BBVA Research

Creating Opportunities

Mexico Economic Outlook

3Q22

The expectation of economic growth for 2022 improves due to the greater dynamism of the first semester

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- We upgrade our growth estimate for 2022 to 2.0% (1.2% previously), following a strong performance in the first half of the year driven by the tertiary sector.
- We believe that the momentum of 1H22 will fizzle over the rest of the year, as households and businesses face persistently high prices and rising interest rates.
- Investment is 9% below its January 2019 level, with global value chains driving the machinery and equipment segment, and construction the biggest laggard.
- Bottlenecks are steadily dissipating in manufacturing, especially in the automotive sector; capacity utilization reaches 90% in the light vehicle industry.
- We downgrade our growth estimate for 2023 to 1.6% (2.1% previously) in view of a likely worsening of private consumption and investment as we move forward amid an environment of high inflation and tighter monetary conditions.
- The creation of formal employment strengthens at the end of the year, however, given our revision to economic growth, we reduce our expectation for 2023.
- We anticipate a gradual slowdown in headline inflation starting in 4Q22; we anticipate that core inflation will not converge towards the target range until 2Q23.
- We now expect inflation to peak in Q3; while non-core inflation has slowed, aided by gasoline subsidies, core inflation has continued to rise.
- Banxico sped up its hiking pace: now we anticipate a 9.50% terminal rate for the current tightening cycle, which we expect to be reached by the end of this year.
- Interest rates along the curve continue to rise amid uncertainty about Banxico's terminal target rate; the spread between Mexican and US 10-year yields remains at around 600 bps as the monetary tightening process in both countries continues.
- We forecast an exchange rate of 20.60 pesos per dollar by the end of 2022 against a peso that continues to show relative strength due to wide interest rate spreads.
- The public deficit will remain at levels similar to those observed in recent years; we expect it to reach 3.1% and 2.8% in 2022 and 2023, respectively.

Growth in the first quarter of the year exceeded expectations, with a real quarterly change of 1.0%, coupled with private consumption growth of 3.4% QoQ. The BBVA Research Big Data Consumption Indicator (BBVA Research BDCI) showed rapid growth in the services segment – particularly in tourism and entertainment – during the months of March and April, driven by the Mexican and US holiday periods. The latest IGAE (global indicator on economic activity) releases point to a positive performance in 2Q22, given the continued buoyancy of the tertiary sector during April, and with a likely carry-over effect from the first quarter of the year. Consumer credit, in conjunction with the recovery of formal employment (and to a lesser extent financial savings), has supported private spending. That said, the total balance of the consumer lending portfolio among financial intermediaries still remains 10% below its pre-COVID level, while the balance of total deposits (demand plus time) is 6% above its pre-pandemic level. In May, the wage bill was 9% above its pre-pandemic level (January 2020).

Looking ahead, we do not expect the 1H22 momentum to last throughout the rest of the year; the latest indicators on economic activity are already showing a slowdown in consumption that we expect to deepen in the second half of the year and moving into 2023, in a context of high prices and rising interest rates. The BBVA Research BDCI is somewhat less healthy in May–June, while INEGI's Critical Employment Conditions Index is already pointing to a deterioration in labor market conditions, which we expect to persist throughout the second half of the year.

Total investment is 9% below its January 2019 level, with global value chains driving the machinery and equipment segment, which is now 7% above its pre-COVID level, while the construction sector is 16% below its pre-COVID level. An analysis by components reveals that both residential and non-residential construction are off the pace. We expect this component of domestic demand to weaken moving forward as businesses face higher interest rates and given the absence of public policies to stimulate investment.

Meanwhile, bottlenecks in the manufacturing sector are steadily dissipating, especially in the automotive sector; capacity utilization in the light vehicle industry has reached 90% of its pre-pandemic level, signaling a recovery in auto parts manufacturing and imports (including semiconductors). Total manufacturing exports (excluding the automotive sector) are now 32% above the pre-pandemic figure.

Given all these factors and the solid performance in the first half of the year, we are upgrading our growth estimate for 2022 to 2.0% (1.2% previously). However, we are downgrading our growth estimate for 2023 to 1.6% (2.1% previously) in view of a likely worsening of private consumption and investment as we move forward amid an environment of high inflation and tighter monetary conditions.

According to the May 2022 figures of INEGI's National Occupation and Employment Survey, the labor force participation rate has remained stagnant at levels similar to those recorded before the pandemic, at 59.6%, 0.5 pp below the level recorded in February 2020. This stagnation in the participation rate and the reopening of the economy has brought down the unemployment rate to one of its lowest levels ever seen (3.4%). The informal employment rate also remains stagnant (55.7%), which is partly down to the performance of the labor force participation rate, since at the onset of the pandemic, eight out of ten jobs destroyed were informal, and there is still an excess of available economically inactive population of more than 2 million people. The most relevant aspect of the labor market in its current state is the trend in the critical employment conditions rate, which continues to rise. After reaching an all-time high in March 2022 (33.2%), it has since presented a slight deceleration, standing at 30.5% globally and 27.0% in urban environments (vs. 28.8% in March).

In the case of formal employment, 449 thousand jobs were created during the first half of the year, according to official figures on workers affiliated to the Mexican Social Security Institute (IMSS), with year-on-year growth of 4.4% at June 2022, for a total of 21.1 million jobs. Despite this momentum, the level of employment still remains 1.4 million below the trend. Permanent employment remains relatively strong, with year-on-year growth of 5.6% and cumulative creation of 358 thousand jobs this year. Real wages continued to grow in May (3.1% YoY), with average annual rates of 2.9% over the last three months. In this sense, job creation and wage reviews have pushed up real wages and total wage bill despite the high levels of inflation, although this is likely to slow over the coming months, again due to the high inflation.

We expect the labor force participation rate to continue to increase gradually and unemployment levels to remain around 3.2% at the end of the year. On the formal employment front, we are upgrading our growth forecast from 3.5% to 4.1% (end of period), due to our updated growth outlook and solid job creation figures at the start of the year.

Inflation continued to rise during the second quarter, reaching new highs due to persistent inflationary pressures. While non-core inflation has fallen in response to gasoline price subsidies, core inflation has risen further. Thus, at the end of Q2 (in June), headline inflation reached 8.0% YoY (+0.6 pp on the end of 2021 and 5 pp above Banxico's target) and core inflation stood at 7.5% YoY (+2.6 pp on the end of the previous year). While inflationary pressures are broad based, they are at their greatest in the goods sector, mainly food (inflation in this sub-index reached 11.8% YoY in June). Meanwhile, prices for services other than housing and tuition fees have stabilized recently (6.6% YoY in June), but still remain high. Because these pressures have been higher than anticipated, we now expect inflation to peak in Q3 (having previously expected it to peak in Q2). While we still expect inflation to start showing clear signs of turning around in Q4, we foresee a somewhat slower pace of deceleration compared to Banxico's expected trend. We believe headline inflation will average 7.7% YoY in Q4 (0.2 pp above Banxico's new forecast), with core inflation averaging 7.1% YoY in the same quarter (+0.3 pp compared to Banxico's 6.8% YoY forecast). We expect inflation to slow considerably over the course of 2023, with headline inflation falling to 4.1% YoY by the end of 2023 and core inflation slowing to 3.7% by that time.

In this context, Banxico will continue to raise its policy interest rate to avoid a de-anchoring of long-term inflation expectations and to maintain a wide interest rate differential, which will continue to support the relative strength of the peso. At its last meeting, Banxico accelerated the pace of its hikes by raising the policy rate by 75 bps to 7.75%. It also indicated that a further 75 bp hike would be a distinct possibility at its next meeting (in August). It is highly likely that the Fed will once again hike rates by 75 bp at its upcoming July meeting (as it did in June), we expect Banxico to follow suit by hiking rates by a further 75 bp at its next meeting in August, thus bringing the rate to 8.50%. In addition, our baseline scenario is that the Fed will raise the federal funds rate by another 50 bp in September, followed by two further 25 bp hikes in November and December. We believe that given the upside risks to inflation and the fact that the current levels are above the target, and in order to maintain a wide interest rate differential, Banxico will match the 175 bp of additional rate hikes we anticipate for the Federal Reserve. We therefore expect Banxico to raise the policy rate to 9.50% by December. In our view, this level will mark the peak of the current hiking cycle, as we expect inflation to start retreating from 4Q22 onwards and the economy will continue to show plenty of slack. In other words, there will be no need to increase the nominal rate further in a context where the real rate will be climbing because of the expected decline in inflation. Thus, we expect that during 2023 Banxico will no longer join the Fed in implementing further hikes (+50 bp in 1H23), if indeed the Fed decides to make further hikes in 2023. In fact, we expect that the high levels of the real rate (ex-ante and ex-post) will prompt Banxico to initiate a gradual downward cycle starting in 3Q23.

In recent weeks, bouts of volatility in financial markets have led the 2-year M Bond yield (which tends to be a good market indicator of the expected near-term monetary stance) to hover around 9.5% since mid-June, at levels not seen since 2005. Meanwhile, 10-year M Bond yields reached levels close to 9.3%, similar to those seen at the end of 2018. As a result, the spread between 10 and 2-year yields has been in negative territory for some weeks now and we expect it to remain there until Banxico ends and ultimately reverses its cycle of rate hikes (or at least shows signs of being close to doing so). Therefore, as long as the inflationary scenario remains global in nature, the level of long-term rates in Mexico will be attractive for foreign capital. The spread between Mexican and US 10-year rates remains at around 600 bps as the monetary tightening process in both countries continues.

In January–May 2022, government revenue increased by 4.0% in real annual terms as oil revenues expanded by 26.9%. Non-oil revenue showed a real annual change of only 0.1%. While tax revenue recorded a real annual increase of 3.3%, non-tax revenue fell 34.0% influenced by an adverse base effect. Within tax revenue, income tax revenue grew by 15.5% in real annual terms, while VAT revenue remained virtually unchanged in constant pesos. In contrast, revenue from excise tax (IEPS) on gasoline and diesel dipped by 92.2% due to the government's policy of controlling the increase in the prices of these fuels. We expect this policy to continue for the rest of the year and the loss in tax revenue to be more than offset by surplus oil revenues.

The historical balance of public sector borrowing requirements came to 46.5% of GDP in May, versus 50.0% in December of last year. This reduction is down to contributions of 1.8 and 1.7 percentage points made by the domestic and external components, respectively. We expect this broad concept of public debt to close the year at 50.2% of GDP and to show moderate growth in the following years to reach 52.3% of GDP by the end of 2026. We also anticipate the public deficit to be 3.1% and 2.8% in 2022 and 2023, respectively. Disciplined management of public finances will considerably mitigate the risk of loss of the investment-grade status.

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