BBVA Research

Creating Opportunities

Mexico Economic Outlook

September 2023

Better prospects for economic growth and inflation in 2024

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- **We revised our 2023 GDP growth estimate upward to 3.2%** (2.4% previously) and we anticipate growth of 2.6% in 2024 (1.8% previously).
- **Consumption remains resilient,** driven by gains in real wage, employment and the lower saving rate among higher income deciles.
- **Investment shows a positive performance** favored by public investment and the rapid growth of the imported machinery and equipment component, in view of normalization of production.
- **The higher dynamism of domestic demand in 2H23 provides a better starting point for economic activity in the coming year,** in addition to the improved economic outlook for the U.S.
- **Formal employment will continue to be strong during 2023 and improves our outlook for 2024.** The labor market will remain robust throughout the year, underpinning the total wage bill.
- **The 2024 economic package will not result in significant fiscal imbalances next year,** even though it proposes a target of -1.2% of GDP for the primary balance and the highest deficit since 1990. However, it will impose significant challenges for the upcoming administration.
- The decline in inflation is now being driven by lower merchandise inflation; **we anticipate a more pronounced slowdown in core inflation in the coming months.**
- We anticipate **both headline and core inflation to be below 4.0% as of 2Q24**; we maintain our 2023 year-end forecasts at 4.6% and 4.8%, respectively.
- According to the downward trend in inflation, we deem it justified to avoid a further increase in the real rate, but **we are pushing back the start of a rate-cut cycle to 1Q24, to reach a level of 8.25% by the end of 2024.**
- **Higher-for-longer rates along the yield curve, due to the delay of Banxico's easing cycle,** but they will gradually decline, discounting the eventual monetary easing cycle.
- **We expect the exchange rate to be 18.0 pesos per dollar by December 2023,** which would imply a marginal depreciation of the peso compared to current levels.

Domestic demand remains resilient; improved outlook for 2H23 with positive impact on 2024

We revised our GDP growth estimate upward for 2023 to 3.2% (2.4% previously) in light of the resilience of domestic demand, and the higher-than-expected growth of the U.S. economy, with better prospects for 2H23. According to INEGI figures, in 2Q23, GDP grew 0.8% Q/Q, driven by the tertiary sector (0.7% Q/Q) and the dynamism of construction (6.5% Q/Q). The first of these sectors has been favored by the accumulated gains in real wages (+6.2% since June 2022) and in the real wage bill (+10.6% since June 2022). Additionally, the most recent ENIGH data point to a reduction in the household savings rate, especially among higher income deciles. According to Banxico data, the balance of deposits (short- and long-term) held by households has declined significantly since 2021 and is still 7.6% below its pre-pandemic trend.

With respect to the construction industry, the non-residential segment has benefited from the rapid growth of public investment due to the speed with which the federal government has been working on its flagship projects this year (the Dos Bocas refinery and the Mayan Train). According to the latest data from INEGI's gross fixed investment indicator, investment in the non-residential segment is at a level 60% above its January 2019 figure, with rapid growth since 3Q22 (and within this segment the public component is 41% above its pre-COVID level). Residential construction continues to lag, at 20% below its January 2019 level.

With respect to the manufacturing industry, output remains resilient, driven by the automotive sector and the manufacture of machinery and electrical equipment. The latest data of the industrial production indicator shows that the manufacturing sector has reached a level that exceeds its pre-COVID figure by 8%, with the manufacture of electrical appliances exceeding its pre-pandemic level by 21%. The stabilization of the manufacturing industry following the disruptions in global value chains has promoted the rapid growth of investment in machinery and equipment, the imported component of which has surpassed its pre-pandemic level by 31%. We predict that the emergence of nearshoring will boost the growth of gross fixed investment in the coming years and have a positive effect on potential growth.

We estimate that the good dynamism of domestic demand will extend into the second half of the year due to gains in labor income, lower savings rate, resilience of the industrial sector, as well as a better growth outlook for the U.S. The greater dynamism of 2H23 favors the starting point for economic activity next year; private consumption will remain resilient, with special impulse from the services sector, while investment will show a favorable performance due to the rapid growth of the machinery and equipment segment and the positive drag effect of public construction in 2023. Thus, we revise our GDP growth estimate upward for 2024 from 1.8% to 2.6% (Figure 1).

Labor market continues to show strength with some incipient signs of slowdown

The labor market continues to show strength, which has largely contributed to the improved growth expectations for the Mexican economy in 2023. According to the latest available data from the National Survey of Occupation and Employment (ENOE), the unemployment rate in July stood at 2.9%, slightly above the year-to-date average of 2.8%, its lowest level from 2005 to 2022. It is worth noting that the boom in job creation has not been accompanied by an acceleration in the labor informality rate, which in July stood at 55.5%, a level 2.8 percentage points (pp) below the historical average.

Regarding formal employment, the Mexican Social Security Institute (IMSS) figures also reflect robustness. From January to August 2023, 624,000 jobs were created, slightly above the same period last year (617,000). Despite this good pace, job creation has slowed in recent months. In July and August 2023, the average monthly change in employment was 0.2%, 0.2 pp lower than in the same period of the previous year.

Real wage growth has maintained a positive trend driven by minimum wage increases and wage revisions at the beginning of the year. Real wages grew 5.7% YoY in August and, year-to-date, year-on-year growth has averaged 4.7%, 2 pp above the average growth observed in the same period of the previous year, even though inflation remains at high levels and above Banxico's target range. Solid job creation and real wage growth have jointly boosted the total real wage bill, which in July reached a year-on-year growth of 9.4%, 18.6% above its pre-pandemic level (February 2020).

We maintain our expectation that the strength of the labor market will continue throughout the year, and we make a slight adjustment to our employment forecasts. We expect employment to close the year with 748,000 new jobs, reflecting year-over-year end-of-period growth of 3.5%, in line with our previous scenario. For 2024, we upgrade our job creation outlook and now expect a total of 718,000 cumulative new jobs at year-end, representing year-on-year growth of 3.2%, 0.1 pp higher than our previous forecast (Figure 2).

Declining inflation, now largely driven by core inflation; we expect the slowdown to gain momentum

Disinflation has continued. Both headline and core inflation have declined for seven consecutive months. Headline to 4.6% YoY, the lowest since February 2021, and (-)4.1 pp below the 8.7% peak reached in August and September 2022. As we anticipated, base effects favored a pronounced decline in headline inflation during the second quarter (Q2) and during the current quarter (Q3). Base effects in the next quarter (Q4) will not be favorable. Thus, although we expect headline inflation to slow to 4.5% YoY in September and 4.4% YoY in October, we also expect a small rebound in November and December that will bring it to close the year around current levels of 4.6% YoY. The slowdown that had been driven mainly by non-core inflation, which declined 11.3 percentage points (pp), from 10.6% to -0.7% YoY, between August 2022 and August this year, is now being favored mostly by lower core inflation, which had shown greater downward rigidity at the beginning of the year. Thus, while it decreased only (-)0.3 pp during the first quarter, in the second quarter it slowed down (-)1.2 pp to 6.9% YoY, and the pace of slowdown during this quarter will end up being very similar, to close in September at around 5.7% YoY.

The slower pace of core inflation has started to become more broad-based, and although services inflation still shows higher resistance to decline and has decreased only marginally in the last four months (-0.3 pp), it has slowed for five consecutive months despite an unusually high increase in the prices of educational services during August and September. Thus, the decline in core inflation has continued to be explained mostly by the slowdown in goods inflation, which has been partially offset by the downward resilience of services prices. While goods inflation has slowed (-)4.2 pp so far this year (from 11.1% YoY in December to 6.9% YoY in August), services inflation, which had increased in 1Q23, has started to show signs of a slow deceleration. Thus, although it had an additional increase during 1Q23 (of 0.3 pp with respect to the 4Q22 average), its current level (of 5.2% YoY) is 0.5 pp lower than the peak reached in March of this year.

Despite the slower pace of core inflation slowdown so far, its trend—calculated by seasonally adjusting the index, annualizing monthly increases and smoothing with moving averages—points to the downward trend continuing to gain traction in the coming months. This trend measure that anticipates a faster decline in core inflation is consistent with our baseline scenario's forecast path and also with Banxico's forecasts. Thus, going forward, we continue to expect inflation to converge to Banxico's target of 3.0% YoY +/-1 pp. In fact, we anticipate that as of 2Q24, both headline and core inflation will be below 4.0%, that is, within the variability range of Banxico's target. By the end of this year, we continue to forecast 4.6% YoY for headline inflation (Figure 3) and 4.8% YoY for core inflation. Thus, while we continue to anticipate that inflation will remain above Banxico's target range throughout 2023, we also continue to forecast that it will be below 4.0% YoY as of 2Q24. This represents a similar trend to that forecast by Banxico for both inflation rates during 2023, but still more positive than the consensus forecast, which, although it has gradually converged with our forecasts, anticipates that core inflation will close 2023 at levels above 5.0% YoY (at 5.1% YoY).

We are pushing back the start of the potential easing cycle to 1Q24

With regards to monetary policy, we think Banxico will remain cautious in the short term, particularly now that the Federal Reserve has shown a more restrictive tone, noting that U.S. rates will remain high for a longer period of time. Thus, despite the high real rate levels, in a context of above-potential growth and with inflation still above target, we expect Banxico to maintain the pause adopted in recent months for longer than previously expected. We believe that at this month's meeting Banxico will close the door on the possible start of this rate-cutting cycle at one of the two remaining meetings of the year. Despite this, we continue to anticipate that, with inflation falling, we deem it justified to avoid a further increase in the real rate in the coming quarters.

Thus, we now expect the central bank to maintain a longer pause, with the monetary rate remaining at current levels of 11.25% for the rest of the year. Nevertheless, we continue to expect a significant cut in the monetary rate next year, which would take it to a level of 8.25% by the end of 2024 (Figure 4). This is despite the fact that although the reference rate has stopped rising, the monetary stance (proxied by the real ex-ante rate) has continued and will continue to tighten during the rest of the year and early next year given that the decline in inflation will be accompanied by that of 12-month inflation expectations, which in our view remain elevated (they stand at 4.3%, 0.7 pp above our inflation forecast of 3.6% YoY for September 2024). In a context of gradual convergence of inflation to the target range and with a slowdown in economic activity next year, we expect Banxico to initiate an easing cycle in 1Q24 to avoid additional and unnecessary tightening of the monetary stance.

Higher-for-longer rates along the yield curve

The latest increase in long-term interest rates has been driven by the dynamics of the U.S. yield curve, a global context of increased risk aversion, and a delay in expectations of the timing of the start of an eventual easing cycle in Mexico. Despite this, we continue to anticipate that rates along the curve will gradually decline, discounting a likely monetary easing cycle given recent signs of progressive disinflation ahead. Yields at the short end of the curve have remained relatively stable after Banxico ended the monetary tightening cycle in May. From July to date, the yield on 12-month Cetes has been 11.4%, slightly below its average level observed in the first half of the year (11.5%). Long-term yields have recently increased significantly. So far in September, the yield on 10-year Bonds has averaged 9.7%, after hovering around 8.9% during the first half of the year, and around 8.8% in July and August.

Despite this, the curve remains significantly inverted. The 10-year yield maintains a negative spread of approximately 170 and 90 bps against the 3-month and 2-year yields, respectively. Based on our baseline scenario for the policy rate, we expect the yield curve to remain inverted for the remainder of this year and most of next, but gradually flattening. With the expectation that the start of an easing cycle will be delayed to 1Q24, we now expect 2-year yields of 10.5% and 8.0% by the end of 2023 and 2024, respectively. We expect the 10-year yield to be around 9.2% and 8.4% for the same periods (Figures 5 and 6), and to outperform the Cetes yield until 2025.

The 2024 Economic Package will close the six-year term without a fiscal imbalance, but the proposed public deficit for next year is a cause for concern

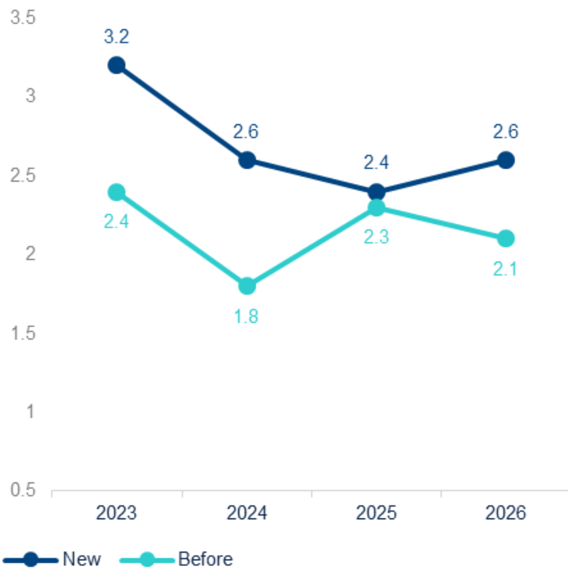
The 2024 Economic Package was drafted with realistic macroeconomic assumptions. Fiscal balance will be maintained despite the fact that the package proposes a target of -1.2% of GDP for next year's primary balance. Nevertheless, it is worrisome that the public deficit of 4.9% of GDP (estimated by the Ministry of Finance) for next year is the highest since 1990 (Figure 7). This deficit is striking in a scenario in which the same government agency estimates that the Mexican economy will grow above its potential (2.6% vs. 2.4%). This implies a pro-cyclical fiscal policy that is detrimental to the public debt performance (% of GDP). In contrast, a countercyclical fiscal policy would promote greater stability in the public debt to GDP ratio and could provide more room for maneuvering in the future in the event of a recession or a significant drop in oil prices.

The Ministry of Finance (SHCP for its acronym in Spanish) estimates that the Historical Balance of Public Sector Borrowing Requirements (HBPSBR) will be 48.8% of GDP at the end of 2024, a level that will not cause any problem for the repayment of sovereign or Pemex debt maturities. Our own calculations show that it would be necessary for the SHRFSP to be approximately -3.5% of GDP in 2024 to maintain the historical balance of these requirements at 46.5% of GDP. This balance could also be maintained with PSBR at -5.4% of GDP (projected by the SHCP) if economic growth were 7.8% next year, a scenario we consider highly unlikely. Given the expected fragility of public finances in the coming years, it will be necessary for the next federal government to design and implement a fiscal reform to increase tax revenues.

The Mexican peso is expected to show some volatility in the months leading up to the June 2024 elections

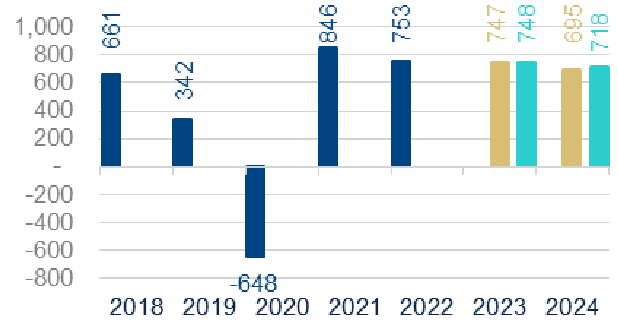
We anticipate that the exchange rate will close the year at levels around 18.0 pesos per dollar, which would imply a marginal depreciation of the Mexican peso from current levels. In the months leading up to the June 2024 elections, we expect the peso to show some volatility, which will not be a cause for concern. Our forecasts indicate that the exchange rate could reach levels close to 19.0 pesos per dollar in May and June of next year. Given Mexico's solid macroeconomic fundamentals, this increased volatility will be transitory and will gradually dissipate once the electoral process is over. Our forecast for December 2024 is 18.80 pesos per dollar, which would be equivalent to an annual depreciation of 4.4% and would be partly explained by the reduction in the interest rate differential between Mexico and the U.S.

FIGURE 1. **GDP** (ANNUAL % CHANGE.)



Source: BBVA Research / INEGI.

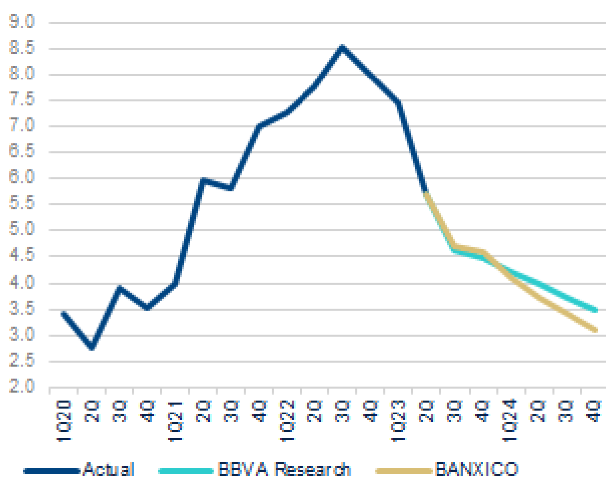
FIGURE 2. **IMSS-AFFILIATED JOBS** (% ANNUAL CHANGE EOP, & THOUSANDS)



Pronóstico	2023	2024	2025	2026
Miles, Fdp				
3T23	**748**	**718**	**800**	**873**
2T23	747	695	750	775
Variación Anual, % Fdp				
3T23	**3.5**	**3.2**	**3.5**	**3.7**
2T23	3.5	3.1	3.3	3.3

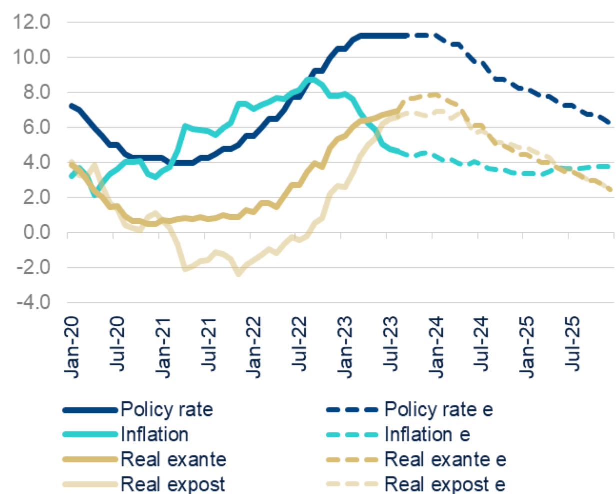
Source: BBVA Research / INEGI.

FIGURE 3. **HEADLINE INFLATION OUTLOOK** (% ANNUAL CHANGE)



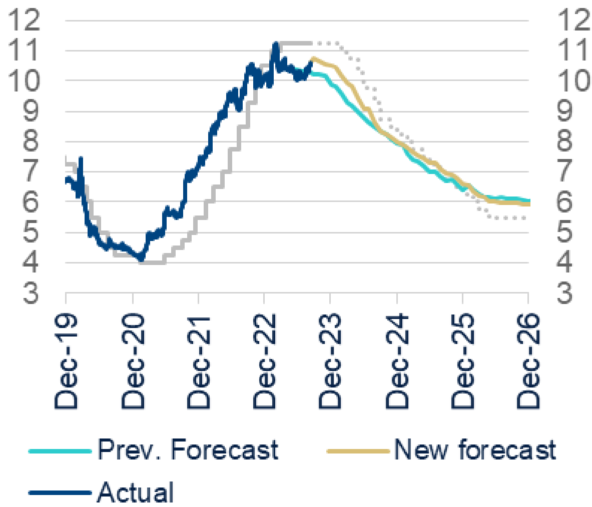
Source: BBVA Research / INEGI / Banxico.

FIGURE 4. **MONETARY POLICY RATES IN MEXICO AND THE UNITED STATES** (%)



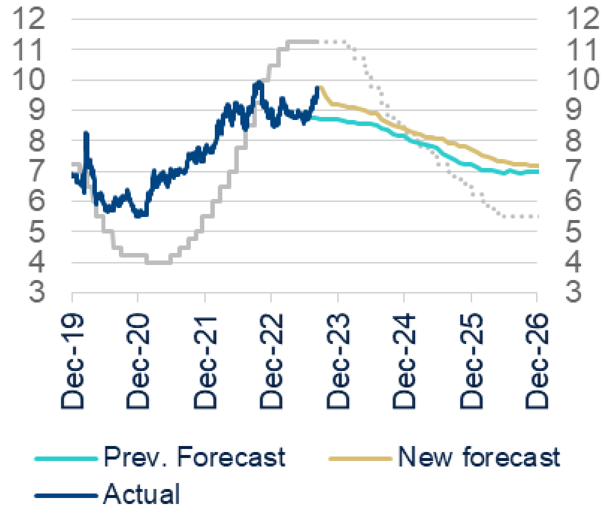
Source: BBVA Research / Bloomberg / Banxico.

FIGURE 5. **MEXICO 2-YEAR BOND YIELD** (%)



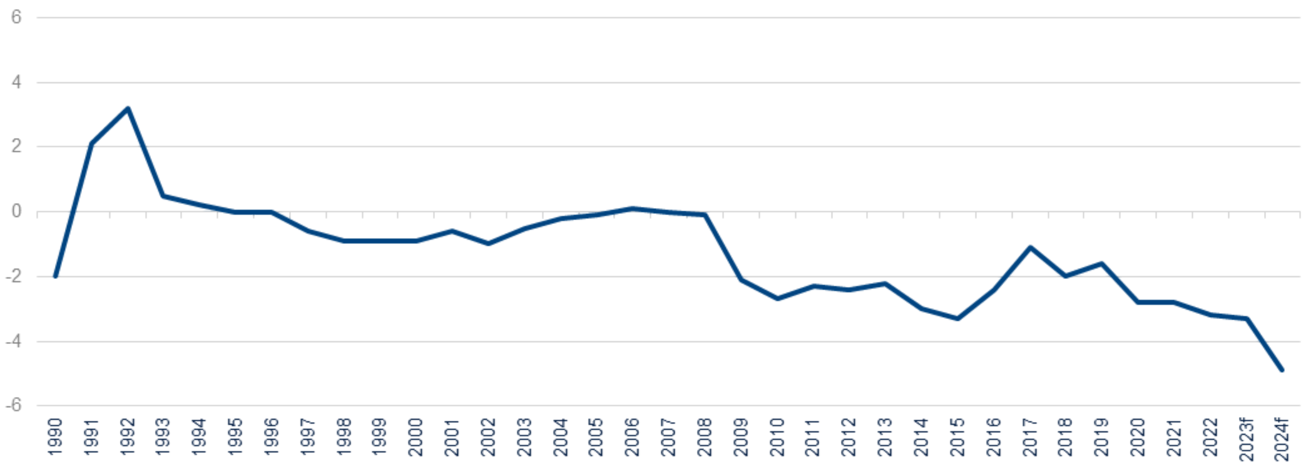
The solid (actual) and dotted (forecast) gray line indicates Banxico's target rate.
Source: BBVA Research / Bloomberg.

FIGURE 6. **MEXICO 10-YEAR BOND YIELD** (%)



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

FIGURE 7. **TRADITIONAL PUBLIC BALANCE** (% OF GDP)



/f means forecast
Source: BBVA Research / SHCP.

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