BBVA Research

Creating Opportunities

Mexico Economic Outlook

December 2023

Upward revision to economic growth forecasts for 2023 and 2024

Javier Amador / David Cervantes / Iván Fernández / Arnulfo Rodríguez / Saidé Salazar / Carlos Serrano

December 2023

- **We revised our 2023 growth estimate upward to 3.4%** (3.2% previously) and we anticipate growth of 2.9% in 2024 (2.6% previously). Growth in 2024 would be lower than this year's due to the lower external stimulus.
- **Consumption remains resilient,** driven by real wage gains, employment and the lower household saving rate.
- **Investment shows a positive performance,** boosted by public investment and the rapid growth of the imported machinery and equipment component, which we attribute to expectations for *nearshoring*.
- **The greater dynamism of internal demand in 2023, with a positive carry-on effect on 2024,** with resilience of private consumption and dynamic private investment in machinery and equipment.
- **Formal employment is ending** 2023 strongly, with a gradual slowdown forecast for 2024. The labor market will continue to bolster the total wage bill.
- We expect **inflation to end the year at 4.5% and to fall to levels below 4% from 2Q24 onwards**; core inflation will remain on a steady downward path, but will stay above headline inflation for some time.
- We still forecast **the beginning of a rate cut cycle in 1Q24, but we now anticipate a slower pace to reach a level of 9% at the end of 2024.**
- **The dynamics of long-term US Treasury yields remain the main determinant of the movements of the 10-year M Bond**; we still expect rates along the yield curve to gradually decline.
- **We expect the exchange rate to close 2024 at 18.5 ppd**. The reason for a slight depreciation would be a lower interest rate differential.
- **We estimate that public debt will increase to 48.6% by the end of 2024 vs. 46.4% of GDP in 2023** due to the higher public deficit.

Domestic demand will remain resilient in 2024

We are revising our growth estimate for 2023 upward to 3.4% (3.2% previously), given the better-than-forecast figure for 3Q23 and the resilience of domestic demand looking forward. According to the latest figures from the INEGI, GDP grew by 1.1% Q/Q in 3Q23, following the growth of 0.9% reported the previous quarter. By component, the tertiary sector grew by 0.9% Q/Q, while industry reported a 1.3% change in the same period. The first of these sectors benefited from the increases in real wage and real total wage bill (+7.2% and +11.6% since June 2022), and a lower tendency to save, as indicated by the balance of household deposits held by the financial system, which is currently 6.6% below its pre-COVID level.

With regard to investment, non-residential construction benefited from the rapid growth of public investment driven by the federal government's flagship projects (the Dos Bocas oil refinery and the Maya Train). According to INEGI data, non-residential construction exceeds its January 2019 figure by 42.9%, while residential construction continues to lag (18.9% below that same threshold). The machinery and equipment segment performed well, in light of the normalization of manufacturing output and the expectations of relocation of production in the sector (*nearshoring*). To September the imported machinery and equipment component topped the January 2019 figure by 28.9%.

Looking forward, we expect consumption to remain buoyant, supported by gains in labor income and the lower household saving rate. Although public construction will lose steam in 2024 (in line with the content of the fiscal package for next year), we estimate that private investment (in particular the machinery and equipment segment) will remain dynamic, driven by the expectation of *nearshoring*. The rapid economic growth seen in 2023 represents a strong platform for 2024, with a positive carry-over effect. Given the above factors, we are revising our 2023 growth estimate upward to 3.4% (previously 3.2%) and 2.9% for 2024 (previously 2.6% (Figure 1).

For the third year running, the labor market will end the year strongly, notwithstanding incipient signs of a slowdown

The labor market continues to show signs of robustness and strength, in line with the trend noted in the growth of the Mexican economy. According to data from the National Job and Employment Survey (ENOE), the unemployment rate stood at 2.6% (seasonally adjusted), its lowest historical level (since information from the survey was available in 2005). In addition, labor informality has continued a downward trend, although the October figures show an uptick of 1.1 percentage points compared with the previous month to 55.2% in seasonally-adjusted terms, it remains 2.6 percentage points lower than the historical average. This suggests that neither the strength of the labor market nor the increases in the minimum wage have resulted in an excessive increase in labor informality.

Regarding formal employment, the data provided by the Mexican Social Security Institute (IMSS) underscore the labor market's strength. In November, 107,000 jobs were added, equivalent to a year-on-year growth of 3.2%. This translates to the creation of 1.04 million jobs from January to November; however, a seasonal downturn is anticipated in December, and we expect 731,000 jobs to have been created at year-end, equivalent to interannual growth of 3.4% at the end of the period. This scenario becomes particularly noteworthy when considering that this growth rate has been presented only eight times since 1998 (a period characterized by consistent records). Consequently, we are expect an unprecedented occurrence of job creation surpassing this threshold for the third consecutive year (846,000 in 2021 and 753,000 in 2022).

We anticipate a 3.1% job growth by the end of 2024, equivalent to 691,000 new jobs. Although this suggests a gradual deceleration in employment compared to previous years, the anticipated job creation, coupled with the declining trend in inflation, will contribute to the resilience of the total wage bill and, in turn, household consumption (Figure 2).

Continuous fall in core inflation despite core services inflation stickiness

The disinflation process has continued. Both headline and core inflation have fallen for nine months running. Headline inflation has fallen to 4.3% y/y, its lowest level since March 2021, and (-) 4.3 pp below the peak of 8.7% reached in August and September 2022. As we expected, base effects drove a sharp fall in headline inflation in the second (2Q) and third quarters. The base effects in the last two months of the year will not be favorable and will prompt a slight temporary uptick in the annual headline inflation rate. Thus, although we forecast that headline inflation will have been maintained at around 4.3% y/y in November (rising slightly to 4.35% y/y), we expect a small rebound in December that will see the rate end the year at around 4.5% y/y, far below the levels at the end of 2021 (7.4% y/y) and 2022 (7.8%). Initially, the disinflation process was mainly driven by non-core inflation, which fell 11.3 percentage points (pp), from 10.6% to -0.7% y/y, between August 2022 and July of this year. However, the (lower) core inflation has made a consistent contribution throughout this year to the disinflation process, and has recently shown a growing relative importance in this positive dynamic. So, while it fell just (-) 0.3 pp in the first quarter, in the second it slowed (-) 1.2 pp to 6.9% y/y while the pace of slowdown was very similar, (-)1.1pp to 5.8% y/y, and although the pace of the slowdown is easing - we forecast a slowdown of (-) 0.7pp to 5.1% y/y in the fourth quarter -, we see scope for it to continue steadily falling over the next year, and at a similar pace to this quarter during the first quarter of 2024 i.e. (-) 0.7pp to 4.4% y/y.

The slower pace of core inflation has continued, mainly driven by lower goods inflation, and although services inflation is still showing greater resistance to falling and only declined marginally between the 2Q and the 3Q, from 5.4% y/y to 5.2% y/y, the significant increase in school fees in August and September that took this subindex to an annual rate of 6.6% y/y prevented a greater slowdown. We think this is a temporary effect. Inflation for services other than housing and school fees fell (-) 0.5pp between the 2Q and the 3Q, from 6.9% y/y to 6.4%. So, while goods inflation slowed (-) 5.5 pp in the year to date (from 11.1% y/y in December to 5.6% y/y in October), services inflation has not slowed so far this year. Although there was an additional increase in 1Q23 (from 0.3 pp compared with the average in 4Q22), its current level (5.3% y/y) is 0.4 pp lower than the peak reached in March of this year.

Despite the slower pace of the core inflation slowdown so far, a trend measure, 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 gradually converge to Banxico's target of 3% y/y +/-1 pp. In fact, we anticipate that as of 2Q24, headline inflation will be consistently below 4% (the upper limit of the variability range of Banxico's target of 3%), while the core rate will be at this level from the second half of 2024. By the end of this year, we continue to forecast 4.5% y/y for headline inflation (Figure 3) and 5.1% y/y for the core rate. This represents a similar trend to that forecast by Banxico for both inflation rates during 4Q23 and 1H24.

We still forecast the beginning of a rate cut cycle in 1Q24, but we now anticipate a slower pace

With regard to monetary policy, in a context of gradual convergence of inflation to the target range, medium-term inflation expectations firmly anchored, under the most likely scenario that the Federal Reserve does not increase rates, and amid a slowdown in economic activity next year, we expect Banxico to start a rate cut cycle in 1Q24 to avoid an additional and unnecessary tightening of the monetary policy stance. The Board has given clear signs that it has started the discussion to avoid a more restrictive stance in 2024, which suggests a rate cut cycle will start soon. As we have been expecting, with inflation falling, it is justified to avoid a larger increase in the real rate in the coming quarters, cutting the nominal rate. After starting the pause at 11.25% until the September meeting, Banxico had been signaling that the monetary rate would be kept unchanged “for an extended period”. At its latest meeting, however, Banxico had a less hawkish tone and indicated that it will be kept at its current level “for some time”. Banxico held the monetary rate at 11.25% for the fifth consecutive meeting and revised its short-term headline inflation forecasts downward. The trajectory for core inflation remained unchanged since, in our view, Banxico still expects that it will continue falling. There was a marked change in the tone of the communication which suggests that discussions have started about a less restrictive stance in the coming months. The renewed prospective guidance suggests that the members thought it appropriate to communicate that the start of a rate cut cycle in 1Q24 is more likely. We still expect rate cuts to start at the beginning of 2024.

However, we now expect the cuts in the monetary policy rate over the next year to be smaller because Banxico has also signaled that it will proceed with caution. In other words, we expect the pace of the downward cycle to be slower. We now expect Banxico to raise the monetary rate to 9% at the end of 2024 (Figure 4); previously we expected a rate of 8.25%. As a result, although the reference rate will fall, the monetary stance (proxied by the real ex-ante rate) will remain extremely restrictive throughout 2024. The rate cut cycle will simply prevent the restrictive stance continuing to tighten in the first half of the year and though it will become less restrictive in 2H24, it will be kept very restrictive given that the decline in inflation will be accompanied by that of 12-month inflation expectations, which in our view remain high (they stand at 4.1%, 0.7 pp above our inflation forecast of 3.4% y/y for December 2024).

We still expect rates along the yield curve to gradually decline

Mexican long-term interest rates rose in a sustained manner throughout the second half of the year. The 10-year M Bond yield increased by around 150 basis points (bp), rising from 8.7% at the start of July to a peak of 10.2% at the end of October. This increase was largely due to the behavior of interest rates in the US, where the 10-year Treasury note yield rose from 3.9 to a peak of 5% in the same period. Various experts agreed that the reason for the higher interest rates in the US was the increase in the term premium, i.e., the greater compensation required by investors to assume the risks associated with investing in long-term Treasury bonds. It is likely that these risks are related to the uncertainty around various future economic developments including the volatility of inflation, the pace of issuance of long-term bonds by the Treasury and the corresponding will and capacity of the typical potential buyers.

However, long-term rates fell significantly in the last few weeks following the Fed's decision at the start of November to keep its reference rate unchanged for the second consecutive meeting, and following the positive inflation and labor market data that suggested that a gradual rebalancing process between supply and demand is underway. The 10-year Treasury bond yield has since fallen to 4.3%, suggesting that a large part of the increase in the term premium in the third quarter was also related to the greater uncertainty over the future trajectory of reference interest rates, about which there now appears to be greater consensus amid improved prospects for inflation: the Fed has concluded its hiking cycle and it is highly likely that it will start a rate cut cycle before the end of the first half of next year. This dynamic was reflected in our country's interest rates, since the Mexican 10-year bond has fallen by around 100 bp since its October peak and now stands at around 9.2%.

While we are now expecting the start of a rate-cut cycle by Banxico to be more gradual, we still expect rates along the yield curve to gradually decline. We estimate that the yield on 2-year M-bonds will be 8.6% and 7.1% at the end of 2024 and 2025 respectively, and that the yield on 10-year M-bonds will be 8.6% and 7.9% in the same periods (Figures 5 and 6).

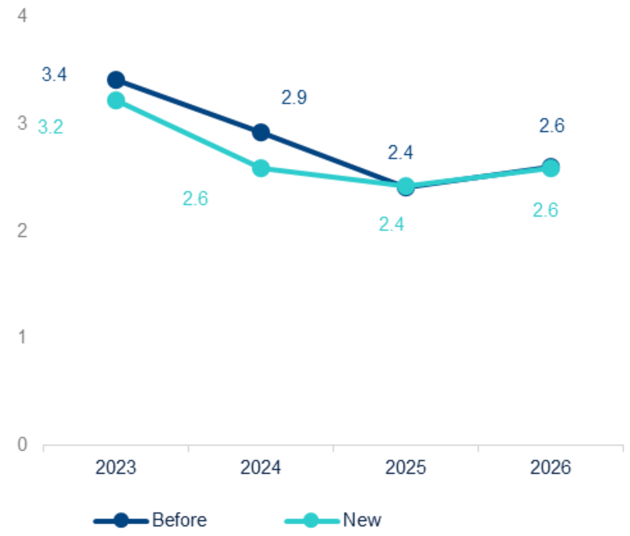
The historical balance of public sector financial needs will increase to 48.6% of GDP in 2024, compared with 46.4% in 2023.

We forecast that the Historical Balance of Public Sector Borrowing Requirements (HBPSBR) will be 48.6% of GDP by the end of 2024, a level that will not cause any sustainability problems for Mexico's public debt (Figure 7) or its sovereign credit rating. However, from 2025 onwards public deficits of around 2% of GDP will be required to keep this public debt ratio stable. Given the expected fragility of public finances in the coming years resulting from the greater pressure from social spending, public pensions, debt service and the low margin for tax revenue growth as a result of tax enforcement efforts, the next federal government very likely will have to design and implement a fiscal reform that increases tax revenue as a percentage of GDP.

The Mexican peso will perform strongly in 2024 without ruling out some volatility due to the elections in Mexico and the US.

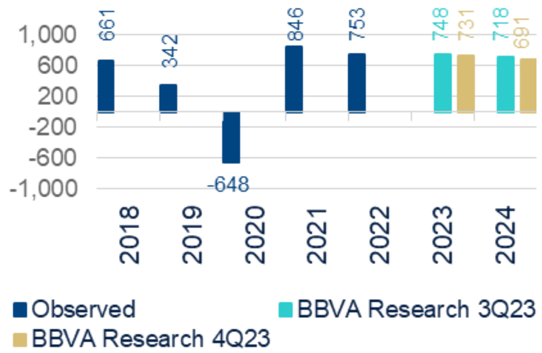
We expect the exchange rate to be 18.5 pesos per dollar by the end of 2024, implying a depreciation of the peso of around 6% compared with current levels. In the months before the elections of June 2024, we expect the peso to display some volatility and the exchange rate to reach levels of around 18.90 and 18.80 pesos per dollar in May and June of next year, respectively. This increased volatility will be transitory and the exchange rate will be around 18.50 per dollar by December 2024. The reduction in the interest rate differential between Mexico and the U S would be the main factor behind this slight weakening of the peso in 2024.

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



Source: BBVA Research / INEGI.

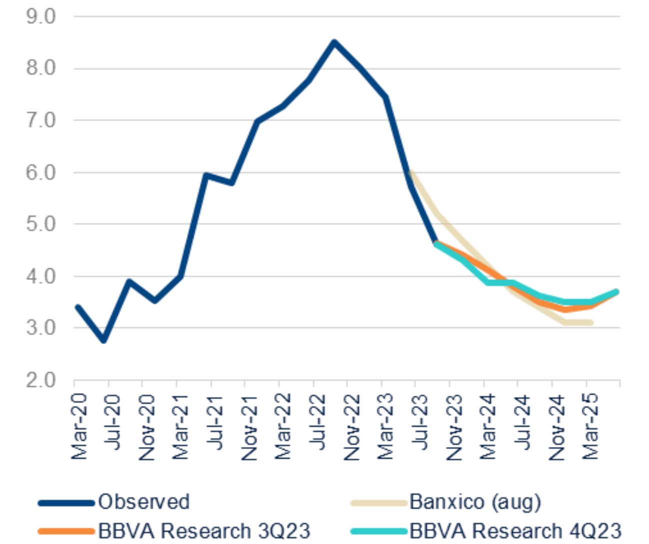
FIGURE 2. **JOBS AFFILIATED WITH THE IMSS**
(THOUSANDS AND Y/Y. % CHG. EOP)



Forecast	2023	2024	2025	2026
Thousands, Eop				
BBVA Research 4Q23	**731**	**691**	**780**	**835**
BBVA Research 3Q23	748	718	800	873
Annual Var., % Eop				
BBVA Research 4Q23	**3.4**	**3.1**	**3.4**	**3.5**
BBVA Research 3Q23	3.5	3.2	3.5	3.7

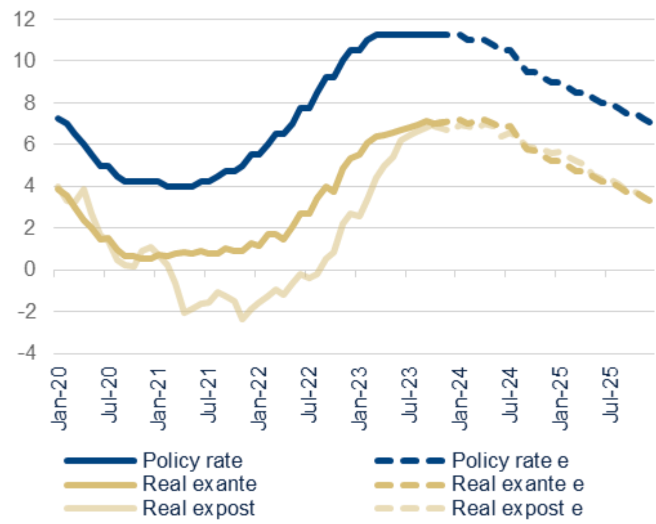
Source: BBVA Research / INEGI.

FIGURE 3. **HEADLINE INFLATION**
(Y/Y % CHANGE)



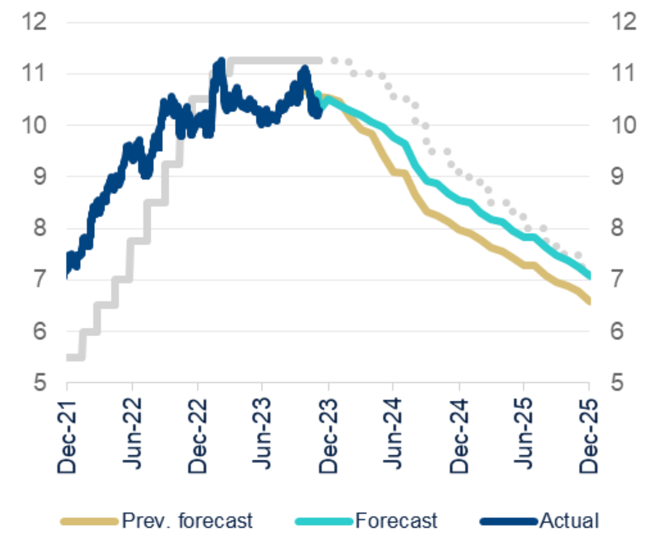
Source: BBVA Research / INEGI / Banxico.

FIGURE 4. **MONETARY POLICY RATES** (%)



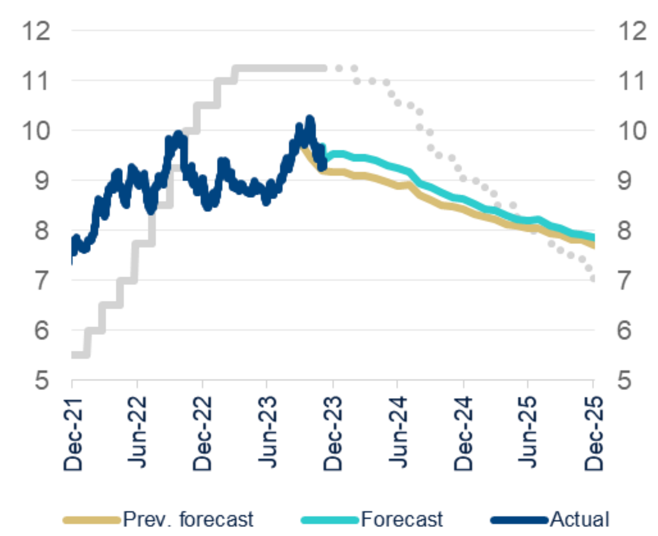
Source: BBVA Research / Bloomberg / Banxico.

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



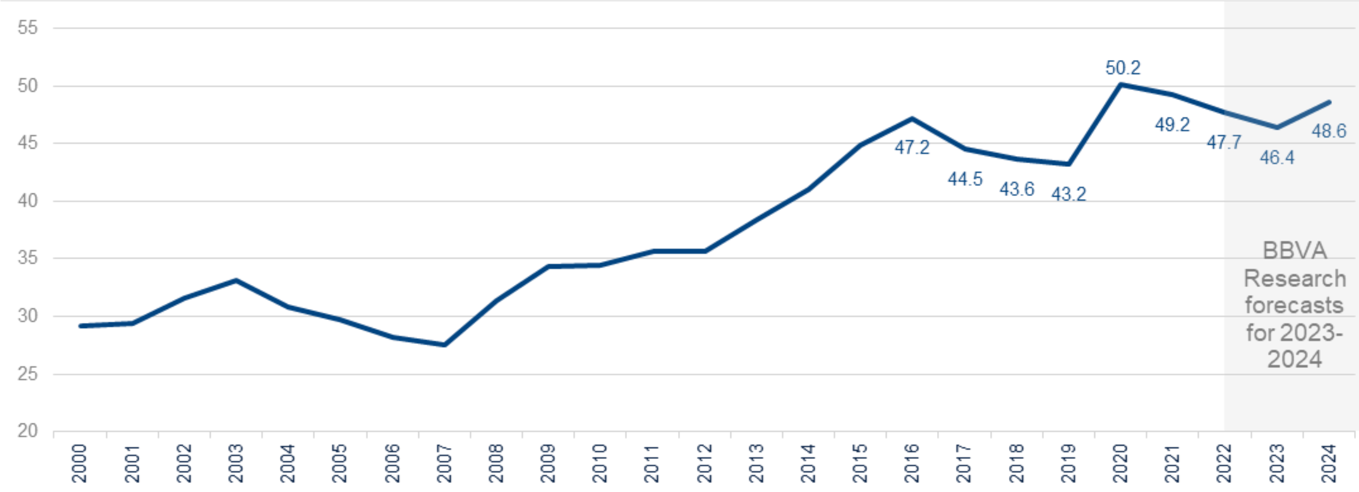
The solid (observed) and dotted (forecast) gray line indicates Banxico's target rate.
Source: BBVA Research / Bloomberg.

CHART 6. **10-YEAR BOND YIELD** (%)



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

FIGURE 7. **HISTORICAL BALANCE OF THE PUBLIC SECTOR BORROWING REQUIREMENTS** (% OF GDP)



Source: BBVA Research / SHCP.

DISCLAIMER

The present document does not constitute an “Investment Recommendation”, as defined in Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (“MAR”). In particular, this document does not constitute “Investment Research” nor “Marketing Material”, for the purposes of article 36 of the Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (MIFID II).

Readers should be aware that under no circumstances should they base their investment decisions on the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

This document has been prepared by BBVA Research Department. It is provided for information purposes only and expresses data or opinions regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

ENQUIRIES TO:
BBVA Research: Paseo de la Reforma 510, Colonia Juárez, C.P. 06600 Mexico City, Mexico.
Tel.: +52 55 5621 3434
www.bbvaresearch.com