BBVA Research

Creating Opportunities

Mexico Economic Outlook

June 2023

Upward revision to our 2023 GDP growth forecast; downward revision to 2024

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- **Upward revision of our 2023 GDP growth estimate to 2.4%** (1.4% previously); we forecast a GDP growth of 1.8% in 2024.
- **Resilient domestic demand drives growth in 2023;** the gains in real wages and employment drive private consumption.
- **The machinery and equipment segment is showing rapid dynamism in the investment segment,** in light of the normalization in manufacturing.
- **We anticipate lower growth in 2H23** due to weaker external demand in a context of high interest rates and the tightening of financing conditions in the US.
- **Better prospects for job creation in 2023.** The expected inflation dynamics and upward employment revision will continue to boost the real total wage bill. We have adjusted our forecast for 2024 downwards due to the lower growth expected..
- **Public debt will remain stable at around 50% of GDP in 2023-24** and therefore the risks of losing the investment grade will be very limited.
- The decline in inflation has been driven mainly by lower non-core inflation, but **the pace of the slowdown in core inflation has also gained traction.**
- **Trending measures point to a more pronounced slowdown in the coming months**, as we forecast in our baseline scenario.
- **We continue to be more optimistic than the consensus for the trend in inflation in 2023:** now we expect it to decelerate to 4.6% by the year-end.
- **We expect Banxico to initiate a rate cut cycle in 4Q23** to avoid a further increase in the real ex-ante rate with inflation falling. We forecast that the monetary rate will reach 8.00% by the end of 2024.
- **We expect the yield curve to remain inverted this year and next,** but settling into a gradual flattening process ahead of the eventual easing cycle to be adopted by Banxico.
- **We expect the exchange rate to be 18.5 pesos per dollar by December 2023,** which would imply a gradual depreciation of the peso due to the inflationary and interest rate differentials with the United States.

Domestic demand drives growth in 2023; downward revision for 2024

We have revised our GDP growth estimate for 2023 upward to 2.4% (previously 1.4%) in view of the good dynamism of the economy in the first quarter of the year. According to INEGI figures, in 1Q23, GDP grew 1.0% QoQ, driven by the tertiary sector (1.5% QoQ) and the resilience shown by industry (0.6% QoQ). The figures are in line with the favorable performance registered by the BBVA Research Big Data Consumption Indicator, especially in the services segment. We estimate that private spending will continue to show a good performance given the observed gains in real wages and formal employment, coupled with the positive effect of remittances and the gradual recovery of the banking system's consumer portfolio, which is currently 1.1% below its pre-COVID level.

Meanwhile, the April figures for the industrial activity indicator (0.4% MoM) suggest that normalization continues in this sector, especially in manufacturing (with a monthly growth of 6.6% in the automotive sector). After being significantly affected by bottlenecks and shortages in the supply of inputs (in the months following the onset of the pandemic), manufacturing output has surpassed its pre-COVID level by 6.1%, with some sectors showing an outstanding performance (such as the manufacture of electrical appliances, which has surpassed its pre-pandemic level by 22.3%). The dynamism in this industry segment has driven the rapid recovery in investment in machinery and equipment, especially the imported component, which to date is 16.4% above its January 2019 level. However, other gross fixed investment segments are still trailing, such as residential construction, which registers a level 21.6% below that observed in January 2019 (keeping total investment 2.1% below the same threshold).

Toward the second half of the year, the economy is expected to gradually decelerate as demand for durable goods in the US weakens (in an environment of high interest rates and tightening financing conditions as a result of the recent bank failures). Mexico's manufacturing sector is expected to slow down in the second half of this year due to lower external demand; there will be lower growth in machinery and equipment investment during this period, coupled with prolonged weakness in the private residential construction sector. The resilience of consumption would prevent a further decline in Mexico's GDP during the second half of 2023, fueled by the accumulated gains in income since the second half of last year. Expectations for public investment are boosted by the construction of the flagship infrastructure projects promoted by the federal government. We estimate GDP growth of 1.8% by 2024, as a result of the drag effect caused by the slowdown in the economy at the end of this year (Figure 1).

Labor market with sustained strength and improved growth expectations for the end of year

The labor market has shown strength and great dynamism in the post-pandemic recovery, with unemployment rates at historically low levels, contained levels of informal employment, growth in real wages, and high formal job creation.

According to data from the National Job and Employment Survey (ENOE), the employed population is currently 5.7% above pre-pandemic levels (February 2020). Since then, 3.2 million jobs have been created, of which 64.8% are paid subordinate workers, 13.7% are employers, 13.8% are self-employed and 8.7% are unpaid workers. This employment growth has been accompanied by the lowest unemployment rates since 2005. From January to April 2023 (seasonally adjusted, sa) the unemployment rate has averaged 2.8%, 1.4 percentage points (pp) below the historical pre-pandemic average. Another relevant aspect of this employment dynamic is the behavior of the labor informality rate, which even displays a good performance. In the first four months of the year, it has averaged 55.1% (sa), 3.3 pp below the historical average until before the pandemic.

Regarding formal employment, data from the Mexican Social Security Institute (IMSS) show record employment generation figures. From January to May 2023, a total of 490 thousand jobs were created, the highest figure since 1998 in absolute terms. Compared to the same period of the previous year, formal employment grew by 2.3%, 0.4 pp and 0.2 pp higher than in the previous two years, respectively, setting a constant growth dynamic.

Also noteworthy is the 12.0% growth in the average real wage of IMSS-registered workers compared to the pre-pandemic level, which has been supported by increases in the minimum wage and wage negotiations that have been above inflation. This fact, together with the creation of 2.3 million jobs from August 2020 (the month in which employment lost due to the pandemic began to recover) to date, has been a determining factor in the 18.8% growth of the total wage bill with respect to February 2020, contributing directly to household consumption.

Based on this dynamic and the upward revision of our growth expectation, our forecast for formal job creation this year improves to 747 thousand new jobs, which represents a y/y growth of 3.5% at the end of the year. For 2024, the adjustment is downward; therefore, we anticipate that 695 thousand new jobs will be created, equal to a y/y growth of 3.1%. (Figure 2).

Government debt (as a % of GDP) will remain stable in 2023-24 and therefore the risk of losing investment grade will be very limited

The reduction in the Historical Balance of Public Sector Borrowing Requirements (SHRFSP, for its acronym in Spanish) to 45.6% in March 2023 from 49.4% of GDP in December 2022 was mainly due to the 2.0 and 1.8 pp fall in the domestic and external component, respectively. The fiscal discipline that we expect the current federal public administration to maintain will allow the SHRFSP to increase moderately to 50.0% in 2024. Although the Ministry of Finance forecasts that this ratio will be 49.4% of GDP in 2024, it is debatable whether the Public Sector Borrowing Requirements will be reduced from 4.1% of GDP to 2.7% through a drop in physical public investment from 3.6% to 2.2% of GDP. It is important to mention that this public debt stabilization policy (% of GDP) does not contemplate a reduction in current spending (% of GDP) in 2024 and, as it is explained by reductions in public investment, it could affect Mexico's potential growth.

The January-April 2023 public revenues were affected by the performance of oil revenues while the annual drop in discretionary expenditure more than offset the significant annual increase in the financial cost of public debt. Public revenue fell 3.1% in real annual terms while public expenditure showed a real annual contraction of 2.1%.

The decline in inflation is now widespread; the slowdown will be more pronounced in the coming months

After the temporary rebound due to one-off factors in January (to 7.9% y/y), headline inflation resumed its downward trend in February, and has declined for four consecutive months, to 5.8% y/y, the lowest since August 2021, and (-)2.9 pp below the peak of 8.7% reached in August and September last year. We continue to anticipate that the slowdown will remain pronounced for the remainder of this quarter (Q2) and the next (Q3). The slowdown has been driven to a greater extent by lower non-core inflation, which fell 9.4 pp, from 10.6% to 1.2% y/y, between

August 2022 and May this year. In turn, core inflation, which had shown stickiness, has also begun to decline and the downward trend among its components is starting to become more generalized, although services prices still show resistance to decline and have decreased only marginally in the last two months - albeit after maintaining an upward trend in 1Q23. On average, core inflation decreased only 0.1pp, from 8.4% y/y to 8.3%, between 4Q22 and 1Q23, but the decelerating trend has gained traction in 2Q23: in April-May, it averaged 7.5% y/y and we forecast that by the end of 2Q23, core inflation will have averaged 7.3% y/y, one pp lower than in 1Q23. The decline in core inflation is explained to a greater extent by the deceleration of consumer goods inflation, which has been partially halted by the downward resistance of services prices. Consumer goods inflation decelerated 2.2 pp between November 2022 and May this year (from 11.3% to 9.0% y/y). The level remains very high, largely explained by high processed food inflation (11.4% y/y in May) which continues to be significantly higher than that of non-food consumer goods (6.3%). Services inflation, which had risen in 1Q23, seems to be showing signs that it is beginning to show signs of a slow deceleration. Therefore, although it had an additional increase during 1Q23 (of 0.3 pp with respect to the 4Q22 average), its current level (of 5.4% y/y) is 0.3 pp lower than the maximum reached in March of this year.

Despite the slower deceleration, its trend -calculated by seasonally adjusting the index, annualizing monthly increases and smoothing with rolling averages- points to the downward trend continuing to gain traction in the coming months. This trend measurement that anticipates a decline in the pace of core inflation is consistent with the forecast path in our baseline scenario and also with Banxico's forecasts. So, moving forward, we continue to expect a marked deceleration in both headline and core inflation. By the end of this year, we anticipate levels of 4.6% y/y (Figure 3) and 4.8% y/y, respectively. The downward trend in annual inflation will be supported not only by lower increases in monthly terms, but also by positive base effects, which will be more pronounced during the second and third quarters. As a result, headline inflation could already be below 5.0% as of July, while core inflation could be below 6.0% y/y as of September. In other words, we continue to anticipate that inflation will remain above Banxico's target range throughout 2023, and that it will not be below 4.0% y/y until 2Q24. This represents a similar trend to that forecast by Banxico for both inflation rates during 2023, but more positive than that forecast by the consensus, which anticipates that both headline and core inflation will close 2023 at levels above 5.0% y/y.

Banxico to maintain an extended pause before initiating a rate cut cycle in 4Q23

Regarding monetary policy, we expect Banxico to maintain an extended pause during 2Q and 3Q23 after initiating it in May and having kept the monetary rate unchanged at 11.25%, regardless of a possible Fed hike in July. Despite this pause, the monetary stance, proxied by the real ex-ante rate, will continue to tighten during this and the next quarter as the faster pace of inflation decline will be accompanied by a decline in 12-month inflation expectations, which in our view remain still elevated (they stand at 4.7%, 0.9pp above our inflation forecast of 3.8% y/y for May 2024). In a context of gradual convergence of inflation to the target range and amid a weakening trend in economic activity in the second half of this year, we expect Banxico to initiate a rate cut cycle in 4Q23 to avoid additional and unnecessary tightening of the monetary stance. We therefore anticipate that the monetary rate will close 2023 at 10.75% and that Banxico will implement a rapid rate cut cycle during 2024 that will bring it to 8.00% at the end of that year (Figure 4).

The yield curve will remain inverted this year and next, but in a gradual flattening process

We anticipate that rates along the yield curve will gradually decline from now on, discounting the eventual monetary easing cycle to be adopted by Banxico in light of recent signs of a slow but sustained disinflationary process moving forward. Yields in the short and medium nodes of the curve would have peaked between February and March following the uncertainty generated by the surprising 50bp increase in Banxico's reference rate in its first decision of the year. The yield on 12-month Cetes, for example, reached a high of 12.1% at the end of February and is currently around 11.5%. Yields at the long end of the curve peaked in the last quarter of last year. Such is the case of the 10-year M-Bond yield, which reached highs of 9.9% last October, while in recent weeks it has hovered around 8.8%, maintaining a spread of approximately 520 bps with respect to the 10-year US Treasury bond yield, with which it is highly correlated.

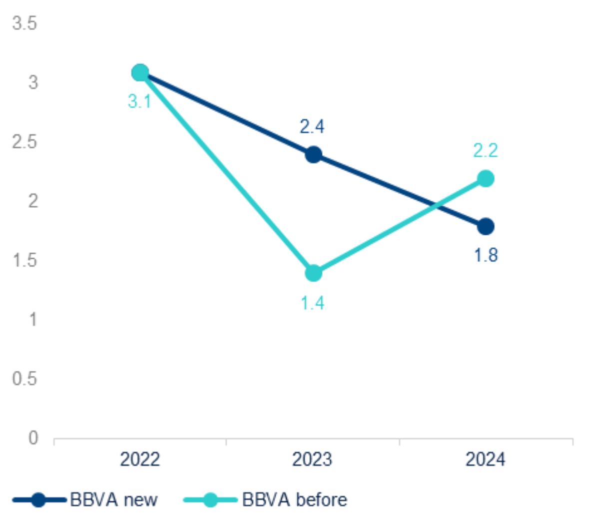
Thus, the curve remains significantly inverted. The 10-year yield maintains a negative spread of approximately 250 and 150 bps against the 3-month and 2-year yields, respectively. Based on our baseline scenario for the monetary rate, we expect the curve to remain inverted for the remainder of this year and next, but in a gradual flattening process. In particular, we expect 2-year yields of 9.9% and 7.9% by the end of 2023 and 2024, respectively. We expect the 10-year yield to be around 8.7% and 8.2% for the same periods (Figures 5 and 6), and to outperform the Cetes yield until 2025.

The Mexican peso resumed its appreciation after the bout of banking concerns in the United States and Europe

After various economic authorities acted in a timely manner to limit the international financial risks associated with the problems in several regional banks in the United States and Credit Suisse in Europe, the Mexican peso resumed the path of appreciation it had shown since the beginning of the year. Factors such as the high interest rate differential with the United States, fiscal soundness and the expectation of low current account deficits in the short- and medium-term help to understand the strength that the Mexican peso has exhibited in recent months. Since we expect the inflation differential between Mexico and the United States to be positive at the end of 2023 and the interest rate differential with the United States to narrow in 2023-24, we anticipate a gradual depreciation of the peso and an exchange rate of 18.5 pesos per dollar at the end of this year (Figure 7).

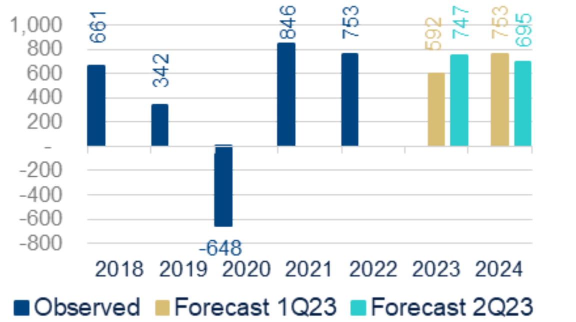
Forecasts

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



Source: BBVA Research / INEGI.

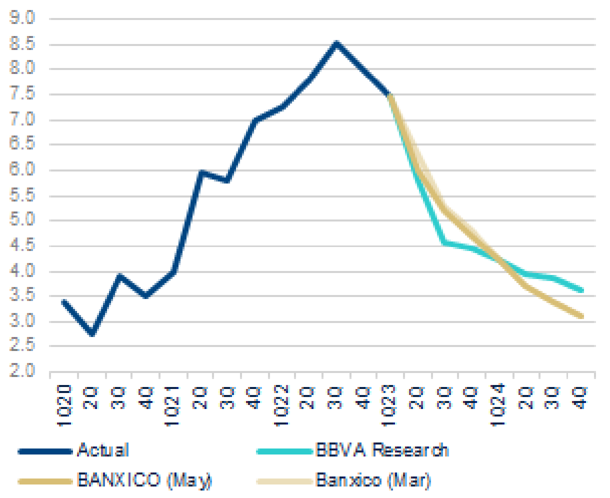
Figure 2. **IMSS-AFFILIATED JOBS**
(% ANNUAL CHANGE EOP, '000s)



Forecast	2023	2024	2025
Thousands, Eop			
2Q23	**747**	**695**	**750**
1Q23	592	753	764
Annual Var., % Eop			
2Q23	**3.5**	**3.1**	**3.3**
1Q23	2.8	3.4	3.4

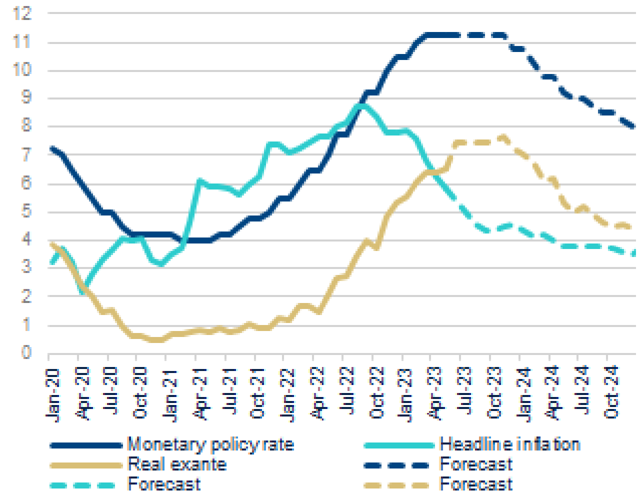
Source: BBVA Research / INEGI.

Figure 3. **HEADLINE INFLATION (% ANNUAL CHANGE)**



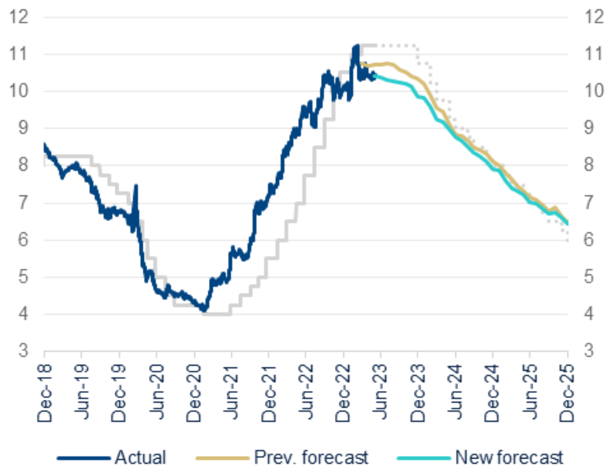
Source: BBVA Research / INEGI / Banxico

Figure 4. **REFERENCE RATES IN MEXICO AND THE UNITED STATES (%)**



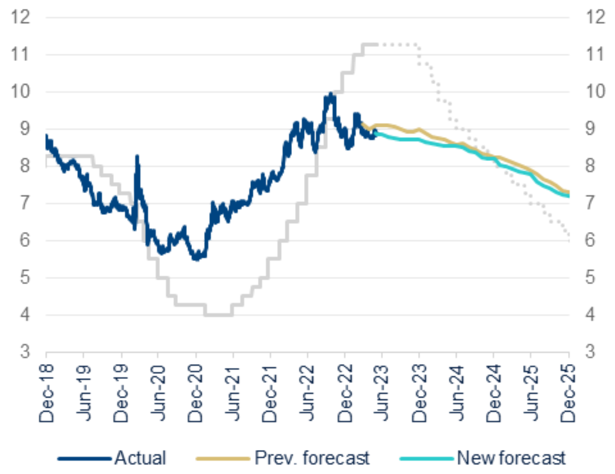
Source: BBVA Research / Bloomberg / Banxico

Figure 5. **2-Y M BOND YIELDS (%)**



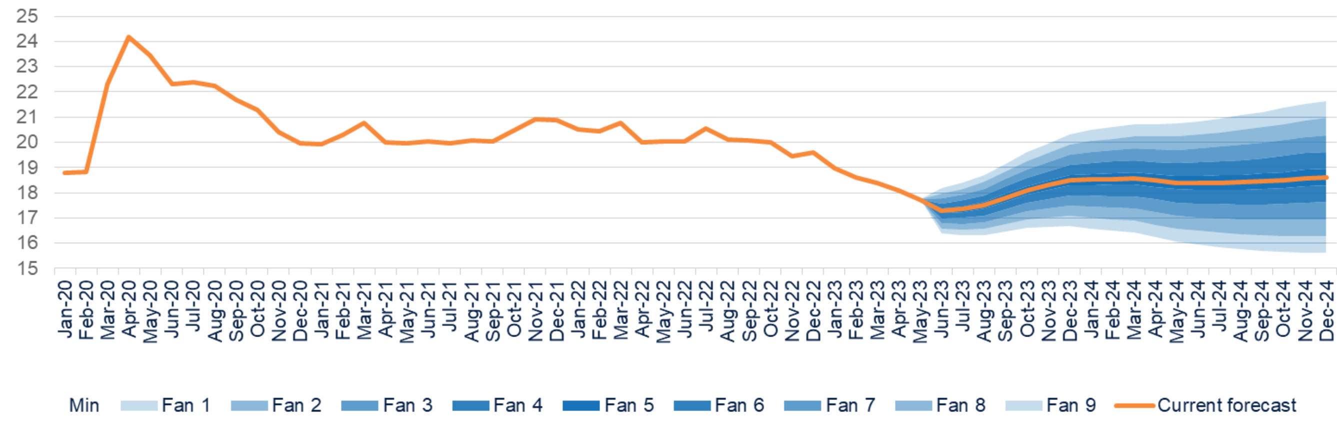
The solid (observed) and dotted (forecast) gray line indicates Banxico's target rate.
Source: BBVA Research / Bloomberg.

Figure 6. **10-Y M BOND YIELDS (%)**



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

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



Source: BBVA Research / Banxico.

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