Research

Creating Opportunities

Mexico Economic Outlook

Third quarter 2020

The road to recovery will be long and bumpy

Mexico needs countercyclical economic policies and to regain investor confidence to better address the challenging environment

- **We've revised our GDP growth forecast downward to -10.0% (ranging from -9.0% to -12.0%), in the face of the halt of economic activity caused by COVID-19 and the effects that the dynamic inconsistency resulting from economic policy decisions have had on private investment**
- **In 2021, the economy will grow 3.7% (ranging from 2.0% to 4.5%), despite the wide output gap. The lack of aggressive countercyclical fiscal and monetary policies and the impact on investor confidence stemming from recent economic policy decisions have worsened the environment for recovery, which was already challenging**
- **With the strong deterioration of the labor market, the negative impact that the pandemic has had on the economic activity of 22 million people and the destruction of more than 1.1 million formal jobs, job losses could reach up to 1.5 million and the unemployment rate could stand at 7.1% in December, remaining persistently at higher levels than those that were seen prior to the pandemic**
- **We anticipate that inflation will remain under control, paving the way for Banxico, which recently adopted a dovish tone, to cut rates to 3%**
- **The central bank has kept real rates very high for a long time. We continue to anticipate an accommodative monetary policy, but we now anticipate that it will last longer. We expect the monetary policy rate to decrease to 3% by December 2020 and to remain at that level during 2021 and 2022**
- **The anticipated gradual decline in global risk aversion will be reflected in an additional return of the exchange rate to levels of lower peso depreciation by the end of the year**
- **We expect that public debt (in its broadest terms) will be 56.2% of GDP in 2020 versus 44.7% in 2019 as a result of a significant decline in public revenues, a nominal fall in GDP and the depreciation of the peso**
- **There are no significant risks to the balance of payments in 2020. The expected reduction in foreign investment portfolio flows, remittances and tourism will be more than offset by international reserves and the International Monetary Fund's (IMF) flexible credit line**

We anticipate a contraction in GDP of (-)10.0% in 2020 (ranging from -9.0% to -12.0%) in the face of the halt of economic activity caused by COVID-19 and the effects that the dynamic inconsistency resulting from economic policy decisions have had on private investment. In 2021, the economy will grow 3.7% (ranging from 2.0% to 4.5%), despite the wide output gap. The lack of aggressive countercyclical fiscal and monetary policies and the impact on investor confidence stemming from recent economic policy decisions have worsened the environment for recovery, which was already challenging.

The timeliest economic activity figures show the biggest decline in April, but considerable risks still remain ahead. Industrial output data for May point to a 25.1% cumulative decline since the end of March, although automotive production data show signs of partial recovery in June. The increase in the number of COVID-19 cases in the US could lead to stagnation in its industrial activity following the positive figures in June, and this represents a risk to the improvement of Mexico’s export sector, especially manufacturing. For its part, the BBVA Consumption Indicator points to a slow and bumpy recovery in private consumption in the face of massive job losses and the permanent closure of companies with medium-term effects on disposable household income. The gradual reopening of activities could lead to a short-term revival of household expenditure, although the momentum will be temporary. We anticipate a (-)10.5% decline in private consumption for 2020 and a (-)20.8% reduction in private investment.

The labor market has been severely affected by the closure of the economy. Comparing the figures of the National Occupation and Employment Survey (ENOE) for the first quarter of 2020 with the figures from May of the Telephone Occupation and Employment Survey (ETOE), both from INEGI, we can identify that the shutdown of the economy has had three significant effects on people's activity: the expulsion of millions of workers from the labor market, an exponential increase in underemployment and a practically constant volume of unemployed workers. In the first case, according to figures from May, the Economically Inactive Population (PNEA) over the age of 15 increased by 13.5 million people compared to the first quarter of 2020. However, this reduction in the labor force is temporary and caused by the shutdown of the economy, which has accumulated a total of 19.4 million people who are available to work, but who do not have the conditions to resume their activities or to start searching for jobs; of which 9.5 million were absent from their work, did not have any employment relationship or weren't receiving any payments. At the same time, an additional 8 million people became underemployed, and the volume of unemployed workers remained virtually the same, around 2 million. Based on the above, we can see that the negative impact of the pandemic on employment activity has reached around 22 million people over the age of 15. Concerning formal employment, the pandemic has led to the loss of 1.1 million formal jobs, whose year-on-year growth rate in July showed a significant decline and deterioration of (-)4.3%. This result confirms the loss of 2.5 years of formal job creation. In addition to the above, and with the indicated GDP contraction scenario, we've updated our formal job loss estimates to 1.37 million at the end of December and maintain the lower limit of the estimated range at a loss of 1.50 million, as GDP contraction approaches the lower estimated range. By the end of December 2021, 428,000–495,000 formal jobs are expected to be generated; however, we assume the recovery in employment and growth rate to be slow and likely won't occur until 2024. As noted above, the most significant impact of the pandemic on the labor market in an aggregate way has been on the levels of underemployment and on the population's exit from the labor market, and to a lesser extent on the level of unemployment, which is at similar levels as before the pandemic. However, with the reopening of the economy, the available population is expected to return to the labor market. This will have a direct impact on the level of unemployment, which is expected to reach 7.1% by December 2020 and will remain at levels higher than before the pandemic, at over 4% during 2024.

We anticipate that inflation will remain under control, paving the way for Banxico, which recently adopted a dovish tone, to cut interest rates to 3%. Inflation volatility should not prevent Banxico from further reducing the interest rate in the context of a widening negative output gap. In the short term, higher inflation volatility will continue to be associated with the strong rebound in energy prices and pressures on food prices (fresh and processed). The downward trend in the services component of core inflation is offsetting the upward trend in the goods component, driven by the sharp rise in processed food prices. We expect somewhat higher and more volatile headline inflation in the short term, driven mainly by supply-related temporary effects. However, this will then decline supported by a significant weakness in demand. Core inflation will tend to moderate gradually in the short term and more abruptly next year in the context of a growing negative output gap. We expect headline inflation to close 2020 at 3.3% with core inflation at 3.2%, and to then slow down to 2.8% and 2.7% respectively by the end of 2021. Looking ahead, we now anticipate that inflation will be around 3.0% during 2022–25, below our previous forecast of 3.5%, again mainly due to a persistent negative output gap. In short, inflation is likely to remain within Banxico's target range and does not represent a problem for monetary policy.

Banxico has kept real interest rates very high for a long time. In contrast, most emerging-market central banks have maintained an adequately flexible stance this year, with real rates slightly below 0% on average. We continue to anticipate that Banxico will reduce rates more than what the market is discounting and what analysts currently expect, until real rates are close to 0%. In fact, the minutes from the last Banxico meeting on June 25 showed that the Board is still leaning toward further cuts, and one member said, in line with our scenario, that real interest rates should be near zero, or even at negative levels before the end of the year, as long as inflation remains close to the bank's target. Analysts and market expectations continue to converge slowly with our scenario of a more accommodative stance on monetary policy. In the context of an increasingly wide negative output gap, low inflation and high real rates, we continue to anticipate an accommodative monetary policy, but now we anticipate that it will last longer. We expect the interest rate to be at 3% in December 2020 and to remain at that level during 2021 and 2022. We anticipate a slow cycle of return to a neutral rate of 5.5% to begin in 2Q23; however, this figure will not be reached until the end of 2025.

The MXN depreciated much more than EM average in February–March and has remained more volatile since then, with positive differentiation in June but returning to negative levels so far in July. However, once global risk aversion is mitigated toward these economies' assets, we anticipate that there will be a significant appreciation in the Mexican currency. We expect the peso to appreciate to levels of 20.80 to 21.40 and 20.50 pesos against the dollar for December 2020 and 2021, respectively.

SHRFSP (Saldo Histórico de los Requerimientos Financieros del Sector Público – Historical Balance of Public Sector Borrowing Requirements), the broadest indicator of public debt, will increase from 44.7% of GDP in 2019 to 56.2% of GDP at the close of 2020 (even without a significant tax stimulus). This significant increase of 11.5 percentage points of GDP is mainly due to the following factors: (i) higher PSBRs compared to previously anticipated levels; (ii) the significant nominal fall in GDP; and (iii) a higher than anticipated exchange rate level (peso/USD) for December 2020 versus December 2019. Under our baseline scenario of a 10% fall in GDP in 2020, the contribution to the increase in the SHRFSP of the aforementioned factors would be 6.0, 3.8 and 1.7 percentage points, respectively.

While foreign M-bonds holdings have declined by about USD 14 billion between March and June, and a sharp fall in foreign currency from remittances and tourism is expected, we do not anticipate significant risks to the balance of payments in 2020. This is due to the relatively large amounts represented by the country's international reserves and the possibility of accessing the IMF's flexible credit line. These resources currently total around USD 253 billion, while the expected reduction in foreign portfolio investment flows, remittances and tourism for this year is approximately USD 28 billion. We also expect the current account to run a deficit of 0.3% of GDP in 2020.

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