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Creating Opportunities

# Mexico Economic Outlook

## March 2023

# Our 2023 growth forecast is revised upward

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- **Upward revision of our 2023 growth estimate to 1.4%** (0.6% previously); GDP growth of 2.2% for 2024.
- **Private spending will drive growth this year and** mitigate the slowdown in manufacturing in the face of sluggish external demand.
- **Gains in real wages and employment drive private consumption;** consumer credit recovery and the positive performance of remittances will contribute to households' spending resilience.
- **Manufacturing is set to lose ground** on weaker demand for durable goods in the US.
- **In investment, the machinery and equipment segment shows more dynamism, driven by nearshoring.** Construction remains 12% below its pre-COVID level.
- **The labor market continues to show strength at the beginning of the year.** Wage review and the expectation of lower inflation will be key in maintaining the growth path of real wages and the total wage bill, which will benefit household consumption.
- **Public debt (as a % of GDP) will remain stable for the rest of this administration** and therefore the risk of Mexico losing the investment grade will be very limited.
- **Inflation is easing mainly driven by lower non-core inflation,** but the core inflation trend points to a more pronounced slowdown in the coming months.
- **We remain more optimistic than the consensus for inflation in 2023:** we expect it to slow down to 4.8% by year-end.
- **We expect Banxico to raise the monetary rate to a 11.50% peak.** We foresee a rate-cut cycle during 2024 that will bring the benchmark rate to 8.50% by year-end (downward bias).
- **Nominal rates along the yield curve declined after rallying in the first months of the year** as a result of recent events in the US banking system.
- **We forecast the exchange rate to be 19.5 pesos per dollar by December 2023,** which would imply a gradual depreciation of the peso due to anticipated higher inflation for Mexico vs. the US.

# Vigor of domestic demand in 2023

The economy grew 3.1% in 2022, driven by private consumption and manufacturing. We anticipate that the former will continue to show resilience this year, while the latter will weaken in the face of lower external demand. The manufacturing sector recovered its pre-COVID production level in 2H22, driven by the fading of bottlenecks and the reactivation in supply, while private spending was boosted by the income gains registered since 3Q22.

Private consumption grew 0.5% QoQ (real, sa) in 4Q22, 0.2 percentage points (pp) above the previous quarter. The continued growth in household spending benefited from the increase in real wages in the second half of 2022 and so far this year. In particular, from June 2022 to February 2023, the average IMSS wage reported a cumulative variation of 2.9% in real terms, while the total wage bill registered a cumulative variation of 4.5% in the same period. In addition to the improvements in wages and formal employment, there was a gradual recovery in consumer credit (which is still 4% below its pre-COVID level), and the positive performance of remittances.

On the industrial side, we anticipate an eventual weakening of manufacturing output in the following months, as slower growth in demand for durable goods in the US materializes. The BBVA Multidimensional Manufacturing Indicator grew 2.0% in February (YoY), the lowest figure since late 2021, representing a turning point for manufacturing this year, in the face of gradually slowing external demand. According to IGAE data, the automotive sector is already showing signs of weakening, having recorded in January a (-)1.7% MoM drop in the level of production, while figures from the US Bureau of Economic Analysis show a (-)1.8% MoM (real, sa) contraction in vehicle and auto parts sales during February. In terms of capacity utilization, the transportation equipment segment (20% of Mexico's manufacturing output) recorded in January a level of 84.7%, the lowest since July 2022 (1.2 pp below its pre-pandemic level).

In terms of gross fixed investment, the machinery and equipment segments showed the highest vigor, driven by nearshoring. According to INEGI figures, the imported machinery and equipment component reported in the month of December a level 8.4% above that recorded in January 2019, while its domestic counterpart stood 5.5% above that same threshold. Construction, meanwhile, represents the weakest component of investment, standing at a level 12% below its January 2019 figure, which keeps total investment 4% below that same threshold. We believe that an environment of greater certainty and a change in energy policy would enhance the positive effect of nearshoring.

Considering these factors, we have revised our growth estimate for 2023 upward to 1.4% (0.6% previously), with domestic demand driving growth, and manufacturing production slowing. We anticipate growth of 2.2% for 2024, as demand for durable goods in the U.S. rebounds (Chart 1).

# The labor market starts the year with strength, but we expect it to slow down compared to the previous year

The labor market has shown signs of strength. Data from the National Job and Employment Survey (ENOE, an acronym in Spanish) show that the national unemployment rate stood at 2.9% (ae) in February, its lowest level since 2005 (the initial year of the data series), which is explained by the economic growth dynamics at the end of last year, which was better than expected. A key element that had a decisive influence on these low levels of unemployment was the slow recovery of the labor participation rate, which in recent data has begun to show a recovery and, 36 months after the pandemic began, has recovered its pre-pandemic level, largely due to the reincorporation of women into the labor market, who were the most affected during the pandemic. A positive aspect is that these labor market conditions were not accompanied by a growth in labor informality, which remains at levels of 55.0%, 3.4 pp below the historical average prior to the pandemic (2005 to 2019).

Formal job creation also began the year with great strength. Records from the Mexican Social Security Institute (IMSS) show that 288 thousand new jobs were created from January to February, making it the second-highest job creation since 1998. While this growth is significant, it is in line with a gradual expected slowdown according to our forecast. In February, employment saw year-on-year growth of 3.4%, practically in line with expectations, which were 0.1 pp lower and 1.6 pp below the year-on-year growth of February 2022. Within this job creation, the dynamics of permanent employment stands out, which is 5.8% above the pre-COVID level, compared to temporary employment, which is only 0.8% above the pre-COVID level.

As mentioned in the previous section, real wages and payrolls performed better than expected, which helped to maintain household consumption despite high inflation levels. Going forward, job creation will be key to maintaining real wage and total wage bill levels, but even more relevant this year will be wage reviews and the expected downward bias of inflation.

The expected economic dynamics will result in lower job creation but better than expected in the middle of the previous year. We expect employment to grow 2.8% this year, representing a net creation of 592 thousand new jobs (Chart 2).

## Public debt (as a % of GDP) will remain stable for the rest of this administration and therefore the risk of Mexico losing the investment grade will be very limited

The reduction in the Historical Balance of Public Sector Borrowing Requirements (Spanish “SHRFSP”) to 49.5% in 2022 from 50.8% of GDP in 2021 was mainly due to the 2.6 pp drop in the external component despite the 1.3 pp increase in domestic debt. The fiscal discipline that we expect to continue to be kept up by the current federal administration and the next federal government will moderately raise the SHRFSP to 50.7% in 2028 from 49.5% in 2022. While the SHCP expects this ratio to stabilize at 49.4% of GDP between 2023 and 2028, it is doubtful that Public Sector Borrowing Requirements will be reduced from 4.1% of GDP to 2.7% through a drop in physical public expenditure from 3.6% to 2.2% of GDP. It is important to mention that this policy of stabilizing public debt (as a % of GDP) would be detrimental to Mexico's potential growth.

January 2023 public revenue was supported by all types of income while the annual fall in discretionary expenditure offset the annual increase in public debt service. Public revenue increased 6.3% in real annual terms while public expenditure showed a real annual contraction of 0.9%.

## The seasonally-adjusted core inflation trend points to a more pronounced slowdown in the coming months

After decelerating during Q4 2022 having peaked at 8.70% YoY during August and September, headline inflation rebounded temporarily in January (to 7.9% YoY), but resumed its downward trend in February, declining 0.3 pp to 7.6% YoY. We expect the slowdown will be more pronounced during the next two quarters (Q2 and Q3). So far, the slowdown has been driven to a greater extent by lower non-core inflation, which declined 5 pp, from 10.6% to 5.6% YoY, between August 2022 and February this year. On the other hand, core inflation has shown downward rigidity. The January-February average (8.4% YoY) is the same as in Q4 22. This persistence is explained by a marginal decline in core goods inflation that has been offset by an additional moderate increase in core services inflation. Thus, although goods inflation has started to slow and decelerated 0.7 pp between November 2022 and February this year (from 11.3% to 10.6% YoY), it continues to be very high, largely explained by high processed food inflation (13.7% YoY in February) which remains significantly higher than non-food goods inflation (7.2%). Core services inflation still shows no signs of slowing down, and in fact has had an additional increase during the first two months of the year, and its current level (of 5.6% YoY) is 0.3 pp higher than the average during Q4 22.

Despite this recent persistence in core inflation, its trend--calculated by seasonally adjusting the index and annualizing monthly increases--points to a downward pathway in the coming months that will break the recent stickiness. This trend measure that anticipates a decline in the pace of core inflation is consistent with the path forecast in our baseline scenario and also with Banxico's forecasts. Thus, going forward, we anticipate a marked slowdown in both headline and core inflation. By the end of this year, we anticipate levels of 4.8% YoY and 4.7% YoY, respectively (Chart 3). The downward trend in annual inflation will be driven not only by lower increases in monthly terms, but also by positive baseline effects, which will be more pronounced during the second and third quarters. Thus, in September, headline and core inflation could already be below 5.0% and 6.0% YoY, respectively. Nevertheless, we anticipate that inflation will remain above Banxico's target range throughout 2023, and that it will not be below 4.0% YoY until Q2 24. This represents a similar trend to that forecast by Banxico for both inflation rates during 2023, but more positive than the consensus forecast, which anticipates that both headline and core inflation will close 2023 at levels above 5.0% YoY (of 5.3% and 5.3% YoY, respectively).

## Banxico is set to raise the monetary rate to 11.50%, but will implement a rapid rate-cut cycle during 2024

In the context of high inflation and a divergent trend with respect to the target during 2022, the Bank of Mexico (Banxico) has acted "forcefully" (its own word) to promote a convergence with the inflation target in the coming quarters. Under its latest decision in February, it surprisingly raised the rate by 50 basis points (bp) to 11.00%, having increased it by 500 bp in 2022, from 5.5% to 10.50%, raising the rate by 50 bp over four meetings and by 75 bp over another four. Thus, since the beginning of the current hiking cycle, Banxico raised the rate differential with respect to the United States from 400 bp to 600 bp between July 2021 and March 2022, and maintained it at that level until January. In February, by raising the benchmark rate by 25 bp more than the Fed had, Banxico widened the spread to 625 bp. The high differential seeks to: i) respond forcefully to inflationary pressures to avoid a de-anchoring of inflation expectations, and ii) avoid a depreciation of the peso in the face of the more adverse global context for risk assets due to the sharp change in US monetary policy. Banxico was successful on both fronts: long-term inflation expectations have remained anchored and the Mexican peso has shown a better relative performance than most currencies in the world.

We anticipate that next week Banxico will raise the rate by 25 bp to 11.25% and that it will make an additional increase of the same size at the May meeting to conclude the hiking cycle with the monetary policy rate at 11.50%. However, with inflation slowing and the elevated level of the reference rate, the monetary stance will become increasingly restrictive in a context of lower risks to inflation. Therefore, we expect that while Banxico will maintain a pause at 11.50% for an extended period, it will initiate a rapid rate-cutting cycle in Q1 24, and will cut the nominal rate by 300 bp over the next year to a level of 8.50% by the end of the year (Chart 4). Given that even with these cuts the real rate will remain very high, we have a downward bias for this forecast.

## The yield curve shifted down following recent events in the US banking system

Interest rates along the yield curve had mixed movements in the first months of the year. Banxico's surprising decision in February, as well as solid US inflation and employment data for the most recent months, triggered a shift up in the curve, reflecting higher expectations for the level that central banks' monetary stances would reach. However, this trend was abruptly reversed following the collapse of US regional banks Silicon Valley Bank (SVB) and Signature Bank. For example, after hovering slightly above 11% during January, the yield on 12-month Cetes peaked at 12.1% in early March, before declining to levels around 11.7% in recent days. For its part, the yield on 10-year Bonds reached levels close to 9.4% in mid-February (albeit below its highs of 9.9% reached in October 2022), settling more recently at around 9.2%. These developments in sovereign debt financial markets are likely reflecting the expectation that increased attention to financial instability risks will cause central banks, including Banxico, to adopt a more cautious stance in the process of tightening monetary conditions to combat inflation.

Although the behavior of interest rates in the future will remain subject to high uncertainty, we believe that once Banxico concludes the hiking cycle in May and adopts a pause thereafter, rates along the yield curve will start to gradually decline, discounting the eventual monetary easing cycle to be adopted by the central bank next year as inflation undergoes a more pronounced slowdown. We maintain our expectation that the peak level reached by long-term interest rates in October marked the highpoint of this tightening cycle (Charts 5 and 6).

## The Mexican peso will show some volatility due to the recent international financial turbulence

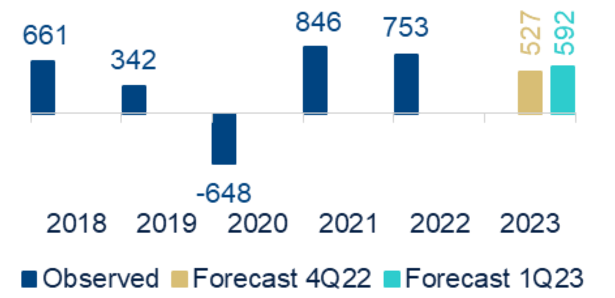
Although the Mexican peso had shown some strength as the exchange rate approached 18.00 pesos per dollar, events associated with the problems in several regional banks in the United States and Credit Suisse in Europe triggered financial volatility and reversed the trend of widespread dollar weakness. Nevertheless, the high interest rate differential with respect to the United States, the prudent management of public finances by the federal government and the forecast of low current account deficits in the short and medium term are factors that will provide resilience to the Mexican peso in the coming months. As we expect the inflation differential between Mexico and the United States to be positive by the end of 2023, we expect a gradual depreciation of the peso and an exchange rate of 19.5 pesos per dollar by the end of this year (Chart 7).

# Forecasts

CHART 1. **GDP**
(% ANNUAL VAR.)


Source: BBVA Research / INEGI.

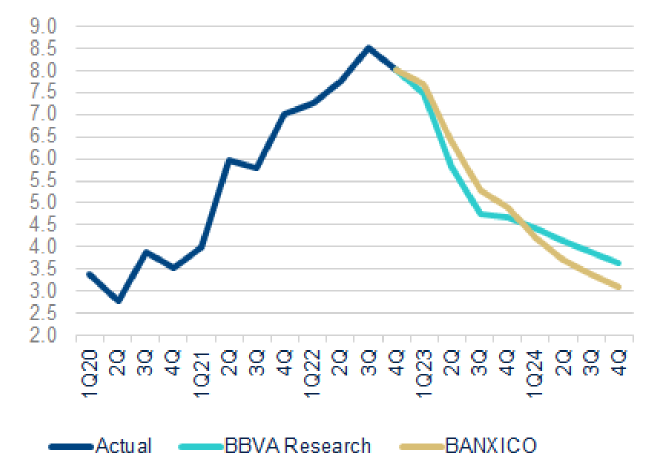
CHART 2. **IMSS-AFFILIATED JOBS**
(% ANNUAL VAR. EOP, '000s)




| Forecast | 2023 | 2024 | 2025 |
|---|---|---|---|
| Thousands, Eop | | | |
| **1Q23** | **592** | **753** | **764** |
| 4Q22 | 527 | 700 | 702 |
| Annual change, % Eop | | | |
| **1Q23** | **2.8** | **3.4** | **3.4** |
| 4Q22 | 2.5 | 3.2 | 3.1 |

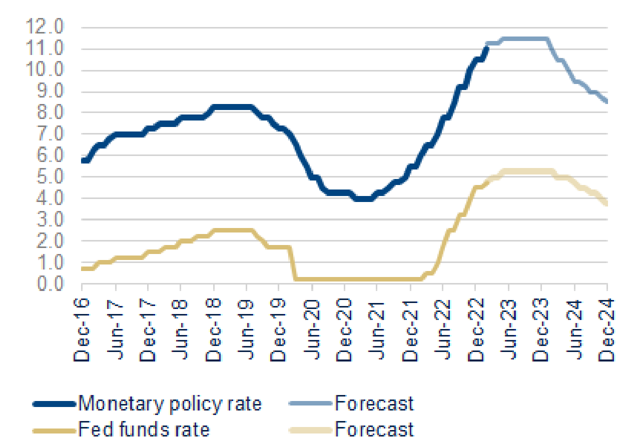
Source: BBVA Research / INEGI.

CHART 3. **HEADLINE INFLATION**
(% ANNUAL VAR.)



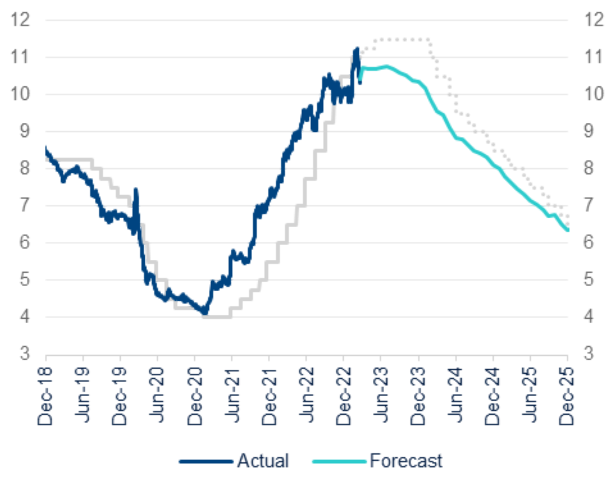

Source: BBVA Research / INEGI / Banxico.

CHART 4. **BENCHMARK RATES IN MEXICO AND THE UNITED STATES** (%)



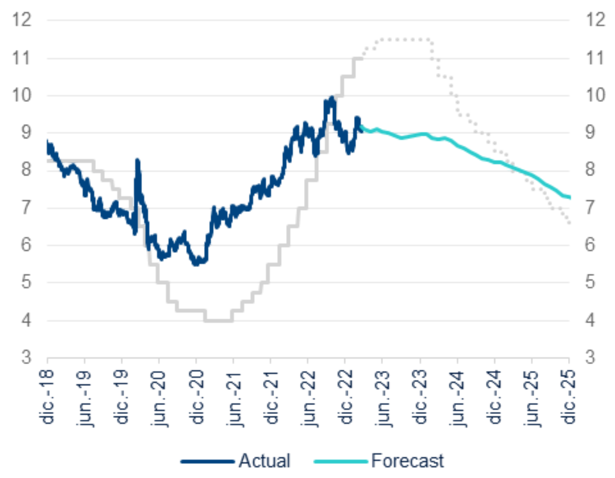

Source: BBVA Research / Bloomberg / Banxico.

GRÁFICA 5. **2-YEAR M BOND YIELD**
(%)



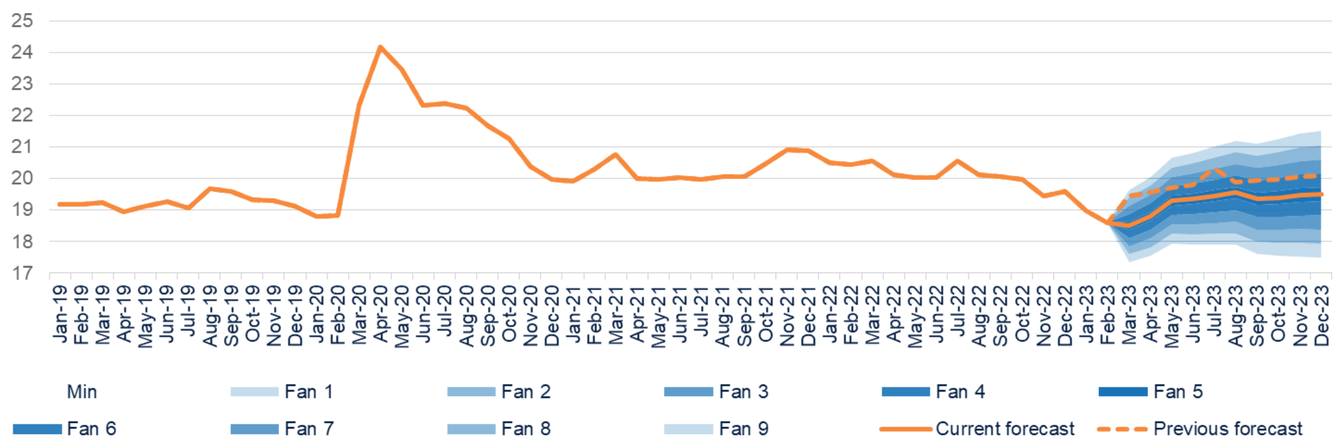

The solid (observed) and dotted (forecast) gray line indicates Banxico's target rate.
Source: BBVA Research / Bloomberg.

GRÁFICA 6. **10-YEAR M BOND YIELD**
(%)




The solid (observed) and dotted (forecast) gray line indicates Banxico's target rate.
Source: BBVA Research / Bloomberg.

CHART 7. **EXCHANGE RATE** (MXN/USD)




Source: BBVA Research / Banxico.

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