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Mexico Economic Outlook

October 2024

Growth and inflation are moderating; we estimate that a continuous cycle of rate cuts has begun

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- **We revised our growth forecast for 2024 downward to 1.2%,** given the extended weakness of domestic demand; we estimate growth of 1.0% for 2025.
- **Consumption registered its largest drop since the beginning of the pandemic** (-0.4% q/q in 2Q24), due to the loss of momentum of the real wage bill amid the lower job creation in the industrial sector.
- **Investment has moderated its growth due to the decline in public expenditure** (0.4% q/q in 2Q24, after registering growth of more than 4.0% q/q during 4Q22-3Q23); the non-residential construction segment is lagging the most.
- **Slowdown in the growth of formal employment:** Going forward, a slower pace of job creation is expected; we revised our forecasts for 2024 and 2025 downward.
- **Headline inflation has resumed its downward trend, which we expect to continue**; core inflation is expected to fall below 4.0% by 4Q24
- **We expect both headline and core inflation to be below 3.5% by the end of 2025**; we continue to anticipate that they will close this year at 4.8% and 3.8%, respectively.
- **Banxico has ample room to steadily continue cutting rates** given lower inflation, fiscal consolidation, weakening domestic demand, and the Fed's rate cut cycle.
- **Higher risk premiums associated with uncertainty surrounding the effects of constitutional reforms** imply higher long-term interest rates than previously expected.
- **We forecast the exchange rate to close 2024 and 2025 at 19.8 and 19.2 pesos per dollar, respectively.**
- **We estimate that public debt will rise to 50.8% at the end of 2024 compared to 46.8% of GDP in 2023.** Public deficits around 2.0% of GDP will be required in the coming years to keep this ratio stable.

Economic activity weakens

The economy slows down due to weak domestic demand. According to INEGI data, the economy grew by 1.4% y/y in 1H24, 2.2 percentage points (pp) below the growth recorded in the first half of 2023 (3.6%). Among supply components, the industrial sector shows the largest lag, with a cumulative growth of 1.1% y/y from January to July, 2.3 pp below the change observed in the same period of 2023. Tertiary activities grew 2.3% y/y during the first seven months of the year (cumulative), 1.3 pp below the figure recorded in the same period of the previous year. We anticipate that the sluggishness of economic activity will extend into the following months, in an environment of greater uncertainty for investment and slow growth in external demand.

According to the most recent INEGI data, private consumption fell (-)0.6% q/q in 2Q24, the lowest figure since the beginning of the pandemic (2Q20), due to the loss of dynamism in the real wage bill. According to the latest figures of workers affiliated to the Mexican Social Security Institute (IMSS), the real wage bill has reported a gradual deceleration since mid-2023, recording a maximum year-on-year variation of 9.8% in June of that year, and a minimum of 6.3% in June 2024. The BBVA Research Big Data Consumption Indicator points to a prolongation of the slow dynamism of consumption in the following months, with a decrease in the average year-on-year variation (6 months) from 12.3% in January to 6.9% in August of this year.

Regarding investment, INEGI data indicates a moderation in growth during 2Q24, with a quarterly change of 0.4%, after having registered growth of more than 4.0% q/q during the period 4Q22-3Q23. The analysis by sector indicates a fall of (-)5.2% q/q in public investment spending (3.3 pp below that recorded in 1Q24), and a 1.2% q/q growth in private investment (0.7 pp above the figure reported in 1Q24). By component, the construction segment is stagnant at its January level (with the non-residential segment 4.4% below its level at the beginning of the year), while the machinery and equipment segment exceeds its January level by 3.1%. We estimate that the slowdown in gross fixed investment will be accentuated in the coming quarters, in an environment of greater uncertainty derived from the recent changes to the judicial system.

As for the export sector, we expect that the low growth in manufacturing since mid-2023 will continue for the remainder of the year, given the slow growth in demand for durable goods in the U.S. Although the most recent ISM manufacturing index suggests that the deterioration in domestic manufacturing output will not deepen, it does point to a prolonged weakness in the sector. The gradual recovery of the segment would materialize until 2025, as the downward interest rate cycle in the U.S. continues.

Considering the prolonged weakness in domestic demand, we revise our growth estimate for 2024 downward to 1.2% (Figure 1). The slow dynamism of consumption and investment, as well as the fiscal consolidation proposed for next year, would impact the pace of economic activity in 2025, recording a GDP growth of 1.0%.

Slowdown in the pace of formal job creation in 2024; expectations of slower economic growth in 2025 point to a weaker labor market next year

So far this year, formal employment growth has experienced a notable slowdown, although the labor market as a whole continues to show some resilience. According to the National Job and Employment Survey (ENOE), the unemployment rate stood at 2.7% in June, a level maintained as an average during the year and 1.4 pp below the historical average (2005-2023). The informal employment rate has remained stable at 54.2%, representing a decrease of 3.4 pp compared to the average in the same period.

Even though unemployment and informal employment rates remain below their historical averages, IMSS data reflects that formal job creation has steadily lost steam, registering lower year-on-year growth rates than in previous years. In August, formal employment grew by only 1.8%, equivalent to 58,000 jobs, accumulating 365,000 new jobs this year. This figure is 41.9% below the average of the last three years, making it the third lowest since 2010, except for 2020, the pandemic year.

The slowdown in the growth of formal employment is also reflected in the trend in wages and the wage bill in real terms. Real wages grew by 5.1% in August, while the total wage bill increased by 6.4%. These levels are 0.6 and 2.5 percentage points lower than the average growth of these variables in 2023. Despite this slowdown dynamic, both remain well above historical averages (2001-2018), 1.2% for the real wage and 3.9% for the total wage bill.

In this context, and although we expect job creation to regain some strength in part of the last quarter, we anticipate a year-end with a slowdown trend that contrasts with previous years. Therefore, we adjusted our forecast for job creation downward to 464,000 positions for 2024 and 558,000 for 2025, which is equivalent to annual growth of 2.1% and 2.5%, respectively, levels 0.5 and 0.7 pp lower than our previous forecasts of 2.6% for 2024 and 3.2% for 2025 (Graph 2).

Headline inflation has resumed its downward trend, which we expect to continue going forward; core inflation will be below 4.0% on a sustained basis from 4Q24 onward

After the disinflation process was temporarily interrupted between April and July due to supply shocks that affected non-core inflation, headline inflation resumed its downward trend in August. Between March and July, non-core inflation increased from 4.0% to 10.4% y/y, which pushed up headline inflation from 4.4% to 5.6% y/y, despite the fact that core inflation continued to decline from 4.6% to 4.0% y/y in the same period. The strong supply shocks that affected the agricultural price component during this period began to dissipate in August and continued to do so during the first half of September. This made possible a partial return of non-core inflation to 8.0% y/y in August and 6.7% y/y in the first half of September, which allowed headline inflation to return to somewhat more moderate levels of 5.0% y/y in August and 4.7% y/y in the first half of September.

In contrast, and more relevant to assessing the disinflation process, the annual pace of core inflation has slowed for 19 consecutive months (until August), and this prolonged trend is expected to continue uninterrupted in September. In the first half of last month, it stood at 3.95% y/y, its lowest level since February 2021. Core goods inflation continues to show a very favorable trend; that of services could soon break its rigid downward trend more clearly in a context of weakening domestic demand and a slowdown in the pace of job creation and real wage growth. Inflation in the goods component has increased this year at a slower pace than the average over the past decade, now standing at 2.9% y/y. Services inflation continues to trend rigidly downward, mainly because the housing and tuition components have exhibited an upward trend this year, but also because the component with the greatest relative weight – that of services excluding housing and tuition – is cooling very slowly. Over the past six months, services inflation has fluctuated within a narrow range between 5.1% and 5.3% y/y.

Going forward, we expect headline inflation to resume a slowing trend, while core inflation will remain on a favorable trend, albeit declining at an increasingly slower pace from the levels already reached. In the final stage of the disinflation process, (lower) services inflation will become more relevant as we expect that the further downward path for goods inflation is limited. We expect headline inflation to end the year at 4.8%, with core

inflation at 3.8% y/y. For 2025, due to the context of greater weakening expected for economic activity and the labor market, in a context in which the monetary stance will remain restrictive despite the continuous cycle of reductions that we foresee going forward, and in which fiscal policy will become less accommodating, we now expect a slightly more marked slowdown in inflation in 2025. We expect headline inflation to be at 3.2% by the end of 2025 (Chart 3), with core inflation at 3.4%. This represents a somewhat less optimistic trend than that expected by Banxico for headline inflation in the short term, but similar to that expected for core inflation. In any case, as for the U.S. economy, we believe that the balance of risks for the Mexican economy has continued to change as inflationary risks are decreasing, while downside risks to economic activity continue to increase.

With inflation “improving” and growth prospects worsening, Banxico has significant room to cut rates

Given the lags with which monetary policy operates, we believe that Banxico has acted late in adjusting the excessively high ex-ante real rate, and consequently, monetary policy will continue to weigh on economic activity in the coming quarters. The real ex-ante rate remains very high (7.1% in August; 6.8% in September), still relatively close to its peak (of 7.4%) in the current tightening cycle. This occurs in a context of continued slowdown and gradual convergence of core inflation to the target range, with medium-term inflation expectations well anchored, with the Fed initiating an easing process and with domestic demand weakening.

The Fed began last month with its efforts to preserve a soft landing: it unequivocally confirmed that its focus has shifted towards the labor market. While the Fed does not seem (so far?) overly concerned about a hard landing, it has made it clear that it is committed to "not lagging behind" in the rate cut cycle. Thus, it started out strong by reducing the federal funds rate by 50 bps. However, it suggested smaller cuts (of 25 bp) going forward. Fed Chair Jerome Powell made a point at the last press conference to clarify that choosing a 50 bp cut over a 25 bp cut does not mean the Fed is in a "rush" to cut rates moving forward. We expect two 25 bp cuts at the upcoming November and December meetings, and six consecutive 25 bp cuts next year, i.e., we do not foresee a pause in the Fed's rate-cutting cycle until it brings the reference rate to its long-term level, which we estimate to be 3.0%. This context provides Banxico with confidence to continue with the rate cut cycle, which seems to have started in August, as the rate differential is unlikely to narrow over the next eight meetings (i.e., in the next twelve months).

As we mentioned in the previous section, headline inflation in Mexico fell to 4.7% y/y in the first half of September, from a peak of 5.6% in July, amid the dissipation of supply shocks. After grazing the upper band of Banxico's target range in August, core inflation fell to 3.95% y/y in the first half of September and would most likely have slowed for the 20th consecutive month in September. In a context in which the inflation trend is improving and growth prospects continue to worsen, Banxico lowered the monetary rate by 25 bp for the second consecutive meeting and for the third time this year, to 10.50%. Most members of Banxico's Board of Governors seem to believe they have significant leeway to cut rates. The tone of the latest statement took a more moderate tone, although it remains cautious. From this, greater confidence about the cycle of cuts in the future can be deduced. Forward-looking guidance suggests that Banxico is likely to be willing to embark on a string of consecutive rate cuts.

We believe there is significant room to normalize monetary policy, given the favorable trend in core inflation, the start of the Fed's rate cut cycle, and the weakening of domestic demand. The changes in Banxico's communication and the direction of the vote of the majority of the members of the Board of Governors in the last two meetings also point to a gradual normalization of monetary policy in Mexico. The high level of the ex-ante real rate implies that despite the cycle of cuts, monetary policy will continue to weigh on economic activity in the coming quarters. In this regard, going forward, larger cuts of 50 bp, rather than the more likely 25 bp cut, will be a very welcome surprise and a sound monetary policy decision. However, we do not anticipate them in the short term. Instead, we forecast

two more 25 bp rate cuts in November and December, to 10.0%, and while we continue to expect cuts at all scheduled meetings in 2025, we now expect Banxico to increase the pace of cuts at two of them, cutting the rate by 50 bp at one meeting in Q3 and another in Q4, bringing the monetary rate to 7.50% by the end of 2025 (Figure 4). This forecast is lower than consensus expectations (8.00%).

Higher country risk premiums will continue to weigh on long-term interest rates for the foreseeable future

As described above, the Fed cut its reference rate last month due to growing confidence that inflation is a near-solved problem and to a labor market that continues to show signs of cooling. Despite the risks of further deterioration in the labor market, the overall expectation continues to be that the U.S. economy will experience a soft landing. This implies that the Fed would seek to bring its reference rate to a neutral level, avoiding an accommodative stance. Against this backdrop, there has been a sharp downward shift along the entire U.S. Treasury yield curve, but the outlook suggests a more differentiated behavior going forward. On the one hand, short-term yields, which are highly sensitive to monetary policy decisions, have room to continue declining as the rate cut cycle continues. However, financial markets are likely to have already priced in much of the easing cycle into long-term yields, thus having less room to fall further. However, if the labor market begins to show more worrying signs of weakness, long-term yields could fall further in a scenario in which the Fed is forced to adopt a more accommodative monetary stance to deal with a possible recession.

Mexico's yield curve has also experienced a notable downward shift (Figure 5), in line with the U.S. curve and with greater certainty that Banxico will continue to cut its reference rate. The behavior of short-term yields (Cetes) has been mostly driven by Banxico's decisions. However, long-term yields continue to reflect the greater uncertainty generated by the constitutional reforms, which have contributed to raising the country's risk perception and, therefore, higher risk premiums on Mexican debt instruments. In particular, market indicators such as the yield spread of Mexican debt, denominated in both pesos and dollars, with respect to U.S. Treasury bond yields, as well as Credit Default Swaps (CDS), continue to be higher than at the end of May (Figure 6), even when compared to those of countries with credit ratings similar to Mexico's, such as the Philippines or Peru. As a result of this higher risk perception, long-term interest rates in Mexico are now at levels above those that would be observed in an environment of greater certainty.

Going forward, although Banxico's still excessively restrictive monetary stance offers room for lower interest rates at all maturities, the persistence of higher risk premiums could limit the downside potential, especially at the long end of the curve. In addition to the uncertainty associated with the constitutional reforms, there is also uncertainty related to the fiscal challenges for the incoming administration, and external events such as the U.S. elections.

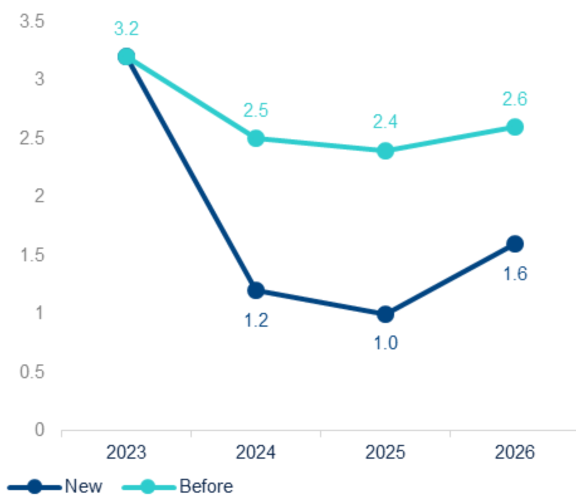
The Historical Balance of Public Sector Borrowing Requirements will rise to 50.8% in 2024 from 46.8% of GDP in 2023

We forecast that the Historical Balance of Public Sector Borrowing Requirements (SHRFSP) will be 50.8% of GDP at the end of 2024. This level does not represent a sustainability problem for Mexico's public debt (Figure 7) or for the sovereign credit rating. However, from 2025 onwards, public deficits of around 2.0% of GDP will be needed to keep this public debt ratio stable. Based on the most recent announcements by the Ministry of Finance and Public Credit, it is foreseeable that next year's fiscal consolidation will bring the public deficit to levels close to 3.5% vs. 5.0% of GDP in 2024 (the highest level in the last 35 years). Given the expected fragility of public finances in the coming years due to the depletion of contingency funds, the expansion of social programs, equity support for Pemex from the federal government, public pensions and debt service, along with little room for tax revenue growth without fiscal reform, the next federal government will most likely have to make adjustments to discretionary

spending to generate public deficits around 2.0% of GDP and thus prevent public debt (% of GDP) from resuming its upward trajectory. This will represent a complex fiscal policy challenge. If fiscal discipline were not enough and the federal government could only reduce the public deficit to levels of around 3.2% of GDP in the following years, then public debt could approach 59.3% of GDP in 2030. This possibility could lead rating agencies to reduce the sovereign credit rating and to the ensuing loss of the investment grade.

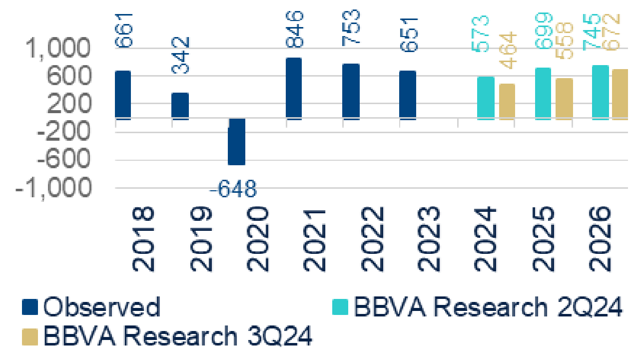
We expect that the Mexican peso will continue to show some volatility as it is subject to greater uncertainty than normal (pending constitutional reforms and the presidential elections in the U.S.) in the remainder of the year. We expect the exchange rate to be around 19.8 pesos per dollar by the end of the year.

FIGURE 1. **GDP**
(Q/Q%, REAL, SA)



Source: BBVA Research / INEGI.

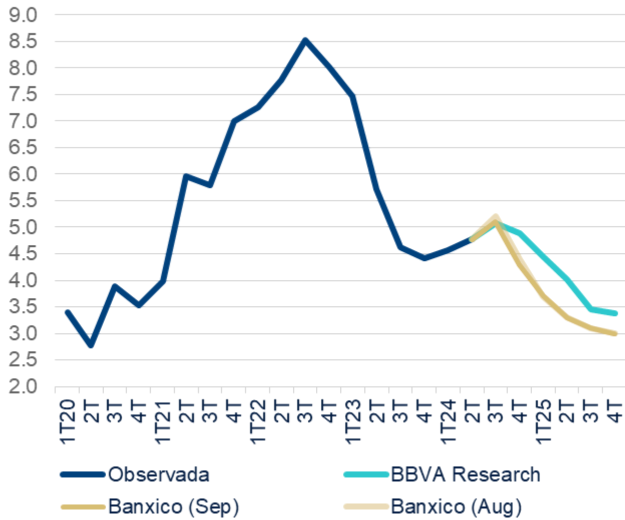
FIGURE 2. **JOBS AFFILIATED WITH THE IMSS**
(THOUSANDS AND Y/Y % CHG. EOP)



Forecast	2024	2025	2026
Thousands, EoP			
BBVA Research 3Q24	**464**	**558**	**672**
BBVA Research 2Q24	573	699	745
Annual Change, % EoP			
BBVA Research 3Q24	**2.1**	**2.5**	**2.9**
BBVA Research 2Q24	2.6	3.1	3.2

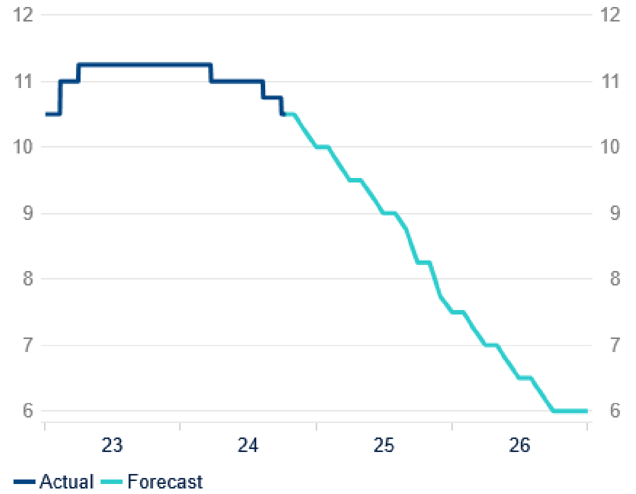
Source: BBVA Research / INEGI.

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



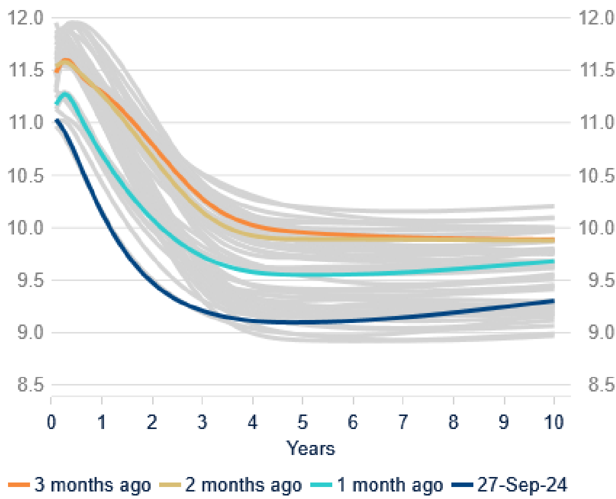
Source: BBVA Research / INEGI / Banxico.

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



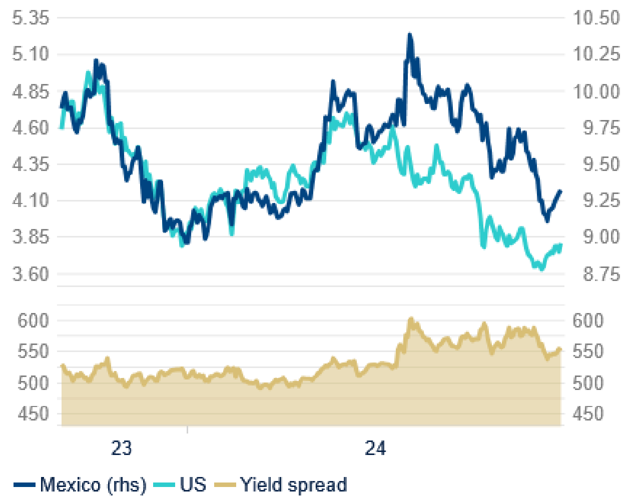
Source: BBVA Research / Bloomberg / Banxico

FIGURE 5. **GOVERNMENT YIELD CURVE (%)**



Gray lines indicate weekly curves over the last year; intermediate rates calculated with natural cubic spline interpolation. Source: BBVA Research / Banxico / Macrobond

FIGURE 6. **MEXICAN AND U.S. 10-YEAR YIELDS (% AND BP)**



Source: BBVA Research / Macrobond / Treasury Dept

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

Source: BBVA Research / SHCP.

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