Macro scenario - Mexico

July 12, 2024

Downshifting growth forecasts

- Potential institutional deterioration and a challenging fiscal consolidation are front and center of the Mexican economy's outlook in the aftermath of the election.
- After a soft first quarter, weaker-than-expected activity in April suggests the 2Q24 GDP is unlikely to rebound strongly. We reduced our GDP growth forecast for 2024 to 1.6% (previously at 2.3%). A slightly weaker U.S. outlook also dragged our activity forecast for this year.
- Banco de Mexico (Banxico) maintained its policy rate for the second consecutive meeting, avoiding additional post-election volatility, yet suggested that further rate cuts are likely. Our base case remains for the central bank to cut its policy rate by 25 bps in each of the remaining meetings of the year, reaching an end-of-year level of 10.00%. An earlier start of Fed's easing cycle also supports our call. Certainly, bouts of volatility related to post-election uncertainty risk another pause.

Heightened institutional uncertainty

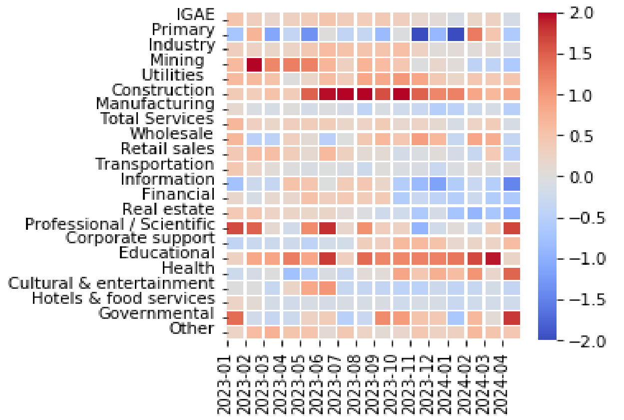
In the aftermath of the elections, focus has turned to potential institutional deterioration. While the president-elect's announced cabinet members who mostly have a technical profile, and the incoming administration has expressed its commitment to macroeconomic stability, constitutional reforms pose risks. In particular, a constitutional judicial reform, which includes the popular election of supreme court justices, district judges and the electoral court in 2025 (more than 1,600 positions). Candidates would be proposed by the executive, legislative and judicial powers. The reform would also reduce the size of the Supreme Court from eleven members to nine and reduce the justices' term from 15 to 12 years. In our view, the election of judges could reduce the independence of the judicial branch. Moreover, the reform intends to limit the power of judges by forbidding them to suspend legislations, regulations or decrees while justices analyze if there is a violation of constitutional rights. While the reform could be adjusted, its core (electing judges by popular vote) is unlikely to be changed. Potential changes include stricter requirements (expertise) for the candidates and the election of district judges when their term ends instead of all at once, to avoid a disruption of the judicial operation. The constitutional judicial reform is expected to be submitted to the new Congress in the beginning of September.

Fiscal consolidation will be challenging, considering spending inertia and the reluctance to discuss a revenue-enhancing tax reform (at least in the short term). The new administration will face a challenging fiscal consolidation in its first year (primary deficit of 1.4% of GDP in 2024 to a MoF projected surplus of 0.9% of GDP in 2025). Moreover, Sheinbaum's proposals include embedding several social programs in the constitution (thereby increasing the rigidity of fiscal expenditure) and a pension reform that could further raise pressure on the fiscal outlook, albeit modestly. These challenges are discussed in detail in our Macro Vision (link).

A weaker start to 2Q24

After a soft first quarter, weaker-than-expected activity in April suggests the 2Q24 GDP is unlikely to rebound strongly. The monthly GDP proxy for April fell by 0.6% mom/sa, dragged by a contraction in manufacturing (-1.5%) and services (-0.6%). Construction was the only positive driver in the month, yet we believe its positive momentum is unlikely to continue in 2H24 as fiscal expenditures slow. Following April's monthly contraction, the statistical carryover for 2024 GDP growth reaches 0.7% yoy (2023: 3.2%). Our GDP growth tracker for 2Q24 points to an expansion of 0.5% qoq/sa, below our June scenario of 1.3%. While the recent depreciation of the currency could support the manufacturing sector and remittances in MXN in 2H24, a weaker-than-expected first half of the year should lead to below-trend GDP growth in 2024.

Heat map: activity softened



Note: The colors of the chart represent the deviations of standardized YoY monthly activity figures (seasonally adjusted), using a mean and a standard deviation for the last 10 years on a rolling basis. Red indicates above the standardized mean, while blue below.

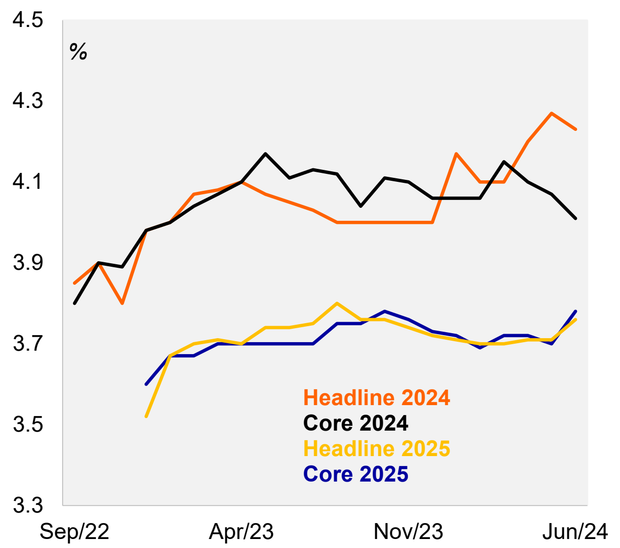
Source: INEGI, Itaú.

Banxico paused, but rate cuts ahead are likely

Banco de Mexico (Banxico) maintained its policy rate for the second consecutive meeting, avoiding additional post-election volatility, yet suggested that further rate cuts are likely. Banxico kept its policy rate unchanged at 11.00%, in a split decision, with Deputy Governor Omar Mejía voting for a 25-bp rate cut. According to our estimates, the one-year real ex-ante rate stands at 7.12%, well above Banxico's real neutral estimate of 2.6%. The forward guidance was similar to the previous statement but raised the board's willingness to consider a rate cut in the next meeting. The new forward guidance states: *"Looking ahead, the Board foresees that the inflationary environment may allow for discussing reference rate adjustments."* The previous forward guidance mentioned: "*Looking ahead, it will assess the inflationary environment in order to discuss reference rate adjustments."* We also note that in the same paragraph, the new statement now emphasizes that they will consider the effects on inflation from weaker-than-expected activity. The corresponding minutes suggest at least three board members (including deputy governor, Omar Mejía) are open for resuming rate cuts. Even one of the board members which had a hawkish tone in the minutes didn't discard fine-tuning adjustments in the policy rate.

While sharp currency depreciation could pressurize the inflation outlook (reducing the odds of rate cuts during the rest of the year), we note pass-through estimates in Mexico are relatively small. A Banxico study[1] estimates the elasticity coefficient of inflation to exchange rate (pass-through) at 0.04 over a 12-month horizon and 0.06 in the long term. In other words, a 10% depreciation could result in a total of 40 bps in higher inflation in the next 12 months after the shock. Although we acknowledge there are passthrough estimates of higher magnitude (closer to 80-bp in the long run). In fact, survey-based headline and core inflation expectations for the end of 2025, published by Banxico a month after the elections, increased only slightly, by 5 bps (to 3.76%) and 8 bps (to 3.78%), respectively. In this context, headline inflation rebounded to 4.98% yoy in June (from 4.69% in May) but driven by the volatile non-core index (mainly fruit & vegetable prices), while core inflation fell further to 4.13% (from 4.21%). Still, we cannot rule out additional pauses during the rest of the year if bouts of market volatility emerge.

Survey-based inflation expectations



Source:Banxico

[1] Estimación del Efecto del Ajuste en el Tipo de Cambio sobre la Inflación, Extracto del Informe sobre la Inflación Julio – Septiembre 2012, Recuadro 1, pp. 7-11, Noviembre 2012.

Revising growth down this year

We reduced our 2024 GDP growth forecast to 1.6% (previously at 2.3%), mainly due to our expectation of a weaker 2Q24. Separately, a moderation in our growth forecast for the U.S. this year also weighs on our activity forecast. For 2025, we now expect growth at 1.7% (previously at 1.9%) dragged by the lower statistical carryover from 2024.

We revised our currency forecast for 2024 and 2025 to 18.6 pesos to the U.S. dollar (previously at 17.9) and 19.3 (from 18.9), respectively. Our new scenario reflects the uncertainty stemming from the new political landscape, although moderated by our expectations of an earlier Fed's start of easing cycle.

While the depreciation of the currency pressures our inflation forecast (although we emphasize pass-through is small), a weaker activity outlook practically offsets said pressure. Thus, we kept our end-of-2024 and 2025 inflation forecasts at 4.3% and 3.9%, respectively.

Our base case remains for the central bank to cut its policy rate by 25 bps in each of the remaining meetings of the year, reaching an end-of-year level of 10.00%. We think the highly restrictive monetary-policy stance relative to the smaller inflationary gap allows for rate cuts this year. An earlier start of Fed's easing cycle also supports our call. We note there is risk of another pause depending on further market volatility stemming from the new political landscape.

A weaker currency and better-than-expected trade balance figures led us to improve our external account estimates. Our trade balance for 2024 and 2025 is now at a deficit of USD 10 billion (previously at a deficit of USD 14 billion) and a deficit of USD 15 billion (from a deficit of USD 17 billion), respectively. Consistently, our current account balance forecasts for 2024 and 2025 are at -0.4% of GDP (previously at -0.6% of GDP) and -0.6% of GDP (from -0.7% of GDP), respectively.

We maintained our nominal fiscal deficit estimates for 2024 and 2025 at 5.0% of GDP and 2.5% of GDP, respectively. While a weaker activity outlook pressures the fiscal deficit through lower tax revenues, a weaker currency increases oil revenues in MXN, offsetting downside pressure on fiscal accounts. Still, a weaker currency is likely to pressure the debt-to-GDP ratio. As such, we increased our net public debt forecast for 2024 and 2025 to 50.2% of GDP (previously at 49.9% of GDP) and 50.6% of GDP (from 50.3% of GDP), respectively.

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Mexico | Forecast

	2019	2020	2021	2022	2023	2024F		2025F	
						Current	Previous	Current	Previous
Economic Activity									
Real GDP growth - %	-0.4	-8.4	6.0	3.7	3.2	**1.6**	2.3	**1.7**	1.9
Nominal GDP - USD bn	1,298	1,129	1,318	1,463	1,794	**1,949**	2,029	**1,937**	2,010
Population (millions)	125.6	127.7	129.0	130.1	131.2	**132.3**	132.3	**133.4**	133.4
Per Capita GDP - USD	10,335	8,844	10,218	11,241	13,672	**14,729**	15,334	**14,527**	15,076
Unemployment Rate - year avg	3.5	4.4	4.1	3.3	2.8	**2.7**	2.7	**2.7**	2.7
Inflation									
CPI - %	2.8	3.2	7.4	7.8	4.7	**4.3**	4.3	**3.9**	3.9
Interest Rate									
Monetary Policy Rate - eop - %	7.25	4.25	5.50	10.50	11.25	**10.00**	10.00	**8.00**	8.00
Balance of Payments									
MXN / USD - eop	18.9	19.9	20.5	19.5	17.0	**18.6**	17.9	**19.3**	18.9
Trade Balance - USD bn	5.4	34.2	-10.8	-26.9	-5.5	**-10.0**	-14.0	**-15.0**	-17.0
Current Account - % GDP	-0.3	2.4	-0.3	-1.2	-0.3	**-0.4**	-0.6	**-0.6**	-0.7
Foreign Direct Investment - % GDP	2.3	2.8	2.7	2.7	1.7	**3.0**	3.0	**3.5**	3.5
International Reserves - USD bn	180.9	195.7	202.4	199.1	212.8	**220.0**	220.0	**225.0**	225.0
Public Finances									
Nominal Balance - % GDP	-1.6	-2.8	-2.8	-3.2	-3.3	**-5.0**	-5.0	**-2.5**	-2.5
Primary Balance - % GDP	1.1	0.1	-0.3	-0.4	-0.1	**-1.4**	-1.4	**0.9**	0.9
Net Public Debt - % GDP	43.9	49.9	48.9	47.6	46.8	**50.2**	49.9	**50.6**	50.3

Source: IMF, Bloomberg, INEGI, Banxico, Haver and Itaú

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