Global Economic Outlook
Weakening supply shocks, resilient demand and China’s reopening back growth, but also inflation fears despite the recent drop in headline measures.

**RECENT DEVELOPMENTS IN THE WORLD ECONOMY**

- Weakening supply shocks
- Resilient demand
- China’s reopening

- Decline of headline inflation
- Slower growth deceleration
- Persistent core inflation

- Optimism in financial markets (now vanishing)
- More hawkish central banks
Weakening supply shocks: bottlenecks and commodity prices have eased; mild weather and healthy storage have helped to push gas prices down.

**BBVA RESEARCH BOTTLENECK INDEX**  
(INDEX: AVERAGE SINCE 2003 = 0)

**COMMODITY PRICES**  
(INDEX: 2019 AVERAGE = 100)

Source: BBVA Research.

Source: BBVA Research based on data from Bloomberg.
China’s reopening: after an initial negative impact on activity, unexpected easing of COVID restrictions has boosted economic activity

China’s flexibilization of COVID policies was faster than expected; together with the measures to stabilize the real estate sector, it suggests that the focus is now on growth.

The reopening initially drove infections up, contributing to the sharp downward surprise of 4Q22 GDP.

But a solid recovery is now underway according to more recent data.

The demand recovery pace compared to the rhythm of supply normalization, in a protectionist context, will be key for global activity and inflation dynamics.

Source: BBVA Research based on data from Haver.
Headline inflation continues to fall in the US, but core inflation shows more stickiness

**CPI INFLATION**
(YoY %)

- **Core Inflation by Category**
  (YoY %)

- **Rent and Owners’ Equivalent Rent Inflation**
  (YoY %)

Source: BBVA Research based on data from Haver.
Price adjustments have become less widespread and frequent in the US, but there are no clear signs yet of improvement in the Eurozone.

**ITEMS OF THE CPI BASKET WITH ANNUALIZED MONTHLY INFLATION HIGHER THAN 4%**
(SHARE OF TOTAL 2-DIGIT CPI ITEMS)

Source: BBVA Research based on local statistics.

**ITEMS OF THE CPI BASKET WITH THREE CONSECUTIVE MONTHLY PRICE RISES**
(SHARE OF TOTAL 2-DIGIT CPI ITEMS)

Source: BBVA Research based on local statistics.
Central banks face a dilemma in their fight against inflation after recent (isolated) events in the banking system

Source: BBVA Research based on data from Bloomberg.
This uncertainty was reflected in episodes of high volatility in the financial markets; authorities’ response contributed to contain it.
Inflation will continue trending downwards, but slower demand deceleration will prevent it from converging to the target over the next two years

- Downward surprises in headline inflation pave the way for lower-than-expected price pressures in the short-run, both in the US and the EZ.

- Still, sticky core prices amid more resilient labor markets as well as scarcer room for further falls in energy prices will keep inflation high for longer than expected.

- In China, inflation will probably remain under control, but the risk is that higher domestic demand coupled with the impact of protectionist measures more than offset the effects from the supply normalization, which would add to inflation pressures.

Source: BBVA Research.
Central banks will remain focused on inflation: interest rates will rise more and will be kept higher for longer than expected.

- Terminal interest rate will be higher than expected, but uncertainty on the timing and the magnitude is large due to the volatile inflation dynamics, the unexpected resiliency of demand and doubts about the power of monetary policy in this context.
- One option is to accelerate quantitative tightening in exchange for smaller additional rate hikes, which could increase the risk of financial instability.
- The most likely is that interest rates soon reach 5.00%-5.25% in the US and 4.00%-4.25% in the Eurozone.
- High rates can be expected for longer, given the slow process of disinflation.

**MONETARY POLICY INTEREST RATES**

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<th>Year</th>
<th>US</th>
<th>Eurozone</th>
<th>China</th>
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(*) In the case of the Eurozone, interest rates on refinancing operations. Source: BBVA Research based on Bloomberg data.

Previous forecasts (4Q22) Updated forecasts (1Q23)
Better growth prospects for 2023: a softer deceleration in both the US and the Eurozone, and a stronger rebound in China

### GDP: ANNUAL GROWTH IN REAL TERMS (*)

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<tr>
<th>Year</th>
<th>US</th>
<th>Eurozone</th>
<th>China</th>
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(*) Previous forecasts: 0.5% in 2023 and 1.8% in 2024 in the US, -0.1% in 2023 and 2.0% in 2024 in the Eurozone, 5.0% en 2023 and 5.0% in 2024 in China.

Source: BBVA Research.

- Global GDP is expected to grow 2.8% (0.5pp higher than forecast) in 2023 and 3.3% (0.0pp) in 2024, after having grown 3.2% in 2022.
- 2023 forecasts have been revised up in the US and the EZ on positive incoming data (resilient demand) and lower energy prices.
- Upward revision in 2023 GDP also in China: the reopening will support consumption and supply-side normalization; policy stimuli will back investment.
- Deceleration prospects remain in place due to monetary tightening and high inflation, but some factors (private sector’s balance sheets, NGEU in Europe) will be supportive and a deep recession will likely be avoided.
Global turmoil in the banking sector: facts and impact

**Trigger: specific problems in some entities**

The **failures of SVB and Signature Bank**. Both banks neglected their A&L management and incurred on a large unhedged interest rate and liquidity risk. They were niche banks with a concentrated and volatile deposit base.

**Takeover of Credit Suisse**

Systemic entity with problems, import outflows in the last 2 years

The trigger of this transaction has been threefold: a) Financial turbulences originated by US mid-sized banks; b) Material weaknesses in internal controls; c) SNB, important stakeholder refused to invest more capital in CS.

**Quick public and private response**

(i) the guarantee of all deposits for both institutions and (ii) Fed launched a new Funding Program (BTFP) to cope with potential liquidity problems. In addition, the 9 largest US banks provided USD30bn to First Republic bank.

- UBS agrees to buy CS for CHF3bn
  - CHF 200bn liquidity support from the SNB for UBS and CS
  - CHF 9bn of government guarantees for UBS losses (which endured first loss tranche of CHF 5bn) on certain assets
  - CHF 16bn CS AT1 written down
  - Coordinated CB action to enhance the provision of USD liquidity

**Markets**

Some contagion, but limited in the financial sector due to decisive action of authorities and on more robust banking sectors than in 2008. Nonetheless sentiment continues to remain fragile and volatility is high

**Monetary policy**

CB have continued to fight inflation by raising rates and financial stability is being addressed with liquidity facilities. We expect CBs to exercise greater gradualism, but without relinquishing the need for high nominal interest rates to control inflation

**Implications for the economic outlook**

Impact in credit provision and activity through traditional channels: the wealth channel, high capital costs and balance sheet reduction by banks. But such effects are likely to be minor in principle
Increased financial tensions could lead central banks to be more cautious if the stress spreads and increases.

**FINANCIAL TENSIONS INDEXES**  
(Standard Deviation from the Mean)

**EUROPEAN BANKS’ CDS**  
(BPS)

Source: BBVA Research, Bloomberg
Mexico: The amount of obligations guaranteed by the IPAB* is equivalent to 93.2% of the traditional deposits of commercial banks.

Moreover, 99.9% of accounts are fully guaranteed (259.5 million of 259.7 million), while 0.1% of them are partially guaranteed.

Source: BBVA Research with data from CNBV and the IPAB.
IPAB = Instituto para la Protección al Ahorro Bancario (Institute for the Protection of Bank Savings)

*
Mexico: In January 2023, the multiple banking capitalization index was 19.7%, achieving a new all-time maximum.

The highest quality capital (tier 1 capital) is equivalent to 84.3% of net capital and represents 16.6% of total assets at risk.

Source: BBVA Research with data from CNBV.
Mexico: As of January 23, investment in government securities represented 17.5% of commercial bank assets.

**FEDERAL GOVERNMENT BONDS AS A % OF TOTAL ASSETS**

Long-term bonds (more than one year to maturity) represent 13.7% of such assets.

Source: BBVA Research with data from Banxico.
Domestic demand will mitigate the slowdown in manufacturing; upward revision to our 2023 growth forecast
GDP grew 3.1% in 2022 with manufacturing and consumption resilience; private spending will continue to show dynamism in 2023.

The sectors linked to external demand shower higher growth in 2022 driven by external demand.
Improvements in formal employment and real wage have driven private consumption resilience; +momentum in remittances and credit recovery

Households have gradually increase their level of leverage, but it is still 5% its pre-pandemic level

Source: BBVA Research/INEGI
The eventual weakening of external demand for durable goods will slow down manufacturing production.

In February, the BBVA Manufacturing Indicator showed the lowest year-on-year variation since the end of 2021.
Investment: the machinery and equipment segment shows high dynamism due to nearshoring; more certainty would potentiate it.

Construction is 12% below its Jan-19 level, keeping total investment 4% below that same threshold.
Upward revision to our 2023 GDP growth forecast to 1.4% (0.6% before); domestic demand and US resilience as main drivers

The economy is currently 1.5% below potential
Labor participation has recovered to pre-pandemic levels; however, the unemployment rate remains at historically low levels.

Labor informality continues without significant changes in the trend and is below the pre-pandemic level.
Formal employment shows strength at the beginning of the year, but we expect moderation in the coming months.

Permanent employment explains 73.9% of job creation in February, presenting an interannual variation of 3.0%, a level lower than that of February of the previous year, which was 6.2%, reinforcing this moderation in employment growth.

Source: BBVA Research, IMSS.
In 2023 we expect a more moderate employment growth compared to the previous year, in line with the expected growth of the economy.

Wage reviews and job creation will be key to supporting the wage bill during 2023 and household consumption.
Public revenue in January 2023 was supported by all sorts of income; discretionary spending compensated the sizable increase in debt servicing.
The reduction of 2.6 pp in the external component of the Historical Balance of PSBR (% of GDP) contributed to the fall of such balance.
Public debt (% of GDP) will remain stable for the rest of AMLO’s government and for this reason the risk of Mexico losing the investment grade is quite limited.

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

Source: BBVA Research / SHCP
Rates will peak at 11.50%; we expect a rapid rate-cut cycle in 2024
Inflation is falling mainly driven by lower non-core inflation...

**HEADLINE INFLATION BREAKDOWN**
(AYY % CHANGE)

**CORE INFLATION BREAKDOWN**
(AYY % CHANGE)

Source: BBVA Research, INEGI..
... but the seasonally-adjusted core inflation trend points to a more pronounced slowdown in the coming months...

**HEADLINE INFLATION: ACTUAL & SA TREND***
(YOY % CHANGE & 3MMA MOM ANNUALIZED % CHANGE OF SA INDEX)

**CORE INFLATION: ACTUAL & SA TREND***
(YOY % CHANGE & 3MMA MOM ANNUALIZED % CHANGE OF SA INDEX)

* Own calculations.
Source: BBVA Research con datos de INEGI.
... as we foresee in our baseline scenario, and as Banxico also anticipates

**HEADLINE INFLATION OUTLOOK**  
(YOY % CHANGE, QUARTERLY AVERAGE)

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

Source: BBVA Research, INEGI, BANXICO.
We anticipate that Banxico will bring the policy rate to 11.50%, but that, with lower inflation, it will implement a rapid rate-cut cycle during 2024...

**MONETARY POLICY RATE OUTLOOK: BBVA RESEARCH VS MARKET AND CONSENSUS (%)**

**MONETARY POLICY RATE OUTLOOK (%)**


Source: BBVA Research, BANXICO, Bloomberg.
…to avoid unnecessary further tightening of the monetary stance with falling inflation

MONETARY POLICY RATE OUTLOOK

Source: BBVA Research, BANXICO & INEGI.
The yield curve shifted down amid recent turbulence caused by the vulnerability of some banks in the US

**MX SOVEREIGN YIELD CURVE**

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The gray lines show weekly yield curves over the last 12 months. Source: BBVA Research based on data by Bloomberg.

**MX AND US 10-YEAR YIELDS**

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Recent concerns on signs of global financial instability reinforce our view that long-term rates are past their peak

2-YEAR M BOND YIELD OUTLOOK (%)

<table>
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<th>Year</th>
<th>Actual</th>
<th>Forecast</th>
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<td>2024</td>
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10-YEAR M BOND YIELD OUTLOOK (%)

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<th>Year</th>
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<tbody>
<tr>
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<td>2025</td>
<td>7.3</td>
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</table>

Source: BBVA Research based on data by Bloomberg and Haver Analytics. The gray solid (actual) and dotted (forecast) line indicates Banxico’s overnight target rate.
Wide rate differential, capital inflows, and fiscal soundness explain the better relative performance of the peso, but it is vulnerable to risk-off episodes.

MXN & EM CURRENCIES RELATIVE PERFORMANCE\(^1\)
2021-22
(INDEX, 31 DEC 2020=100)

MXN & EM CURRENCIES RELATIVE PERFORMANCE\(^1\)
2023
(INDEX, 31 DEC 2022=100)

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1 Based on a reweighting of the JP Morgan EM Currency Index after removing the MXN.
Source: BBVA Research, Bloomberg.
We now expect the ER to reach 19.5 ppd by the end of 2023 and anticipate a gradual depreciation path driven by higher inflation in Mexico vs. US.
Main messages & forecasts summary
Main messages

Growth estimate

Upward revision to our 2023 GDP growth forecast to 1.4% (0.6% before); 2.2% in 2024

- Private spending will boost growth this year and mitigate the slowdown in manufacturing given the deceleration in external demand.
- Gains in real wages and employment will drive private consumption; the recovery of consumption credit and the positive evolution of remittances will contribute to households’ spending resilience.
- Manufacturing will lose ground on lower demand for durable goods in US.
- In investment, the machinery and equipment segment has shown dynamism boosted by nearshoring; construction remains 12% below its pre-COVID level.

Recent developments

The failures of Silicon Valley Bank and Signature Bank in the US prompted decisive action by central banks to provide liquidity to the banking system. Both banks neglected their A&L management and incurred large unhedged interest rate and liquidity risk. In Europe, the Credit Suisse crisis was resolved with the acquisition by UBS, but uncertainty about the creditor hierarchy increased.

In 2023 we expect lower growth in formal employment compared to the previous year. Wage reviews and the expectation of lower inflation will be key to maintaining the growth rate of real wages and the wage bill, which will benefit household consumption.
Main messages

Inflation & Monetary Policy

We expect Banxico to keep a very restrictive stance during 2023-24, but in a backdrop of easing inflation, a rapid rate-cut cycle will be needed to avoid an unwarranted increase in real rates.

- We anticipate that Banxico will bring the policy rate to an 11.50% peak, but that with lower inflation it will implement a rapid rate-cut cycle during 2024
  - The seasonally-adjusted core inflation trend points to a marked slowdown in the coming months…
  - … as we foresee in our baseline scenario, and as Banxico also anticipates. We anticipate headline and core inflation to reach 4.8% and 4.7% by year-end, respectively

Exchange rate

We now expect the ER to reach 19.5 ppd (with a downward bias) by the end of 2023, anticipating a gradual depreciation path driven by higher inflation in Mexico vs. US
### Forecasts summary

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