Mexico Economic Outlook

December 2022

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We expect lower growth and inflation in 2023

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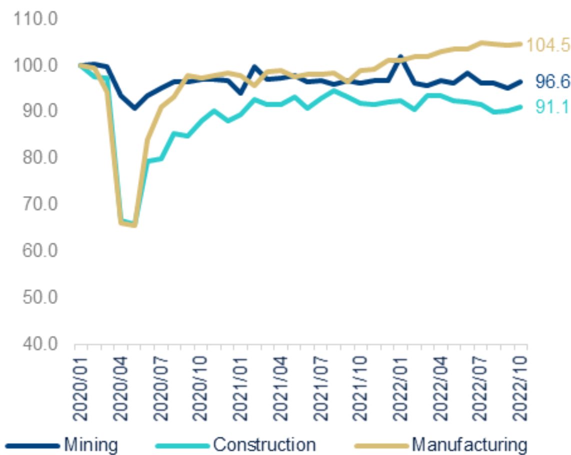
- **Higher-than-expected growth in 3Q22 driven by manufacturing and its positive effect on wholesale trade**; we estimate GDP growth of 3.0% in 2022 factoring in this figure and INEGI's upward revisions to the historical data.
- **Manufacturing is showing resilience to the easing bottlenecks**; we anticipate less dynamism going forward as demand slows against a backdrop of higher interest rates and weaker external demand.
- **On the investment side, the machinery and equipment, and imported capital goods segments stand out, driven by nearshoring**; construction has the biggest lag, with total investment 9% below its January 2019 level.
- **We keep our 2023 growth forecast unchanged at 0.6%,** considering the lower dynamism of domestic and external demand but with an upward bias considering the 3Q22 data, INEGI's revisions and the effect of nearshoring.
- **The labor market has shown great strength during the year with positive effects on the total wage bill.** Given the expected slowdown in growth, we anticipate lower job creation in 2023.
- **It is very likely that the public deficit will be at least 3.6% in 2023** due to higher pressures on public expenditure and lower-than-projected tax revenue. This will be the highest deficit since 1990.
- **November will mark the peak of core inflation**; headline inflation is already declining.
- **We are more optimistic than the consensus for the evolution of inflation in 2023**: we expect it to decelerate to 4.0% by year-end.
- **We anticipate that Banxico will decouple from the Fed in 2023;** we expect the start of a rate-cut cycle in 3Q23.
- **In recent weeks, nominal long-term rates adjusted downward significantly** while short-term rates continued to move upward.
- **We forecast the exchange rate to be 19.6 pesos per dollar by December 2022** and 20.1 by the end of 2023.

Weak growth in 2023

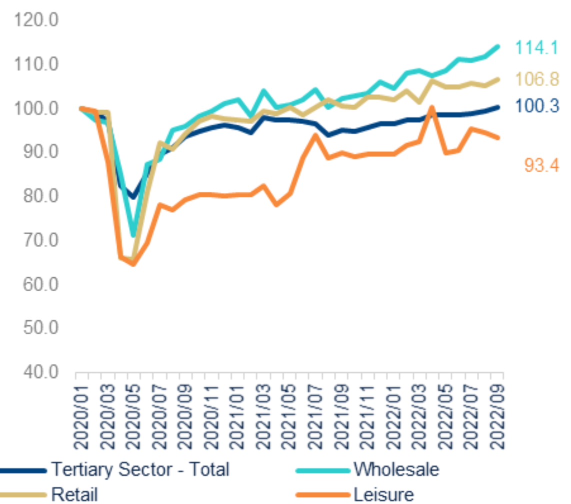
Economic activity grew 0.9% QoQ in 3Q22 driven by manufacturing (2.0% QoQ), and its positive effect on wholesale trade (2.7% QoQ). The automotive sector is recovering from bottlenecks and has surpassed its pre-pandemic output level in August, following the semiconductor shortage that affected the segment in previous quarters. In September, the wholesale trade segment surpassed its pre-COVID level by 14% (and is 9% above its January 2022 level), consolidating its position as the fastest advancing component of the tertiary sector to date, driven by its supply to domestic manufacturing (Figures 1 and 2). While the resilience of manufacturing has provided dynamism to economic activity in 2022, going forward we anticipate a slowdown in this supply component as demand fades against a backdrop of high prices and higher interest rates. In November, the US Manufacturing ISM was in contraction territory for the first time since May 2020, and leading indicators for new orders and new export orders have recorded levels below 50 for several months in a row (Figure 3), suggesting a deterioration in external demand in the following months that may be partially offset by the effect of nearshoring.

Figure 1. **INDUSTRY: SELECTED SEGMENTS (INDEX JAN/2020=100)**



Source: BBVA Research / INEGI.

Figure 2. **TERTIARY SECTOR: SELECTED SEGMENTS (INDEX JAN/2020=100)**



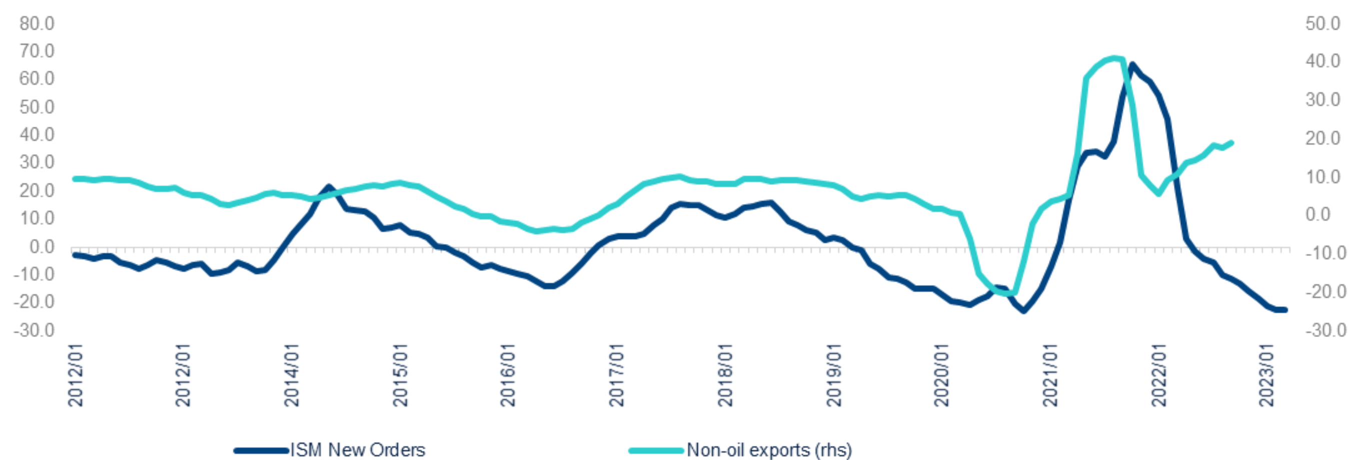
Source: BBVA Research / INEGI.

Meanwhile, retail consumption is 7% above its pre-COVID level, and 5% above its January 2022 level, while the related services segments (hotels, restaurants, and entertainment services) have been decelerating since May. While private consumption has shown resilience to date, the most recent indicators suggest slower growth in the coming months. In particular, the BBVA Research Big Data Consumption Indicator registered a contraction of -3.4% (seasonally adjusted) in November, its largest drop since the beginning of the pandemic (April 2020). Although the shorter duration of the Buen Fin[1] partly explains the loss of dynamism in consumption this November, the consecutive increases in the reference interest rate also represent a restriction on expenditure, to the extent that they increase the cost of financing for agents in the economy. Another contributing factor to this slowdown in consumption is the decrease in savings accumulated by households during the pandemic.

[1] According to the statements of the Ministry of Economy, in 2021 the Buen Fin took place from November 10 to 16 (seven days), while this year it took place from November 18 to 21 (four days).

With respect to investment, the machinery and equipment component stands out for its rapid growth driven by nearshoring and the dissipation of bottlenecks in the industry. In September, investment in imported machinery and equipment exceeded its January 2019 level by 10%, while capital goods imports stood at a level 13% above the same threshold. Construction, meanwhile, shows the largest lag (19% below its January 2019 level) keeping total investment 9% below its pre-pandemic year level.

Figure 3. **NON-OIL EXPORTS AND ISM NEW ORDERS INDEX**
(% Y/Y, 6-MONTH MOVING AVERAGE, ISM 6 MONTHS AHEAD)



Source: BBVA Research / INEGI.

Going forward, we anticipate a slowdown in both domestic and external demand, as households and businesses face higher financing costs. We have revised up our growth estimate for 2022 to 3.0% (previously 2.6%), taking into account the higher-than-expected growth in 3Q22 and the upward revision made by INEGI to the historical GDP data, particularly for 4Q21 (with a positive carry-over effect on GDP growth in 2022). We maintain our forecast for 2023 unchanged at 0.6%, amid lower consumption and investment dynamism, although with an upward bias given the protracted resilience shown by manufacturing and the tertiary sector in 2022, and the possibility that the economic contraction in the United States will be smaller than expected.

Labor market: total wage bill resilience, but with the prospect of weakening by 2023

The labor market has shown great strength throughout the year with unemployment rates that as of October have averaged 3.3%, practically 1 pp less than the historical pre-pandemic average from 2005 to 2019 (Figure 4). This dynamic, in turn, has been accompanied by levels of informal labor that have remained stable, meaning that the strength of the labor market has not increased labor informality, which has remained at an average level of 55.4% during the year, 3 pp below the historical average (Figure 5).

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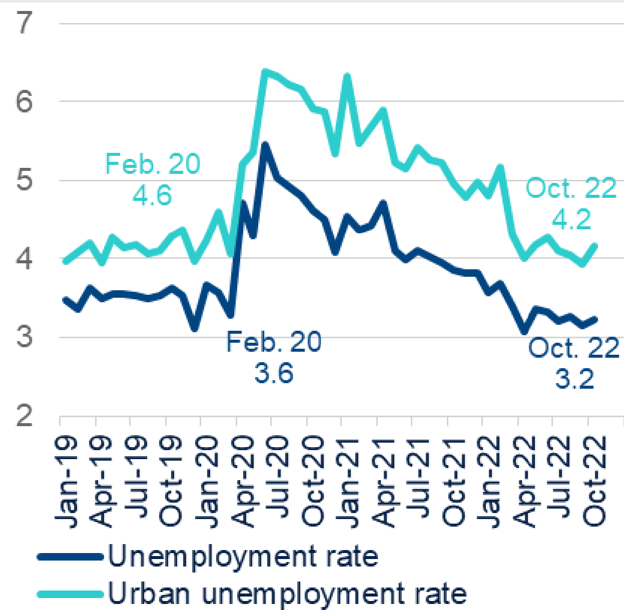
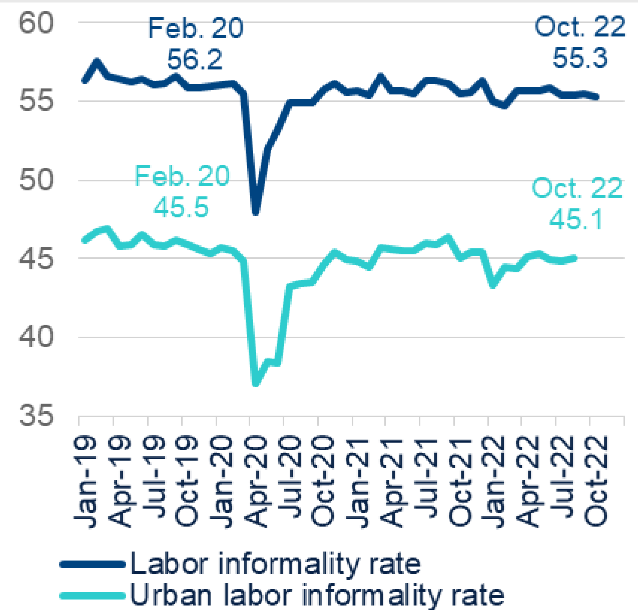
Figure 4. **UNEMPLOYMENT RATE (UR) (% OF LABOR FORCE)**



Source: BBVA Research based on data from INEGI.

Figure 5. **LABOR INFORMALITY RATE (% EMPLOYED)**



Source: BBVA Research based on data from INEGI.

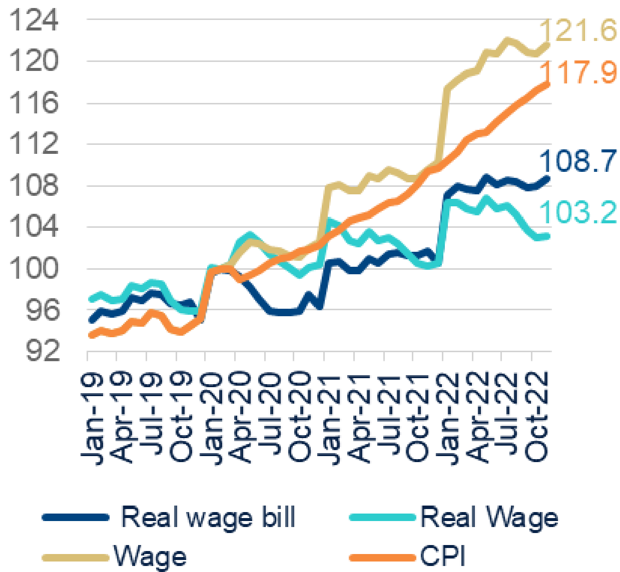
Formal employment, as we expected, has shown a strong job creation dynamic. Records from the Mexican Social Security Institute (IMSS) show that employment has averaged year-on-year rates of 4.4% from January to November, 1.4 pp above the pre-pandemic historical average (1999 to 2019). It is worth noting that although we expect a seasonal adjustment in job creation in December, employment creation will close the year with around 800 thousand new jobs, a level that has only been reached on two occasions since 1998.

Another positive element in the formal labor market is the greater dynamics of permanent employment, with positive year-over-year growth rates, averaging 4.8% from January to November, which compared to the pre-pandemic level (February 2020) is 6.2% higher and partially attributed to the outsourcing reform. Temporary employment since July has accelerated significantly with year-over-year growth rates averaging 7.3%, reaching the pre-pandemic employment level; however, part of this acceleration is due to seasonal factors, so we anticipate that most of the negative employment adjustment in December will be mostly due to this type of employment.

The element that has most affected the labor market has been the high level of inflation, which from January to November averaged 7.9%. This has had a negative impact on real wages and the total wage bill. However, the wage negotiations at the beginning of the year, the increase in the minimum wage and the significant job creation have given them strength and resilience, allowing them to remain at positive year-over-year rates throughout the period: 2.6% in the case of real wages and 7.1% in the case of the total wage bill. As a result, real wages and the total wage bill have remained 3.2% and 8.7% above their pre-pandemic level respectively (Figure 6), a factor that largely explains the resilience of consumption.

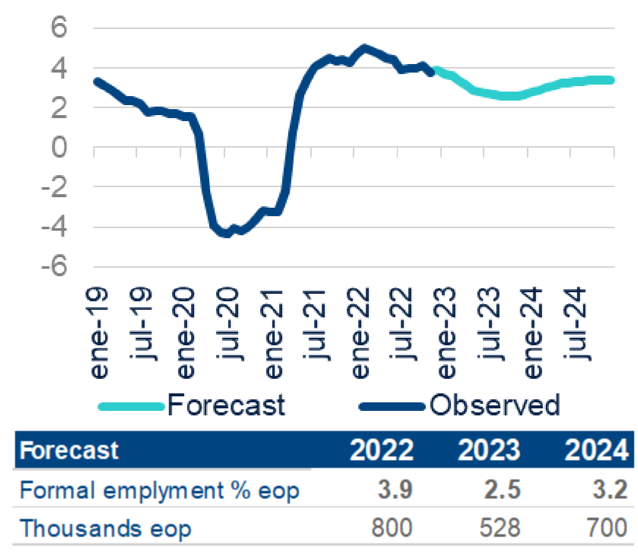
The strength of the labor market will be affected by the expected slowdown in the economy for 2023 and a rebound for 2024, so we expect formal employment to have an end-of-period year-over-year growth of 2.5% and 3.2%, implying the creation of 520 thousand and 700 thousand jobs, respectively (Figure 7).

Figure 6. **REAL WAGES AND REAL TOTAL WAGE BILL, IMSS**
(INDEX FEB.-20 = 100)



Source: BBVA Research based on data by IMSS.

Figure 7. **JOBS REGISTERED WITH THE IMSS**
(CHANGE EOP, % AND THOUSANDS)



Forecast	2022	2023	2024
Formal emplyment % eop	3.9	2.5	3.2
Thousands eop	800	528	700

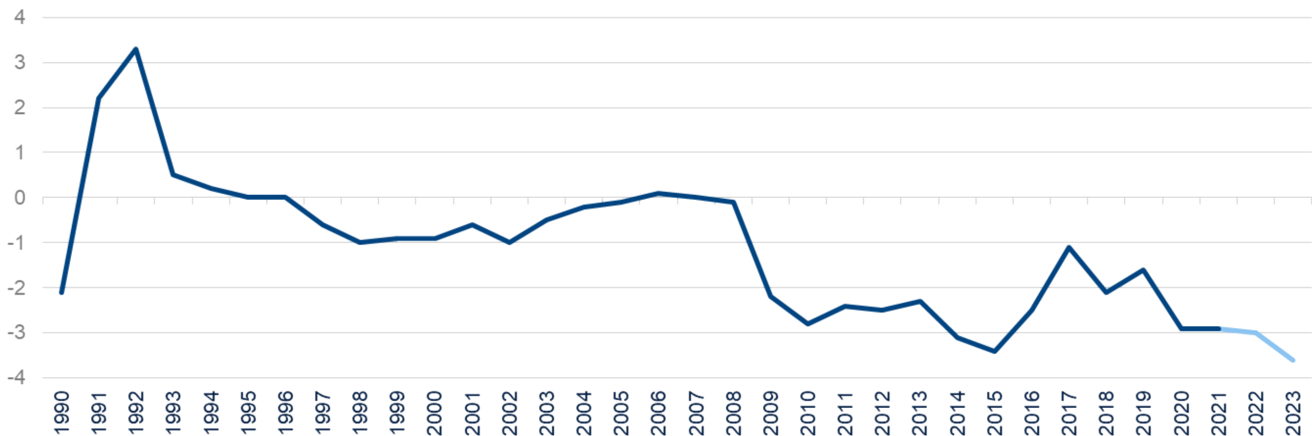
Source: BBVA Research based on data by IMSS.

For next year we forecast that the public deficit level (% of GDP) will reach an all-time high since 1990

Increased pressures on public spending related to pension payments, the financial cost of public debt and revenue sharing with the states will not only widen the traditional public sector deficit to 3.6% of GDP, but will also reduce the fiscal leeway to counteract adverse macroeconomic shocks in 2023 (Figure 8).

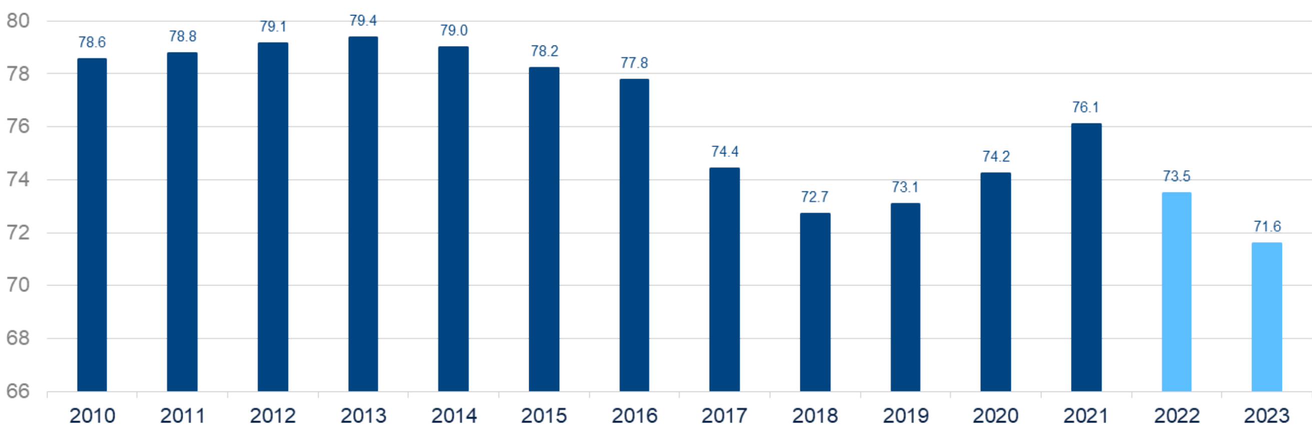
- An additional element of concern is the relatively optimistic assumption of 3.0% for GDP growth in 2023, which the federal government used for tax revenue estimates.
- Should economic growth more closely match the IMF's forecast of 1.2% or our own forecast of 0.6%, tax revenues would be lower than projected and the public deficit could be higher than 3.6%.
- This is mainly due to the fact that the federal government's room for maneuver to make cuts has been reduced given the lower share of discretionary expenditure as a part of total public expenditure. It is expected to be 71.6% in 2023 vs. 79.4% in 2013 (Figure 9).
- In the event that the federal government makes cuts to public expenditure to avoid a larger deficit, this could contribute negatively to GDP growth in 2023.

Figure 8. **TRADITIONAL PUBLIC BALANCE** (% of GDP)



Source: BBVA Research with SHCP data.

Figure 9. **DISCRETIONARY EXPENDITURE** (% of total public expenditure)



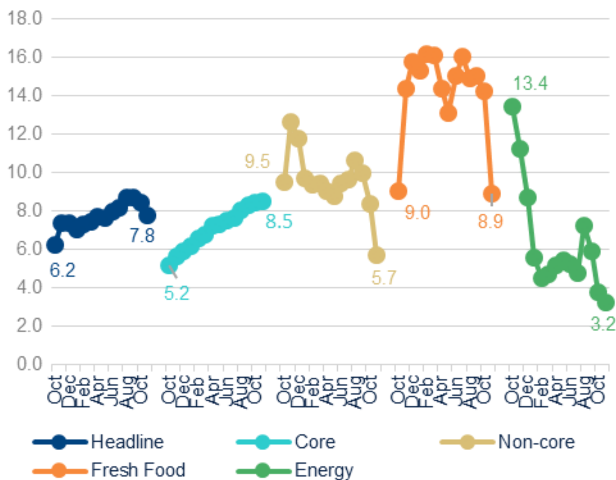
Source: BBVA Research with SHCP data.

Public revenues for January-October 2022 were supported by the performance of oil revenue. Discretionary expenditure accounted for 55% of the 4.9% annual increase in total public expenditure, while the increase in non-discretionary expenditure is mainly explained by revenue sharing with the states and the financial cost of debt. In turn, the Historical Balance of Public Sector Borrowing Requirements (the broadest concept of public debt) was 46.3% of GDP in September 2022 vs. 49.9% in December 2021. We expect this balance to increase moderately in the medium term to reach levels of around 51.4% of GDP in 2027, levels consistent with an investment grade sovereign credit rating.

November will mark the peak of core inflation; headline inflation is already declining

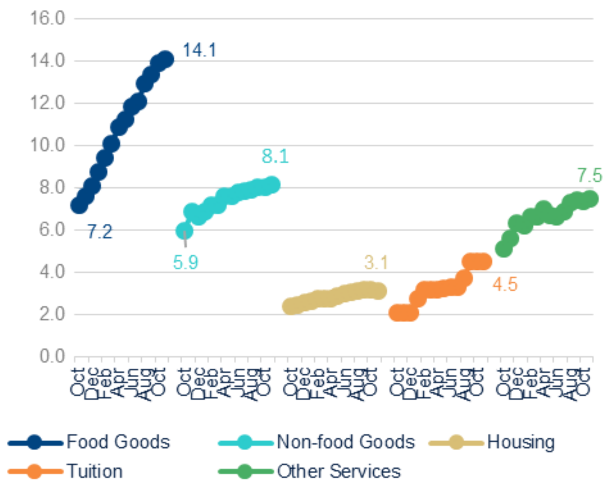
Annual headline inflation accelerated in the first three quarters of the year and peaked in August and September at 8.7%. The upward trend in headline inflation during 2022 has emerged from widespread pressures in core inflation, particularly in processed food prices. Accordingly, annual headline inflation increased from 7.0% to 7.3% between the fourth quarter of 2021 and the first quarter of 2022, to 7.8% in the second quarter, and to 8.5% in the third quarter, peaking in August and September when it reached 8.7%.

Figure 10. **HEADLINE INFLATION BREAKDOWN (ANNUAL CHANGE, %)**



Source: BBVA Research based on data from INEGI.

Figure 11. **CORE INFLATION BREAKDOWN (ANNUAL CHANGE, %)**

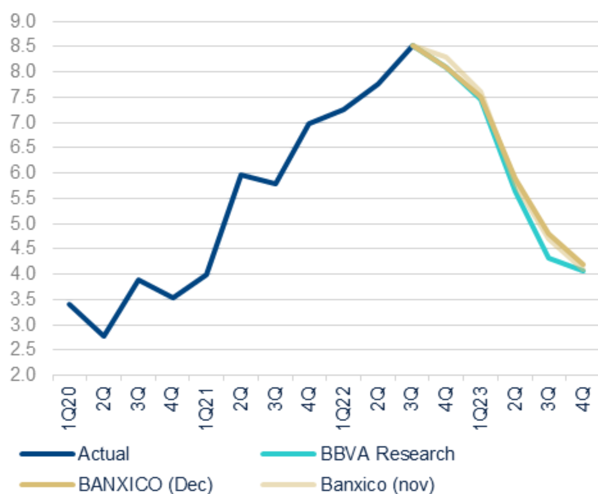


Source: BBVA Research based on data from INEGI.

These developments responded mainly to the strong increase in core inflation. During these same periods, annual core inflation increased from 5.6% to 6.5% between the fourth quarter of 2021 and the first quarter of 2022, to 7.3% in the second quarter, and then to 8.0% in the third quarter. In contrast to the slowdown in headline inflation since October, core inflation has continued to rise. Therefore, while headline inflation decelerated from 8.7% to 7.8% between September and November, core inflation edged further up from 8.3% to 8.5%. This was driven by an additional rise in processed food inflation, which increased from 13.4% to 14.1% in the last two months. Nevertheless, for the first month of the year, during November, the monthly inflation of this sub-index was below 1.0% (0.65% M/M). Furthermore, the sub-index for goods other than processed food also showed the smallest increase (of 0.2% M/M) during November (Figures 10 and 11). This suggests that the lower demand for goods due to both the weakening of the economy and the shift in consumption patterns toward services is beginning to show a positive effect on goods inflation. In addition, inflation in the United States, an important determining factor of the inflation observed in Mexico during the recent inflationary period, has shown a clear downward trend since June, which should contribute to lower inflationary pressures in Mexico. Therefore, we anticipate that core inflation will have peaked in November and will begin a downward trend as of this month.

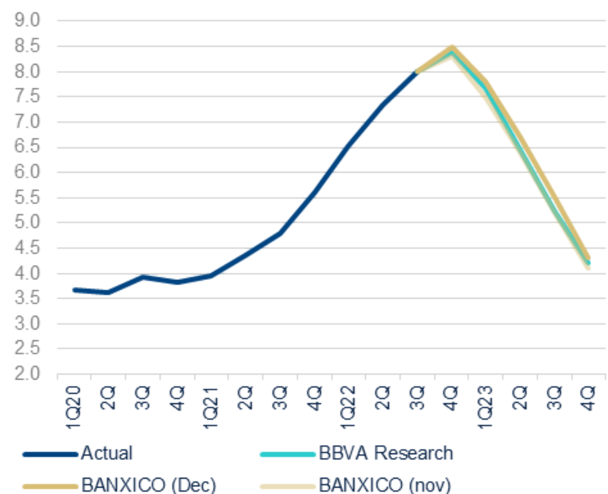
Looking ahead, we anticipate a marked slowdown in both headline and core inflation. By the end of this year, we anticipate levels of 8.1% and 8.2%, respectively. The downward trend in annual inflation will be driven not only by lower increases in monthly terms, but also by positive base effects, which will be more pronounced between February and May. We therefore anticipate that annual headline inflation will have decelerated to levels close to 5.0% in June 2023 and core inflation to levels around 6.0% in the same period. While we anticipate that inflation will remain above Banxico's target range throughout 2023, we expect it to approach the upper limit of this range by the end of the year (Figures 12 and 13). This represents a trend similar to that forecast by Banxico for both inflation rates, but significantly more positive than the consensus forecast, which anticipates that both headline and core inflation will close next year at 5.1%.

Figure 12. **HEADLINE INFLATION FORECASTS (ANNUAL CHANGE, %)**



Source: BBVA Research based on data from INEGI and Banxico.

Figure 13. **CORE INFLATION FORECASTS (ANNUAL CHANGE, %)**



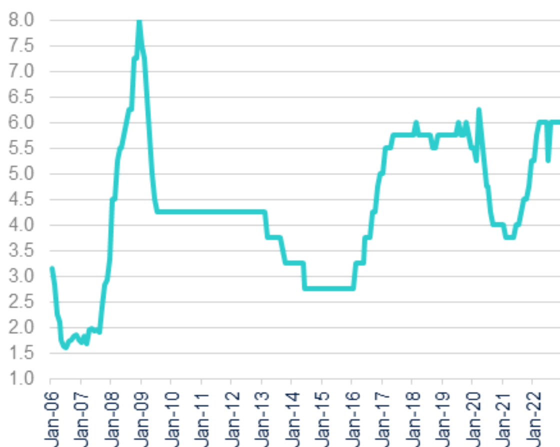
Source: BBVA Research based on data from INEGI and Banxico.

Banxico will decouple itself from the Fed in 2023; we anticipate the start of a rate-cut cycle in 3Q23

Against the background of high inflation and a divergent trend with respect to the target during 2022, the Bank of Mexico (Banxico) has been acting, to quote its own words, in a "forceful" manner to promote a trend of convergence with the inflation target in the coming quarters. Banxico therefore raised the monetary rate by 500 basis points (bp) in 2022, from 5.5% to 10.50%, raising the rate by 50 bps in four meetings and by 75 bps in another four. As shown in Figure 14, Banxico began the current hiking cycle in June 2021 and raised the rate differential with respect to the United States from 400 bps to 600 bps between July 2021 and March 2022. Since then it has kept it at that level. The rationale for first raising it and then maintaining it at that level is for two main reasons: i) to respond forcefully to inflationary pressures to avoid a de-anchoring of inflation expectations, and ii) to avoid a depreciation of the peso in the face of the more adverse global context for risk assets due to the strong change in US monetary policy. Therefore, we expect Banxico to maintain its strategy of matching the Fed's rate

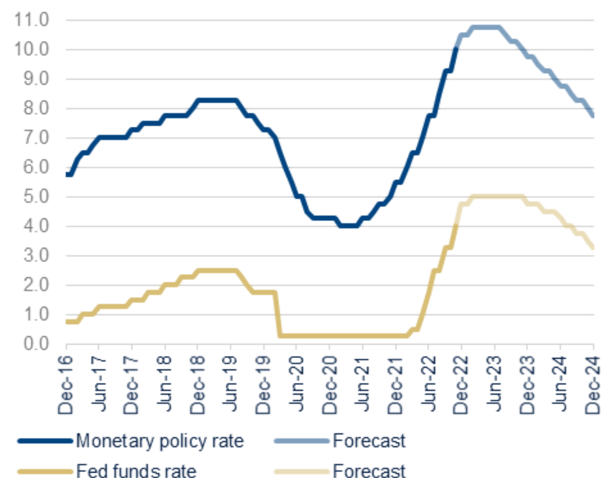
hikes in the coming months. We anticipate that Banxico will raise the benchmark rate to a maximum of 10.75% at the first meeting of 2023, in February.

Figure 14. **RELATIVE MONETARY STANCE**
(DIFFERENTIAL BETWEEN THE MONETARY POLICY RATE AND THE FED FUNDS RATE, BP)



Source: BBVA Research with data from Bloomberg and Banxico.

Figure 15. **OUTLOOK FOR THE REFERENCE RATES IN MEXICO AND THE UNITED STATES**
(%)



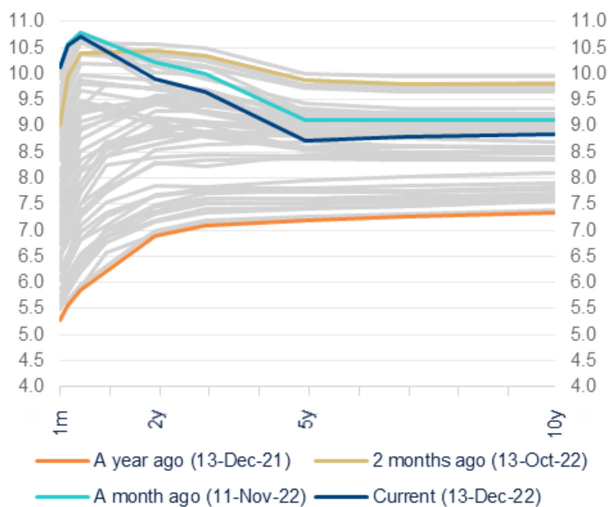
Source: BBVA Research with data from Bloomberg and Banxico.

With inflation decelerating and the high level of the monetary rate, the monetary stance will become increasingly restrictive within a context of lower inflation risks, also partly due to the weakening of demand going forward. By August next year, with headline inflation declining to levels close to 4.3%, the ex-post real rate will be around 6.5%, while the ex-ante real rate will be close to 7.0% (with 12-month inflation expectations probably around 3.5% at that time). In other words, the real rate will be extremely restrictive and considerably more restrictive than what will be observed in the United States. Therefore, we anticipate that after inflation has already declined substantially and is on a converging trend with the target, Banxico will prevent the monetary stance from becoming much more restrictive and will initiate a gradual downward cycle in August next year. We expect the monetary rate to be at 9.75% by the end of 2023 and 7.75% by the end of 2024 (Figure 15). In this variable we also have an important difference with the general consensus, which estimates that the monetary policy rate will be at 10.25% by the end of next year.

Long-term rates fall back from their October highs

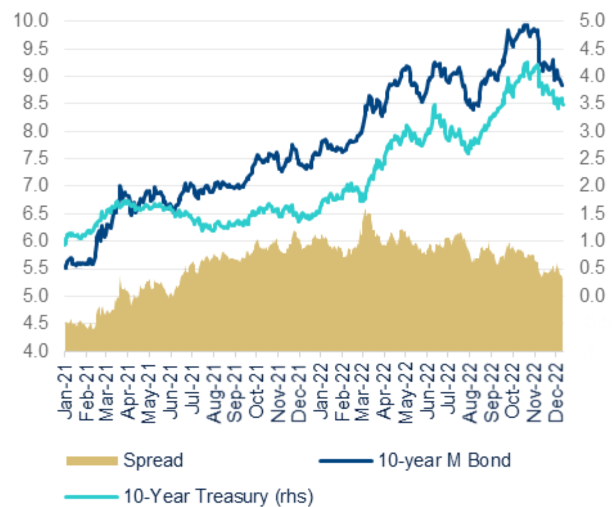
In recent weeks, short-term nominal rates continued to move upward, although at an increasingly slower pace as the end of Banxico's hiking cycle approaches. Medium and long-term rates adjusted significantly downward from their peaks reached in October, causing a sharp inversion of the yield curve (Figure 16).

Figure 16. **MX SOVEREIGN YIELD CURVE** (%)



Source: BBVA Research with data from Bloomberg.

Figure 17. **MEXICO AND US 10-YEAR YIELD CURVE YEARS** (%)



Source: BBVA Research with data from Bloomberg and Haver Analytics.

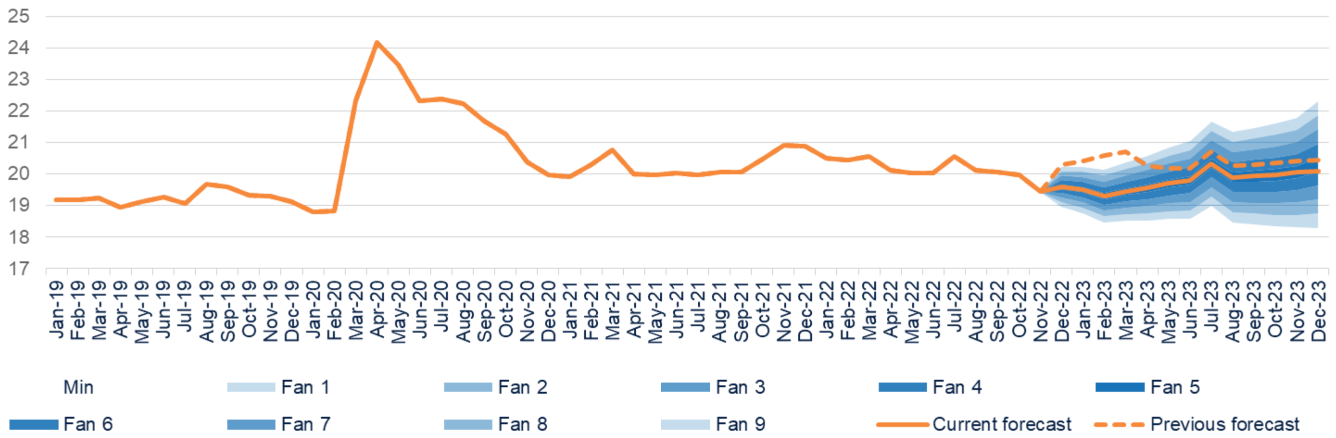
These mixed movements are largely due to the interest rate dynamics in the United States. After several months of disappointing inflation reports, on November 10th the Bureau of Labor Statistics (BLS) announced that both headline and core inflation in October was lower than in the previous month and lower than expected by the analysts' consensus. This flooded global financial markets with optimism, causing the yield on 10-year Treasury bonds to accumulate to date a drop of 75 bps from its peak of 4.25% recorded in October. Given its high correlation with the U.S. fixed income market, the Mexican 10-year M-Bond yield has also accumulated to date a drop of more than 100 bps from its peak level of 9.95%, as shown in Figure 17. This same graph also shows that for the first time since July of last year, the spread between Mexican and US 10-year bond yields fell below 550 bps in view of the further reduction in long-term rates in our country, which could begin to stop providing our currency part of the support that has explained its relative strength this year and reflects market expectations of observing a downward cycle in the monetary policy rate toward levels closer to the neutral rate.

Given that Mexico remains immersed in a globally synchronized process of tightening financial conditions in order to counteract the high levels of inflation derived from the imbalances caused by the pandemic and the war conflict triggered by Russia's invasion of Ukraine, future developments of interest rates remain subject to high uncertainty. On the one hand, the maximum level that long-term interest rates reached in October is likely to have marked the peak of this tightening cycle if, barring other shocks, core inflation shows clear signs in the coming months of moving back toward central banks' target levels (our baseline scenario). However, if the inflationary environment does not show signs of easing, the world's major central banks could reinforce their actions to further tighten financial conditions, putting pressure on interest rates in countries such as ours, thereby reversing the easing observed in recent weeks.

The Mexican peso is one of the best performing currencies in 2022

For the second year in a row, the Mexican peso has outperformed the average of a basket of emerging market currencies. The high interest rate differential with the United States, the prudent management of public finances by the federal government within a context of fiscal expansion in the vast majority of countries, and the expectation of low current account deficits in the short and medium term are the main factors behind the relative strength of the Mexican peso in the recent past and will continue to support its performance in the coming months. We forecast the exchange rate to be 19.6 pesos per dollar by December 2022 and 20.1 pesos per dollar by the end of 2023. (Figure 18).

Figure 18. **EXCHANGE RATE** (pesos/USD)



Source: BBVA Research with data from Banxico.

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