with the withdrawal of monetary stimulus. The Fed will be more aggressive: it is expected to take interest rates to at least 2% this year and 3% in the next.

Risks

A deterioration of the conflict and a further escalation of sanctions could cause a scenario of stagflation, at least in Europe. The withdrawal of monetary stimulus by the Fed, which could cause an economic recession or financial disruptions, and a hard-landing of growth in China, due to the severe Covid restrictions, are also among the main risks.
The Ukraine-Russia conflict reinforces both inflationary pressures and the moderation trend in activity growth, mainly in Europe.

- Invasion of Ukraine, followed by severe sanctions
  - Higher commodity prices
  - Reinforced bottlenecks
  - Lower confidence
  - Financial volatility
- Higher and more persistent inflation
- Accelerated withdrawal of monetary stimulus
- Growth slowdown, despite eventual fiscal stimulus measures
Economic uncertainty, at unusually high levels, once again

**BBVA RESEARCH INDEX DE ECONOMIC POLICY UNCERTAINTY**
(INDEX FROM 0 TO 100)

- Beginning of the pandemic
- US – China trade war
- New wave of contagions
- Ukraine-Russia conflict

Source: BBVA Research based on data by GDELT.
Sharp rise in commodity prices, financial volatility and signs of further deterioration of supply bottlenecks

SELECTED INDICATORS OF COMMODITY PRICES, FINANCIAL MARKETS AND SUPPLY BOTTLENECKS
(Percentage change accumulated in the year up to March 31st, 2022)

Source: BBVA Research based on data by Haver.
Given the increase in inflationary pressures, expectations of monetary tightening ahead have been reinforced.

**INFLATION: CPI**
(Y/Y %)

**POLICY RATES: MARKET EXPECTATIONS; SOVEREIGN BOND YIELDS ***

<table>
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<th>10Y yield</th>
<th>Future rates: Dec/23</th>
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<tr>
<td><strong>Eurozone</strong></td>
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Source: BBVA Research based on data by Bloomberg.
The war represents a significant supply shock, with negative economic effects mainly through higher commodity prices.

- Base economic scenario in an environment of high uncertainty: moderation in growth and higher inflation, mainly in Europe; a scenario of global stagflation is avoided.

- Main assumptions behind the base scenario:
  - the sanctions are potentially permanent and have a higher economic cost in 2022
  - significant further escalation of sanctions (including an imposed reduction of gas/oil flows between RUS and EUR) is avoided
  - commodity prices: strong price increase, especially in the short term
  - confidence: high volatility in 1H22
  - bottlenecks: higher and more persistent
  - financial systems: no significant disruptions.

Source: BBVA Research.
US growth forecasts revision due to the absence of the previously anticipated fiscal stimulus

GDP: ANNUAL GROWTH IN REAL TERMS

Moderate impact adds to prospects of no further fiscal stimulus
Sharp impact of the conflict, partially offset by fiscal stimulus measures
Minor impact of the conflict; structural deceleration on domestic issues
Moderate impact of the conflict; resilience of Asia and Latam

Updated forecasts (Apr.-22) Previous forecasts (Jan.-22)
Commodity prices and additional bottlenecks will add to previous pressures and keep inflation very high, at least this year

INFLATION: CPI
(Y/Y %, PERIOD AVERAGE)

Source: BBVA Research.
More aggressive interest rate hikes by the Fed from 2022; new fiscal stimulus in the Eurozone, but not in the US

Controlling inflation is the main objective
- **Fed:** more aggressive rate hikes and a reduction in the balance sheet from Jun/22 given high inflation and the labor market strength.
- **Fiscal policy:** the approval of further fiscal stimulus packages is no longer expected.

Monetary normalization, fiscal support
- **ECB:** accelerated reduction of the asset purchase program (APP) until its end in 3Q22; gradual rate hikes starting in 4Q22.
- **Fiscal policy:** additional stimuli at national and European level, in defense, energy, refugees...

Focus on avoiding a sharp slowdown
- **PBoC:** one/two more rates cuts, credit expansion
- **Fiscal policy:** local government bond issuance, tax cuts...

* In the case of the ECB, deposit facility rates.
Source: BBVA Research.
Risks are significant and tilted to the downside, not only because of the conflict in Europe, but also because of the Fed’s exit and the deceleration in China.

**USA**
Lower economic growth and financial disruptions due to the withdrawal of stimulus by the Fed.

**Europe**
Stagflation and other extreme economic/geopolitical scenarios due to a worsening of the Ukraine-Russia conflict and further escalation of sanctions limiting the flow of commodity products between Russia and Europe.

**China**
A hard-landing of growth and financial stress due to increased restrictions due to Covid or other factors.

Other
Impact on EM of inflation and high rates in DM, new waves of Covid, social tensions, new geopolitical conflicts...
Possible long-term effects of the conflict

Higher military spending and higher taxes

Nearshoring

Higher cost of security (cybernetics, energetic...)

Geopolitics emerge as a salient global risk

New geopolitics map

More incentives to accelerate energy transition

Further EU integration
Challenging 2022: Ukraine conflicts piles onto weak domestic demand
GDP grew 5.0% in 2021; economy stagnates in 4Q21 with extended effect of the outsourcing law

Source: BBVA Research, INEGI.
Expectations for private consumption overshadowed by higher prices and the ongoing conflict in Ukraine

Challenging environment for consumption going forward: the critical employment conditions indicator worsened in recent months.

*Cut-off date: 30 March 2022.
**The critical employment conditions index reflects the proportion of the employed population working less than 35 hours due to market conditions.
Source: BBVA Research, INEGI.
Ongoing bottlenecks slowed manufacturing growth: conflict in Ukraine triggers further disruptions

Source: BBVA Research, INEGI.
Challenging context for investment: 14% below its Jan/2019 level, with construction lagging behind.

INEGI INVESTMENT INDICATOR (INDEX JAN/19=100)

INVESTMENT: PUBLIC AND PRIVATE (% GDP)

CONSTRUCTION BY COMPONENTS (JAN/19 INDEX=100)

Source: BBVA Research, INEGI.
Mexico's economic recovery is slower than in other Latin American countries; there is still considerable slack in the economy.
Downward revision to our 2022 GDP growth estimate to 1.2% (2.2% previously); risks are to the downside

Ukraine effect: (1) higher energy and commodity prices, (2) ongoing bottlenecks, (3) tighter monetary policy.
Labor participation continues to stagnate; job insecurity and underemployment soar above historical averages…

... labor informality close to its pre-pandemic level. Total recovery of economic activity may increase labor participation and sustain above-average levels of unemployment.
Significant formal job creation from January-March (+386K), reaching 21 million jobs; …

… however, formal employment is still 1.3 million below the pre-pandemic trend. A faster recovery in permanent employment continues, which is good for workers. However, …
… the distribution of income in the formal sector has worsened, and there are still lags in the recovery of jobs with incomes of more than 2 MWs.

High job creation has helped to maintain the wage bill.

Source: BBVA Research, IMSS.

1. Data as of February 2022
Despite our downward revision of GDP, we slightly upgrade our forecast for formal employment growth from 3.0% to 3.5% (fdp) …

... this revision is explained by the strong job creation dynamics at the beginning of the year and the lagged effect of the reopening of the economy. A slowdown in job creation is expected in the coming months.

Source: BBVA Research, IMSS.
Public revenue in January-February 2022 was affected by the performance of non-oil related income

PUBLIC REVENUE AND MAIN COMPONENTS IN JANUARY-FEBRUARY 2022 (REAL YOY %)

- Total revenue: -0.7%
- Oil-related income: 6.2%
- Non-oil-related income: -1.9%
- Tax revenue: -0.7%
- Non-tax revenue: -27.6%

PUBLIC EXPENDITURE AND MAIN COMPONENTS IN JANUARY-FEBRUARY 2022 (REAL YOY %)

- Total spending: 5.1%
- Discretionary spending: 2.6%
- Current spending: 6.4%
- Capital spending: -9.6%
- Non-discretionary spending: 12.4%

Source: BBVA Research / SHCP
The external component of the historical PSBR balance (% of GDP) contributed to the reduction in this ratio during 2021

GOVERNMENT DEBT (% GDP)

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<tr>
<th>Year</th>
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<tr>
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<td>2021 December</td>
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INTERNAL AND EXTERNAL GOVERNMENT DEBT (% GDP)

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<th>Type</th>
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<tr>
<td>Domestic debt</td>
<td>(Dec.-20)</td>
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<tr>
<td>External debt</td>
<td>(Dec.-20)</td>
<td>9.5</td>
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<tr>
<td>Domestic debt</td>
<td>(Dec.-21)</td>
<td>30.8</td>
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<tr>
<td>External debt</td>
<td>(Dec.-21)</td>
<td>8.9</td>
<td>16.9</td>
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</table>

Source: BBVA Research, SHCP.
Public debt will increase moderately in the medium term to reach levels around 52.5% of GDP by 2026

HISTORICAL BALANCE OF PUBLIC SECTOR BORROWING REQUIREMENTS (% OF GDP)

Source: BBVA Research / SHCP
03

With inflation far from target, Banxico will continue to raise rates and maintain a restrictive stance through 2022-24
Core inflation remained on an upward trend; pressures have become more widespread

**BREAKDOWN OF HEADLINE INFLATION** *(YOY % CHANGE)*

- **Headline**: 16.2%
- **Core**: 15.3%
- **Non-core**: 9.0%
- **Fresh Food**: 8.8%
- **Energy**: 9.4%

**BREAKDOWN OF CORE INFLATION** *(YOY % CHANGE)*

- **Food Goods**: 6.6%
- **Non-food Goods**: 7.2%
- **Housing**: 3.2%
- **Tuition**: 2.5%
- **Other Services**: 2.1%

Source: BBVA Research, INEGI.
Top inflation measures have rebounded strongly since 2H21

**HEADLINE INFLATION TRIMMED-MEAN (Y.O.Y % CHANGE)**

**CORE INFLATION TRIMMED MEAN (Y.O.Y % CHANGE)**

**FUNDAMENTAL CORE (VAR. ANNUAL %)**

Source: BBVA Research, BANXICO.
We foresee a gradual deceleration of inflation from 2H22 onwards; we expect core inflation to converge with the target range until 2Q23

OUTLOOK FOR HEADLINE INFLATION
(YOY % CHANGE QUARTERLY AVERAGE)

OUTLOOK FOR CORE INFLATION
(YOY % CHANGE, QUARTERLY AVERAGE)

Source: BBVA Research, INEGI, BANXICO.
Banxico will continue to tighten the monetary stance with core inflation far from its target and a more aggressive Fed's hiking cycle.

**MONETARY RATE AND DEVIATION FROM THE CORE INFLATION TARGET (% & PP)**

**DEVIATION FROM TARGET OF CORE INFLATION EXPECTATIONS (12 MONTHS, % & PP)**

**RELATIVE MONETARY STANCE: MONETARY RATE VS. FEDERAL FUNDS RATE (PP)**

Source: BBVA Research, BANXICO.
We expect that Banxico will take the monetary rate to 8.0% and maintain a restrictive stance during 2022-24; the nominal rate will decrease until 2024.
High inflation levels and the global environment of risk aversion continue to be reflected in higher interest rates and a flatter yield curve.

The gray lines represent the last 24 bi-weekly curves, as of Mar. 16, 2021.
Source: BBVA Research, Bloomberg.
Recent trends and the revised macroeconomic outlook point to higher and more volatile interest rates in the coming months

### 3-MONTH CETES YIELD (%)

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<tr>
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<th>2022</th>
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### 10-YEAR M BOND YIELD (%)

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Source: BBVA Research, Bloomberg.
We revise the exchange rate forecast to 21.20 from 22.00 ppd by the end of 2022 on the back of a resilient Mexican peso supported by higher oil prices.
In March, risk aversion stemming from the conflict in Ukraine accelerated the reduction in foreign holdings of M-bonds
Rising yields maintain SIEFORES' appetite; banks reduce their holdings in March, but maintain between 14% and 16% of the total outstanding

M BOND HOLDINGS
(PROPORTION OF TOTAL OUTSTANDING)

CUMULATIVE CHANGE IN DOMESTIC M BOND HOLDINGS
(USD MILLION, NOMINAL)

March 22, 2022
Source: BBVA Research/Banxico
Key messages and forecast summary
Key messages

Downward revision to our 2022 GDP growth forecast to 1.2% (2.2% previously); 2.1% for 2023 (2.7% previously).

• Challenging environment for households going forward: higher energy and commodity prices around the world, with critical employment conditions having worsened in recent months.

• Ongoing bottlenecks slow manufacturing growth; conflict with Ukraine triggers additional disruptions.

• Investment is 14% below its Jan/2019 level; construction shows the widest lag.

• We revised our growth estimate for 2022 downward to 1.2% (2.2% previously); weak domestic demand in a context of higher prices, ongoing bottlenecks caused by the war in Ukraine, and a tighter monetary policy.

• Strong employment momentum at the beginning of the year leads us to expect employment growth despite the lowering of our growth forecast. Creation of low-wage employment: a limiting factor on consumption growth. New variants of COVID pose a latent risk to the labor market; however, in the event of a fresh outbreak, it is foreseeable that strict lockdown will not occur.
Key messages

Under a high-inflation scenario and in light of the acceleration of the Fed's withdrawal of monetary stimulus, we now expect Banxico to take the benchmark rate to 8.0% by the end of 2022 and to maintain a hawkish stance during 2022-24.

- The question is whether Banxico will continue to raise the monetary rate at a pace of 50 bp per meeting or return to a more gradual pace once core inflation begins to decelerate.

- Our baseline scenario calls for headline inflation to remain above 5.0% for the remainder of the year, while core inflation will begin to decelerate in May to end the year at 5.0%.

- We believe that Banxico will take a more gradual approach in its upcoming meetings and resume the hiking cycle with 25 bp moves; however, if the Fed intensifies its monetary stance and/or core inflation continues to surprise to the upside, Banxico could once again be inclined to raise the rate by 50 bp.

We revise the exchange rate forecast to 21.20 from 22.00 ppd by the end of 2022 in the face of a resilient Mexican peso supported by higher oil prices, a low current account deficit and a wide interest rate differential.
## Forecast summary

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2Q22
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