BBVA Research

Creating Opportunities

Mexico Economic Outlook

March 2024

Downward revision to growth estimate for 2024

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

March 2024

- **We revise down our growth estimate for 2024 to 2.5%** (2.9% previously), with lower investment dynamism and relative resilience of private consumption.
- **Investment shows a sharp slowdown** due to lower spending on public construction and sluggish growth in the associated machinery and equipment segments.
- **Consumption is expected to remain positive** supported by gains in the real total wage bill, the trend toward lower savings, and higher spending on social programs.
- **Slow dynamism in the industrial sector in 2024** with a slowdown in construction and modest growth in manufacturing, in the face of lower external demand for durable goods.
- **Formal employment, with a pronounced slowdown in 2024,** is expected to see lower job creation but with resilience in the total wage bill that will continue to underpin consumption.
- The decline in inflation is now being driven by lower goods inflation; **we anticipate a more pronounced slowdown in core inflation in the coming months.**
- **We anticipate lower inflation and lower interest rates in 2024-25.** Headline inflation has resumed a downward path, core inflation could be below 4.0% from 3Q24 onward
- **There is considerable room to gradually normalize the monetary stance,** which we anticipate will remain tight despite the gradual downward cycle, to 9.25% by year-end, that we foresee.
- **We continue to anticipate that rates along the yield curve will gradually decline**; notable stability of market-implied exchange-rate and sovereign risk measures in the government bond market.
- **We expect the exchange rate to close 2024 at 18.2 MXN/USD**. The reason for a slight depreciation would be a lower interest rate spread.
- **We estimate that public debt will increase to 49.0% at the end of 2024 vs. 46.8% of GDP in 2023** due to the higher public deficit.

Slowdown in domestic demand in 2024

Economic activity slows down due to deceleration in the industrial sector and moderation of consumption. According to the most recent INEGI data, GDP grew 0.1% Q/Q in 4Q23, with a drop of (-)0.1% in industry, and a growth of 0.3% in the tertiary sector. Within the industrial sector, the construction segment lost momentum, with growth of 0.5% in 4Q23 (vs. 6.4% Q/Q in the previous quarter), while manufacturing output contracted (-)0.5% during the same period (after growing 0.3% Q/Q in the previous quarter). In the tertiary sector, wholesale trade grew 1.0% Q/Q, 2.4 pp below its reading in the previous quarter, while financial, communication and corporate services suffered declines in the same period (-2.4, -2.1 and -1.4%, respectively). We anticipate the slow growth of the industry will continue into the coming quarters, given lower public spending on construction and the slowdown in external demand for durable goods; related services are expected to show less dynamism given their link to industry.

With regard to investment, the most recent data from INEGI indicate a rapid slow down at the end of 2023, with a quarterly variation of 0.0% in 4Q23, after registering an average growth of 6.2% Q/Q in the first three quarters of the year. By components, the largest drop was recorded in the non-residential construction segment, which reported a decrease of (-)1.7% Q/Q, which represents a reading 11.1 pp below that recorded in the previous quarter. Investment in machinery and equipment also lost momentum, registering modest growth during the period (0.3% Q/Q, 1.4 pp below the figure observed in the previous quarter). We estimate the loss of dynamism of investment will extend the rest of this year, given the reduction in public investment (federal government budget draft 2024), and the lower growth in its supply chain, including segments of investment in machinery and equipment.

With regard to private consumption, the most recent data from the BBVA Research Big Data Consumption Indicator point to a relative resilience of private spending, with greater dynamism in spending on services in the first months of 2024. We believe that factors such as the accumulated gain in the real total wage bill, the lower trend in savings, and the advance of transfers from some social programs would prevent contractions in consumption this year. According to INEGI figures, private consumption closed 2023 with a growth of 1.1% (4Q23), 0.5 pp below that observed in 3Q23. By component, expenditure on services registered stagnation during the period, while expenditure on domestic and imported goods registered positive variations (1.2% and 4.7% Q/Q, respectively).

Considering the lower dynamism of domestic demand, we revise down our growth estimate for 2024 to 2.5% (2.9% previously), with sluggish investment growth and relative resilience of private consumption (with normalization in spending patterns) (Figure 1).

Formal employment shows clear signs of slowdown; however, unemployment and informality rates remain below the historical average

According to data from the National Job and Employment Survey (ENOE), the unemployment rate in January stood at 2.8% in seasonally adjusted figures, 1.4 percentage points (pp) below the historical average (2005 to 2023). In addition, the informality rate has also maintained a gradual downward trend, standing at 54.5% in seasonally adjusted figures, 0.7pp lower than in January 2023 and 3.1pp below the historical average (2005 to 2023). Formal employment closed the year with an annual growth rate of 3.0%, 0.7pp, and 1.2pp below the level of 2023 and 2022, respectively. As a result, the labor market still shows mixed signals of relative strength but alongside

weakening; however, given our economic outlook of moderating economic growth, we anticipate signs of a broader slowdown will progressively emerge.

Regarding formal employment, the first figures of the year provided by the Mexican Social Security Institute (IMSS) show that job creation stagnated in January with a year-on-year growth of 3.0% (similar to the year-end). In February, the year-on-year rate again fell back to 2.9%, so the job creation dynamic is clearly losing momentum, especially compared with the February year-on-year rates of the previous two years (3.4% in 2023 and 5.0% in 2022). An additional element that has probably influenced the slowdown in formal employment and will continue to do so this year is the adjustment in employment levels derived from the progress and closure of the infrastructure works of the Felipe Angeles Airport (AIFA), the Mayan Train and the Dos Bocas "Olmeca" Refinery which, according to the inaugural testimonies of the works, implied the generation of more than 304 thousand jobs. Therefore, as the projects are completed, a large part of these jobs will be eliminated.

Another element to highlight is the behavior of real wages and the real total wage bill of formal employment, which, unlike employment dynamics, have continued with a significant growth dynamic. In February, year-on-year growth stood at 5.5% and 8.6%, surpassing the rates recorded in the previous year (3.3% and 6.9%, respectively). This growth can be attributed partly to wage revisions at the start of the year. However, it is important to highlight that these figures continue to outpace the trends observed in previous years.

We expect employment to grow by 2.8% by the end of 2024, equivalent to 617,000 new jobs, a notable slowdown compared to previous years. Based on this employment growth outlook and the expectation of lower inflation, the total wage bill and household consumption will remain resilient (Figure 2).

Inflation continues to cool despite the continued services inflation stickiness

The disinflation process continues. After the temporary pick-up in headline inflation in December and January due to a supply shock in fruit and vegetable prices, it resumed a downward trend in February (4.4% Y/Y), which brought it back to almost the same level as before this shock (4.3% Y/Y). Meanwhile, and more importantly, the annual pace of core inflation has decelerated for 13 consecutive months, and is now at its lowest level since July 2021 (at 4.6% Y/Y). Looking ahead, we expect inflation to be close to 4.0% Y/Y from the summer onward and to close the year slightly below this level (at 3.9% Y/Y). We anticipate that the trend of a continuous decline in core inflation over the last 13 months will extend throughout 2024 and that it will be close to 3.5% Y/Y (at 3.6% Y/Y) by the end of the year.

It should be noted that since last August, non-core inflation has shown an upward trend from the minimum levels reached, and that therefore, (lower) core inflation, which had contributed consistently during this year to the disinflation process, has shown in the last eight months an increasing relative importance in this favorable dynamic. Initially, the disinflation process was mainly driven by non-core inflation, which decreased by 11.3 percentage points (pp), from 10.6% to -0.7% Y/Y, between August 2022 and July 2023. From that month to February of this year, it has increased 4.3 pp, to 3.7% Y/Y. Core inflation, which declined only (-)0.3 pp during the first quarter of 2023, decelerated (-)1.2 pp and (-)1.1pp in the second and third quarters to 6.9% Y/Y and 5.8% Y/Y, respectively, and has continued to decline at a good pace, (-)0.7 pp to 5.1% Y/Y in the fourth quarter of last year, and has already done so (-)0.4 pp to 4.6% Y/Y in the first months of this year, and we expect it to fall a further (-)0.2 pp to 4.4% by the end of this quarter. Moreover, we see elements for it to continue to decline steadily for the rest of the year, albeit

at a somewhat slower pace, with goods inflation falling further and services inflation finally breaking its downward rigidity in a context of weaker domestic demand strength.

The slower pace of core inflation has continued to be mainly driven by lower goods inflation which is already close to 4.0% Y/Y (at 4.1% Y/Y in February), while services inflation still shows more resistance to decline and its current level of 5.3% Y/Y is the same as the average of the previous 11 months, and this level is only 0.4 pp lower than the peak reached in March 2023. Inflation in services other than housing and school fees has shown less downward stickiness than total services inflation, but has so far also shown a moderate slowdown of (-)1.4 pp from the peak in March 2023, and is currently still at a very high level of 6.4% Y/Y.

Looking ahead, we continue to foresee a gradual convergence trend of inflation to Banxico's target of 3.0% Y/Y +/-1 pp. We anticipate that during 2H24 headline inflation will average close to 4.0% Y/Y (the upper end of the range for Banxico's 3% target) and that it will end the year at a level slightly below this limit, at 3.9% Y/Y (Figure 3). We anticipate that the core rate will average below 4.0% (expected average of 3.8% Y/Y in 2H24) and that it will end the year close to 3.5% Y/Y, at 3.6% Y/Y. This represents a similar trend to that forecast by Banxico for both inflation rates, albeit somewhat less optimistic.

There is ample room to gradually normalize the monetary stance with a tightening cycle due to start this month

Regarding monetary policy, in a context of an ex-ante real rate that has continued to rise since the last hike in the reference rate in March 2023, gradual convergence of inflation to the target range, well-anchored medium-term inflation expectations, expectations that the Fed will soon start implementing an easing cycle, and in a context of slowing domestic demand, we expect Banxico to initiate a rate-cut cycle next week. While we anticipate that the central bank will eventually cut the reference rate in the remaining seven meetings this year and eight next year, given the expected further inflation easing in a context of a very elevated level of the real rate, the monetary stance will remain tight through 2024-25, with an ex-ante real rate above 3.4%, the upper bound of the estimated range for the long-term neutral rate, by year-end 2025. Initially, rate cuts will seek to avoid additional and unnecessary tightening of the monetary stance. From 2H24 onward, the easing cycle will also seek to gradually ease the excessively tight monetary policy stance with lower inflation, already close to the target, and a slowing economy.

The Board of Governors has given clear signals that a majority is determined to start reducing the excessively restrictive stance in our view. Banxico has held the monetary policy rate at 11.25% for eleven consecutive months since the last hike in March 2023. During that time, headline inflation has declined by 2.4 pp and 12-month inflation expectations by 1 pp, so that the ex-ante real interest rate has risen from 6.4% to 7.4%, and is now 4 pp above the upper bound of the estimated neutral range. The favorable trend in core inflation and core inflation expectations suggest that there is room to start lowering the interest rate, and we believe that with inflation expectations well anchored there is ample room to gradually normalize the monetary stance, which we anticipate will remain tight through 2024-25 despite the gradual downward cycle we envisage.

We expect cumulative rate cuts this year to be 200 basis points (bps), bringing the monetary rate to 9.25% by year-end. We consider that the cycle could be faster but Banxico continues to signal that it will proceed with caution (Figure 4). We think the downward cycle will extend through 2025, with the rate declining to 7.25% by the end of next year, and should continue through 2026. However, given that we now expect the Fed may conclude its easing cycle (in 2025) at a somewhat higher level than we previously expected (at 3.0% vs. the 2.5% previously forecast),

we also anticipate that the end of Banxico's rate cut cycle, which we do not think will be reached until 1H26, will also be 50 bps higher and the monetary policy rate will reach a steady-state level in the medium term of 6.0%.

We still expect rates along the yield curve to gradually decline

Better than expected US inflation and employment data led global financial markets to reassess their expectations for the future path of monetary policy and interest rates. After markets assigned in late December of last year a probability of up to 75% that the Fed would initiate a rate cut cycle starting this month, the Fed will most likely decide to leave the target range for the federal funds rate unchanged at 5.25-5.50% next week. As a result of this change in expectations, 2-year and 10-year Treasury yields rose by 50 bps from late December to late February to 4.7% and 4.3%, respectively. However, some more encouraging data released this month on the continued rebalancing of the labor market, as well as the Fed Chair's comments as part of his semi-annual testimony before Congress, which turned out to be relatively less hawkish than anticipated, led to a 20 bp decline in the aforementioned yields.

Government interest rates in Mexico mirrored recent developments in the US Treasury yield curve, although to a lesser extent. At the short end of the curve, 1-month and 3-month yields on Cetes continued to hover around 11.2% and 11.3% as Banxico has continued to keep the policy rate at its peak level. Yields on 2-year and 10-year M Bonds rose from 9.9% and 9.0% at the end of last year to 10.2% and 9.3% in the last days of February, respectively. Just like in the US, these rates have recently retreated to 10.0% and 9.2%. While both the Mexican and US sovereign yield curves remain highly correlated, the greater degree of certainty about the onset of a rate cut cycle by Banxico may partly explain why bond yield movements in Mexico were relatively less volatile in the recent environment of reshaped expectations, coupled with a remarkable stability of implied sovereign and currency risk measures in the government bond market, which may reflect the country's recent economic performance and outlook, and the narrative around the nearshoring.

While we anticipate the rate-cut cycle by Banxico to be slightly more gradual, we continue to anticipate that rates along the yield curve will gradually decline. We estimate that the yield on 2-year M Bonds will be 8.4% and 6.9% at the end of 2024 and 2025 respectively, and that the yield on 10-year M Bonds will be 8.7% and 7.9% in the same periods (Figures 5 and 6).

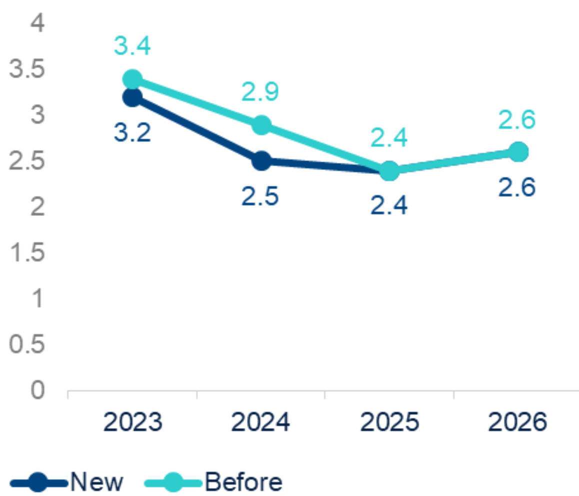
The historical balance of public sector borrowing requirements will increase to 49.0% of GDP in 2024, compared with 46.8% in 2023

We forecast that the Historical Balance of Public Sector Borrowing Requirements (SHRFSP for its acronym in Spanish) will be 49.0% of GDP at the end of 2024. This level does not represent a sustainability problem for Mexico's public debt (Figure 7) or the sovereign credit rating. However, as of 2025 public deficits of around 2.0% of GDP will be required to keep this public debt ratio stable. Given the forecasted fragility of public finances in the coming years resulting from the greater pressure on social expenditure and Pemex, public pensions, debt service and the scant margin for tax revenue without a fiscal reform, the next federal government is highly likely to have to make adjustments to discretionary expenditure to prevent public debt (% of GDP) from resuming an upward trend.

The Mexican peso will continue to show resilience in 2024 with elections in Mexico and the United States inducing some volatility

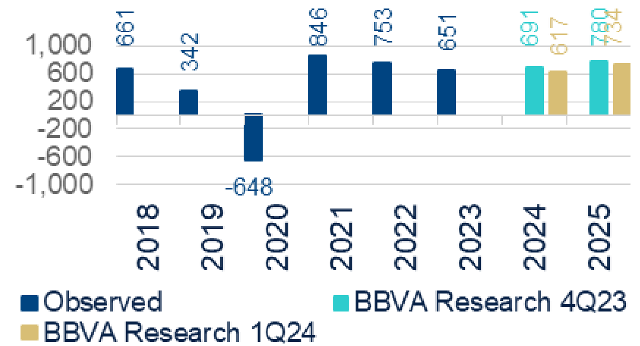
We anticipate that the exchange rate will close 2024 at 18.2 pesos per dollar, which would imply a depreciation of the Mexican peso of around 5.9% with respect to the daily average exchange rate in December 2023. For the months leading up to the June 2024 elections, we expect the peso to show some volatility, with the exchange rate reaching levels close to 18.56 and 18.90 pesos per dollar in May and June, respectively. For the months of October and November, we foresee a transitory return of higher volatility that will bring the exchange rate to levels of 18.70 and 18.80 pesos per dollar, respectively. The expected narrowing of the interest rate spread between Mexico and the United States will be the main factor behind the slight weakening of the peso in 2024.

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



Source: BBVA Research / INEGI.

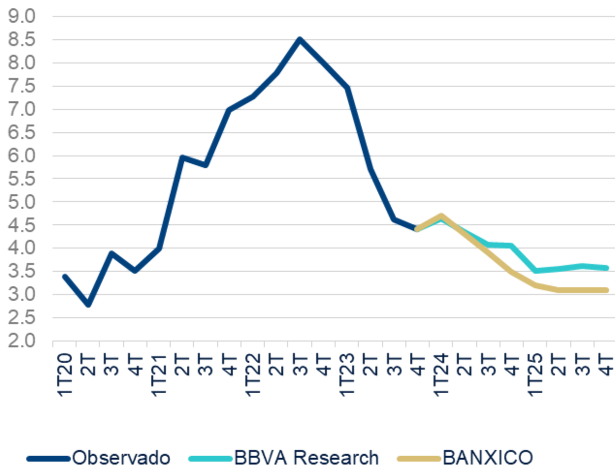
Figure 2. **JOBS AFFILIATED WITH THE IMSS** (THOUSANDS AND Y/Y. % CHG. EOP)



Forecast	2024	2025	2026	2027
Thousands, Eop				
BBVA Research 1Q24	**617**	**734**	**754**	**780**
BBVA Research 4Q23	691	780	835	865
Annual Var., % Eop				
BBVA Research 1Q24	**2.8**	**3.2**	**3.2**	**3.2**
BBVA Research 4Q23	3.1	3.4	3.5	3.5

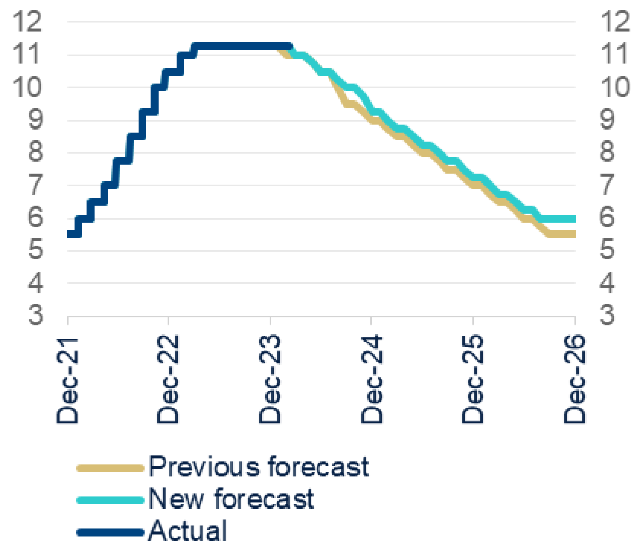
Source: BBVA Research / INEGI.

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



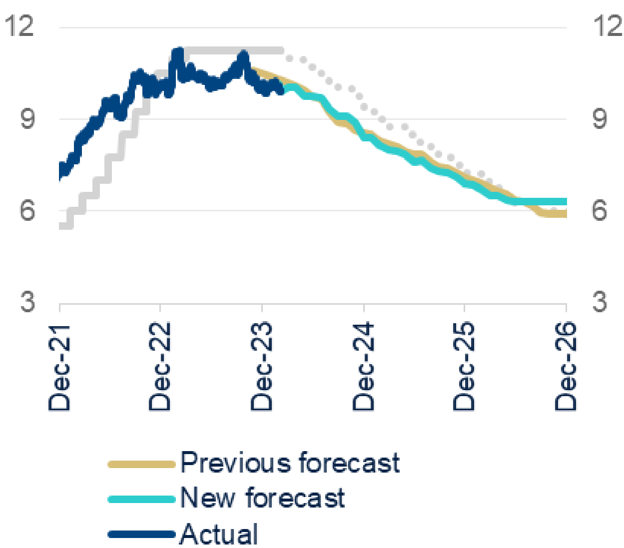
Source: BBVA Research / INEGI / Banxico.

Figure 4. **MONETARY POLICY RATE (%)**



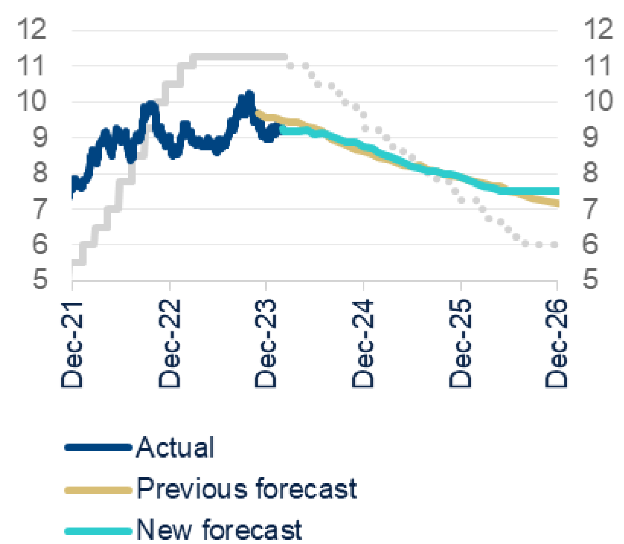
Source: BBVA Research / Bloomberg / Banxico.

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



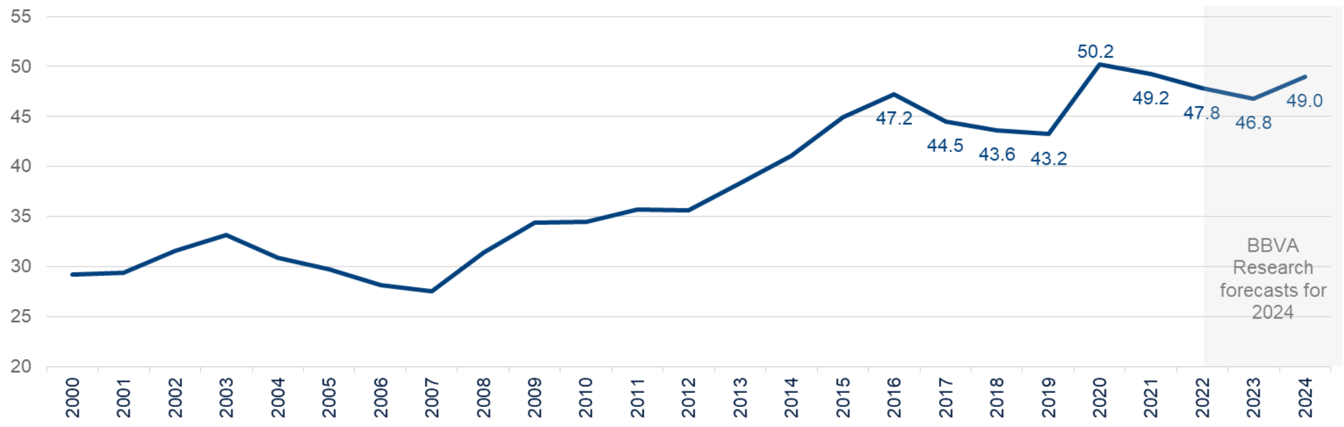
The gray solid (actual) and dotted (forecast) line indicates Banxico's overnight target rate.
Source: BBVA Research / Bloomberg.

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



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

Figure 7. **HISTORICAL BALANCE OF 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.

The content of this document is protected by intellectual property laws. Reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process is prohibited, except in cases where it is legally permitted or expressly authorised by BBVA on its website www.bbvaresearch.com.

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