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Mexico Economic Outlook

2Q22

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Economic outlook of slower growth, high inflation and higher interest rates

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- **We revised our 2022 growth estimate downward to 1.2% (2.2% previously)** on continued weak domestic demand, downward revisions to 1Q21-3Q21 GDP growth by INEGI, and the effect of the conflict in Ukraine.
- **Expectations for private consumption are dimming in an environment of higher prices,** and the critical employment conditions indicator has worsened in recent months.
- **Investment is 14% below its January 2019 level, with construction showing the widest lag,** given the absence of public policies that might promote certainty for this component of domestic demand.
- **The ongoing bottlenecks have slowed manufacturing growth,** especially in the automotive sector, which in January recorded a capacity utilization of only 73%.
- **Formal job creation showed strength at the beginning of the year,** which enables us to keep our job creation outlook unchanged. However, job insecurity by income is sharply on the rise.
- **The conflict in Ukraine causes additional disruptions to value chains and a** prolongation of bottlenecks in several industries, in an environment of tighter monetary policy. All these are factors that will adversely impact growth.
- **Slow recovery of the Mexican economy**: Chile, Colombia, Peru and Argentina achieved growth from 1Q20 to 4Q21 of more than 7.0% (cumulative), while Mexico contracted (-)2.4% in the same period.
- **We foresee a gradual deceleration of inflation from 2H22 onwards;** we expect core inflation to converge with the target range until 2Q23.
- **We revise our inflation forecasts upward**: headline inflation will end the year at 5.6% and core inflation at 5.0%.
- **We expect Banxico to raise the monetary rate to 8.0%;** a gradual downward cycle will start until 2H23, but the monetary stance will remain hawkish during 2022-24.
- **High inflation levels and the global environment of risk aversion** continue to be reflected in higher interest rates and a flatter yield curve.
- **We forecast an exchange rate of 21.20 pesos to the dollar by the end of 2022** in the face of a resilient Mexican peso supported by higher oil prices, a low current account deficit and a wide interest rate differential.
- **Government debt will increase moderately in the medium term** to reach levels of around 52.5% of GDP by 2026.

We revised our growth estimate for 2022 downward to 1.2% (2.2% previously) due to weak domestic demand and the effects of the war in Ukraine on prices, tighter monetary policy and the impact on global value chains. In addition, INEGI revised its GDP growth figures for 1Q21-3Q21 downward. According to official figures from INEGI, the Mexican economy stagnated in 4Q21, following a contraction of (-)0.7% QoQ in 3Q21. The closing quarter of 2021 was affected by the ongoing effects of the new outsourcing law, with an impact on the tertiary sector, which saw a drop of (-)0.6% QoQ in that period.

As to internal demand, expectations for private consumption are dimming in an environment of higher prices, with critical employment conditions having worsened in recent months. The environment looks challenging for consumption going forward, given the increase in commodity and energy prices around the world. Investment is 14% below its January 2019 level, with construction showing the widest lag, given the absence of public policies that might promote certainty for this component of domestic demand.

In terms of supply, the ongoing bottlenecks have slowed manufacturing growth, especially in the automotive sector, which in January recorded a capacity utilization of only 73%, well below the 83% (average) recorded in the year prior to the pandemic. The conflict in Ukraine causes additional disruptions to value chains and an extension of bottlenecks in several industries, in an environment of tighter monetary policy.

That the Mexican economy is recovering only slowly is clearly on display in comparison with other Latin American countries: Chile, Colombia, Peru, and Argentina achieved growth from 1Q20 to 4Q21 of more than 7.0% (cumulative), while Mexico contracted (-)2.4% in the same period. The drag effect of weak growth in 2022 will have an impact on GDP in 2023, alongside the spillover effect of a higher price level, which compels a downward revision on our growth estimate for 2023 to 2.1% (2.7% previously).

The creation of low-income jobs has characterized the recovery of the labor market. The effects of the Omicron variant of COVID-19 on the labor market quickly faded, so there were no new severe lockdowns, and an almost complete return to work activities followed. Despite this, the labor participation rate remained stagnant at levels similar to before the pandemic (76.1%), which largely contributed to the unemployment rate (3.7%) reaching an equivalent level to before the lockdown, and to labor informality remaining at 54.7%, only 1.5pp below February of the previous year. The key fact in the recent dynamics of the labor market is the surprising growth in precarious jobs - as seen through the rate of critical employment conditions; data as of February from the National Occupation and Employment Survey (ENOE) show that 31.2% are in this condition, a historical record since 2005.

In the case of formal employment, from January to March, the number of workers affiliated to the Mexican Social Security Institute (IMSS) grew significantly, reaching 386 thousand new jobs, with a year-on-year growth rate that averaged 4.9% in these three months, bringing the total number of jobs affiliated to the IMSS to 21 million. Despite this boost, employment continues to be 1.3 million below its trend level.

Similar to the data presented by the ENOE, employment affiliated to the IMSS also shows signs of worsening wage levels. Data as of March show that practically six out of every ten workers have an income of up to 2 Minimum Wages (MWs). In fact, there are currently 26% fewer jobs with incomes of more than 5 MWs. On the contrary, employment of up to 2 MWs is 14.2% higher. Despite the worsening income distribution, the wage bill has maintained a significant growth rate, explained mainly by employment gains and to a lesser extent by real wage growth, which was affected by high inflation.

We expect the participation rate to increase in the coming months and unemployment to remain at around 3.5% at year-end. As to formal employment, our growth forecast improves from 3.0% to 3.5% (eop), despite our downward

revision of GDP, which is explained by the strong job creation dynamics at the beginning of the year and the lagged effect of the reopening of the economy. The strong momentum at the beginning of the year will slow down in the coming months.

Inflation in Mexico is still affected by the same factors that have pressured inflation globally: i) bottlenecks in global production and supply chains (transportation), ii) higher commodity prices, particularly for energy and food, iii) the increased demand for commodities in the context of the shake-up of spending on commodities during the pandemic period, but also iv) the more recent recovery of demand for services, with increased mobility following the gradual decline in health risks associated with the pandemic. The adverse effects of these factors on inflation were stronger and more persistent than expected. In this context, headline inflation in Mexico remained high, while core inflation continued to rise. Headline inflation stood at 7.29% YoY in the first two weeks of March, marginally lower than at the end of 2021 (7.36% YoY). Core inflation continued to rise to 6.68% YoY in the first half of March, a level 0.72 percentage points (pp) higher than that observed at the close of the previous year. In qualitative terms, not only has core inflation maintained an upward trend, but also pressures have intensified in the case of goods and have knocked onto services prices. From year-end 2021 to the first fortnight of March, year-on-year food inflation rose 1.7 pp (to 9.8% YoY), non-food inflation rose 0.5 pp (to 7.1% YoY), while services not related to housing or tuition fees only rebounded an additional 0.2 pp but stood at 6.5% YoY. While non-core inflation declined from an average of 11.3% YoY observed in the fourth quarter of 2021, during the first quarter of this year it averaged 9.4% YoY.

Going forward, some global pressures are likely to intensify, particularly commodity prices, hit by Russia's invasion of Ukraine, while the other factors that have affected inflation since the start of the pandemic are also expected to remain active for some time to come. In this context, we now foresee a slower deceleration of inflation during 2022-23. We forecast headline inflation to average 6.3% in 2022, 0.6 pp higher than the 2021 average, and thereafter to show a gradually decelerating trend, from an average of 7.2% in 1Q22 to one of 5.6% in 4Q22. We predict that core inflation will average 6.0% during 2022, 1.3 pp above the average observed in 2021, but will show a decelerating trend starting in the third quarter of the year. We expect the 6.4% average in the second quarter to be similar to the 6.5% average in the first quarter, to average 5.3% by the fourth quarter. We estimate that the deceleration trend will become more pronounced in 2023 and that by the second half of that year headline inflation will average 3.8% and core inflation will average 3.6%.

In this context, although a hawkish monetary policy stance is not highly effective in counteracting the factors that continue to pressure inflation and are unrelated to generalized demand pressures, i.e., disruptions in production chains and higher international commodity prices, we expect Banxico to continue raising interest rates throughout the year until the benchmark rate reaches 8.0%. With these increases, the central bank seeks to avoid a de-anchoring of long-term inflation expectations that would jeopardize the gradual deceleration trend expected for inflation during the rest of this year and next year. We also anticipate that in the second half of 2023, with core inflation at 3 pp below the current figure and gradually converging to the 3.0% target, Banxico will initiate a slow downward cycle that would prevent the monetary stance from becoming much tighter. Therefore, we expect the monetary rate to be at 7.50% by the end of 2023, at 6.50% by the end of 2024 and at a neutral level (of 5.50%) by the end of 2025.

High inflation, intensified expectations of tighter monetary policy from central banks in most of the world and the global environment of risk aversion resulting from the uncertainty caused by Russia's invasion of Ukraine continue to be reflected in higher interest rates and a flatter yield curve, characterized by a sharp increase in short-term rates coupled with a moderate increase in long-term rates. As a result, the yield on 3-month Cetes bonds is expected to be around 8.0% at year-end 2022, while the yield on 10-year fixed-rate government bonds will be 8.4%.

In the first two months of 2022, government revenue fell 0.7% in real annual terms, as non-oil revenue contracted 1.9%. This performance contrasted with the 6.2% real annual increase in oil revenue. Tax revenue declined by 0.7% in real annual terms during the period. Within the latter, revenue from VAT and excise taxes on gasoline and diesel showed a real annual decrease of 10.0% and 60.5%, respectively. Income tax revenue grew 10.4% in real annual terms.

The war in Ukraine has complicated the global macroeconomic environment, reducing economic growth expectations in several geographies and hampering the central banks' mandate to maintain low and stable inflation. The economic impact on Mexico of the Ukraine war is already being felt in higher energy and commodity prices. The expected higher oil prices will have a favorable effect on government revenue in 2022, but the revenue from excise taxes on gasoline and diesel could be negative if the policy of subsidizing gasoline consumption to avoid another "*gasolinazo*" and a greater inflationary impact is maintained. However, we anticipate that, at the consolidated public sector level, higher oil revenue will be more than enough to offset the subsidy to the consumption of these fuels.

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