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Creating Opportunities

Mexico Economic Outlook

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Headwinds will slow economic growth in 2023

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- **Headwinds will slow economic growth in 2023. We revised down our growth estimate for 2023 to 0.6% (previously 1.6%),** given the deterioration of domestic demand in an environment of high inflation, higher interest rates and lower growth in the United States.
- **Private consumption has slowed since May, with a contraction in August,** according to BBVA Research Big Data Consumption Indicator figures.
- **Investment is currently 10% below its January 2019 level;** global value chains have contributed to the resilience of the machinery and equipment segment, while construction has lagged behind.
- Bottlenecks in the automotive sector are dissipating**, while industries such as food are struggling amid the Ukraine conflict; adding to this panorama is the weakness of demand.**
- **The informal sector contributes to the deterioration of working conditions;** the number of workers receiving an hourly wage below the minimum wage has increased significantly since 4Q21.
- **We keep our growth estimate for 2022 unchanged at 2.0%**, considering the rebound in 1H22, but with a slowdown going forward.
- **We anticipate lower job growth than our previous forecast.** Next year the wage bill will likely show less dynamism.
- **We expect inflation to stabilize in 4Q22 and slow significantly during 2023**; however, we expect inflation to fall only to a level at the upper end of Banxico's target rate range (i.e., at around 4.0%) by year-end 2023.
- **Banxico** will not decouple from the Fed in the short term and **will take the policy rate to 10.50% by year end and to a 10.75% cycle peak by February.**
- While the central bank will stick to tightening until 2023, **we expect a downward cycle to start in 3Q23 and expect it to be faster than previously expected.**
- **The nominal government bond yield curve has continued to move upward** as the end of Banxico's monetary tightening cycle approaches.
- **We forecast an exchange rate of 20.30 pesos per dollar by the end of 2022**, given a peso that continues to show relative strength due to the wide interest rate differential, fiscal discipline, a low current account deficit, and remittances and foreign direct investment (FDI).
- **Higher interest rates will increase the financial cost of public debt to 3.4% of GDP in 2023 from 3.1% in 2022**. The higher share of non-discretionary spending in total public spending will reduce the federal government's room for maneuver in 2023.

The upswing in economic activity in 1H22 is fading as demand deteriorates amid high inflation, higher interest rates, and weaker U.S. growth. The BBVA Research Big Data Consumption Indicator has slowed rapidly since May, posting a negative change in August (with the largest decline in the goods and leisure segments). The latest IGAE data point to a moderate growth of 0.4% in July, while INEGI's Economic Activity Indicator (*Indicador Oportuno de Actividad Económica*) does not expect growth in August.

As for the manufacturing sector, bottlenecks in the automotive sector are easing as the supply of semiconductors is restored. However, other sectors are facing difficulties in their supply chain (and a rapid increase in the prices of their inputs) due to the war in Ukraine. In particular, the processed food industry has reported a decline in its capacity utilization since March, due to the impact of the conflict on the supply and cost of fertilizers, vegetable oil, and other inputs. The BBVA Multidimensional Manufacturing Indicator grew by 6.4% (YoY) in August, bringing the average year-over-year change in the first two months of 3Q22 to 5.8%, 0.9 percentage points lower than the 6.8% observed in the same period of 2Q22. The IMEF manufacturing indicator was in contraction territory (49.4) for the second time this year (after a reading of 51.2 in July), reinforcing signs of weakness in the manufacturing sector in the third quarter of the year.

Gross fixed investment is to date 10% below its January 2019 level, with the construction sector lagging the most (especially the housing component). Global value chains and what is known as nearshoring appear to be driving resilience in the machinery and equipment segment, which is currently 8% above its January 2019 level. The technical recession in the U.S. (mid next year) will have a negative impact on FDI, while political uncertainty (related to USMCA controversies and the upcoming election period) will exacerbate investment weakness.

As for the informal sector of the economy, the latest data from the National Occupation and Employment Survey (ENOE) indicate a negative impact of this segment on working conditions, which will contribute to a deterioration in consumption. The number of employees with hourly wages below the minimum wage has increased dramatically since 4Q21 (to date, it is 42% higher than in 1Q21), while the number of better paid jobs has decreased. The ENOE data also show that income deterioration has been accentuated among workers belonging to the employer and self-employed segment (in contrast to the subordinate and salaried workers, usually formal workers, who have seen an increase in their hourly income).

Given the above factors, we revise our 2023 growth estimate downward to 0.6% (previously 1.6%). We maintain our GDP growth forecast of 2.0% for 2022, taking into account the 1H22 rebound, but with a slowdown going forward.

The labor market showed momentum driven by economic growth in the year's first half. Seasonally adjusted ENOE figures show that the unemployment rate was 3.3% in August, 0.9 percentage points below the historical average since 2005. Underemployment (7.7% at the national and city levels) was also below the historical average and the pre-pandemic period. The same is true for the informality rate, which is even 2.6 percentage points below the historical average.

In terms of formal employment, the September data also show that the formal labor market has positive dynamics in job creation, with annual rates averaging 4.5% throughout the year, 0.9 percentage points higher than in the period from April to December 2021, when positive annual growth rates were again achieved after the pandemic. This momentum in job creation has been characterized by an increase in permanent employment, which is 5.0% above pre-pandemic levels; a positive development as permanent employment provides workers with greater job stability. The recovery in employment is mixed when broken down by income level, as there is still a lag in the recovery of employment above 3 minimum wages. In contrast, jobs with up to two minimum wages have recovered faster and are 13.1% above pre-pandemic levels. Nevertheless, at the aggregate level, the total wage bill has withstood not only the lag in the composition of employment by income level but also the high inflation and is so far 8.3% above the February 2020 level and even with a year-on-year growth rate of 6.4% in September, but the strength of the wage bill is starting to show signs of exhaustion.

The economic slowdown will affect the strength of the labor market, so we expect the unemployment rate to be 3.3% s.a. and 3.2% s.a. in the fourth quarter of 2022-23. For formal employment, we made a minor adjustment to the end-of-period annual growth rate from 4.1% to 3.9% for 2022, implying the creation of 800 thousand new jobs, and from 2.7% to 2.5% for 2023, implying net employment growth of only 528 thousand at the end of the period.

Inflation continued its upward trend in the third quarter, reaching a new high since the adoption of the inflation target of 3.0% (in 2003). Pressures remain widespread, but core inflation accelerated at a faster pace in the last quarter. Thus, at the end of the third quarter (in September), headline inflation was 8.7% YoY (+0.7 pp and +1.3 pp from the end of the second quarter and 2021, respectively, and 5.7 pp above Banxico's target) and core inflation was 8.3% YoY (+0.8 pp and +2.3 pp from the end of the previous quarter and year, respectively). Core inflation pressures remain widespread, but the greatest pressure continues to come from goods, especially food (inflation in this sub-index reached 13.4% year-on-year in September, 1.5 pp. higher than in June and 5.3 pp. higher than in December last year). The annual inflation rate for services other than housing and tuition fees increased by 0.8 percentage points in the third quarter to 7.4% at the end of the quarter. We continue to think that headline inflation peaked in August-September and that core inflation either peaked in September or is going to rise slightly more in October. We expect both to decline slightly to 8.5% and 8.0%, respectively, by the end of the year. We continue to expect inflation to show clearer signs of slowing from 1Q23 onward. However, we expect both headline and core inflation to remain above 4.0% for most of next year and not to reach that level until December. These forecasts are similar to those recently updated by Banxico. Overall, we expect inflation to decline significantly next year, although it will remain very high on average (5.7% versus the 8.0% expected in 2022) given the baseline level.

Against the backdrop of high inflation and with no sign (yet) of a clear turning point, Banxico will continue to raise the policy rate to avoid an unwelcome unanchoring of long-term inflation expectations and to maintain a wide interest rate differential, which will continue to support the relative strength of the peso. We expect Banxico to maintain the same pace of rate hikes as the Federal Reserve (Fed) to keep the 600 bps differential between the policy rate and the fed funds rate unchanged. Considering that we expect the Fed to raise the policy rate by 75 basis points in November and by 50 basis points in December, Banxico will follow these hikes and raise the policy rate to 10.50% by year-end. Banxico's rate hike cycle will end when the Fed's rate hike cycle is complete, as Banxico will avoid decoupling in the short term. Therefore, we now expect the cycle to peak at 10.75% by February. After that, Banxico will take a long pause, which we assume will be somewhat shorter than that of the Fed. While the central bank will stick to a tight monetary policy stance for the foreseeable future, we expect a rate cut cycle to start in 3Q23 and now expect it to be faster than previously expected. We believe that Banxico will initiate a downward cycle at real ex-post and ex-ante rates of around 5.75% and 7.00%, respectively, in 3Q23 to avoid overly tight monetary policy in a more favorable inflation context (with gradual convergence to target) and economic weakness. Therefore, we now expect the policy rate to be 10.00% at the end of 2023 and 8.00% at the end of 2024.

The nominal government bond yield curve has continued to shift upward as the end of Banxico's monetary tightening cycle approaches, with long-term rates rising more slowly than short-term rates. The yield on 2-year M-bonds (which is usually a good market indicator of the expected stance of monetary policy in the near term) has been above 10% since the last two weeks of September, reaching levels not recorded since 2001. The yield on 10-year M-bonds is close to 9.6%, the highest since 2008. As a result, the spread between 10-year and 2-year yields has remained in negative territory since May of this year, and we expect this to continue until Banxico completes and eventually reverses the rate hike cycle (or shows signs of being on the verge of doing so), because as long as the inflation scenario maintains its global character, the level of long-term interest rates in Mexico will be attractive to foreign capital. The spread between Mexican and U.S. 10-year rates remains between 550 and 600 basis points as monetary tightening proceeds in both countries. With Banxico's new target rate path scenario, we now expect the 10-year M-bond yield to peak at 10.4% in the middle of next year.

In the January-August 2022 period, public revenue grew by 4.4% in real terms on an annual basis, boosted by the 35.8% increase in oil revenue. Non-oil revenue contracted by 1.4% per year in real terms. Tax revenue registered a real annual decline of 0.4%, while non-tax revenue fell by 19.9% due to a negative base effect. Within tax revenue, income tax revenue increased by 14.8% in real terms on an annual basis, while VAT revenue increased by 2.7%. By contrast, revenues from excise taxes on gasoline and diesel fell by 149.8% as a result of the government's policy to curb price increases for these fuels.

The historical balance of public sector borrowing requirements registered a level of 45.7% of GDP in June, compared to 49.9% in December. This decrease is explained by the contribution of the internal and external components of 2.1 and 2.2 percentage points, respectively. We expect this broad concept of public debt to end the year at 49.6% of GDP and to increase moderately in the following years to reach 51.9% of GDP by the end of 2027. We expect the public deficit to be 3.0% and 3.6% in 2022 and 2023, respectively.

The economic package, announced by the federal government in early September, has a significant downward bias in the balance of risks of tax revenues for 2023, as the estimate was obtained assuming an economic growth of 3.0%. Nonetheless, the federal government will prioritize meeting the primary deficit target of 0.2% of GDP, but its room for maneuver will be constrained by the higher share of non-discretionary expenditures in total public spending, which will rise from 26.5% in 2022 to 28.4% next year. As we expect fiscal discipline to continue under any economic scenario, the risk of an investment grade loss is very low.

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