Macro scenario - Mexico

September 13, 2024

Easing cycle to continue

- We revised our 2024 GDP growth forecast down again, to 1.4% (from 1.6% in our previous scenario), mainly due to persistently weaker-than-expected activity data. Moreover, a projected retrenchment of fiscal spending and a softening of the U.S. economy should pose challenges for an acceleration in domestic activity during the rest of the year.
- The central bank of Mexico cut its policy rate by 25 bps (to 10.75%) in August, leaving the door open for further rate cuts, consistent with the meeting's minutes. A lower core inflationary gap relative to target, weaker outlook for economic activity, and the imminent beginning of the Fed's easing cycle should lead most Banxico board members to vote for a rate cut in the September policy meeting. We expect a 25-bp rate cut in each of the remaining meetings of the year, with the policy rate reaching an end-of-year level of 10.00%.

More rate cuts are likely

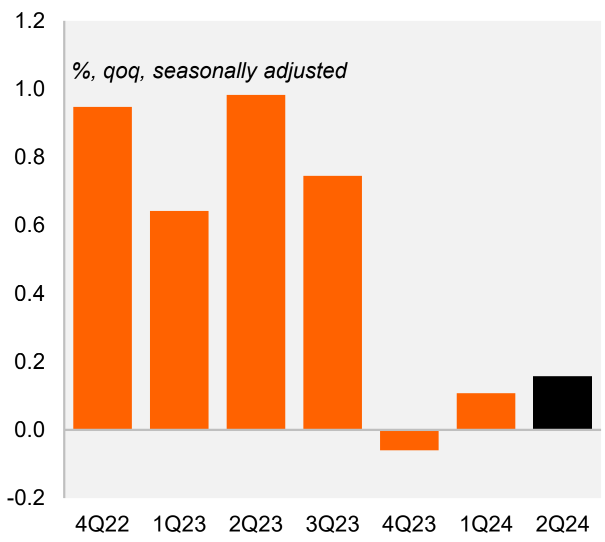
The central bank of Mexico (Banxico) cut its policy rate by 25 bps, reaching a level of 10.75% in August. The second cut since March was also a split decision, this time with deputy governors Irene Espinosa and Jonathan Heath voting for a pause. The forward guidance was left unchanged, suggesting, in our view, that further rate cuts will be data dependent: "*Looking ahead, the Board foresees that the inflationary environment may allow for discussing reference rate adjustments.*" The board will consider global shocks that are expected to continue fading" and the effects of the weakness in economic activity. Banxico's headline inflation forecast was revised slightly to the upside in the short term, but core inflation was left practically unchanged. Quarterly annual headline inflation increased to 4.4% in 4Q24, compared with June's statement estimate of 4.0%. Still, both headline and core inflation are expected to converge to 3.0% in the last quarter of 2025, in line with June's monetary policy statement. In our view, keeping core inflation forecasts unchanged suggests that either Banxico sees the recent depreciation as transitory, or the effect of the depreciation could be offset by weaker activity (the balance of risks for activity is biased to the downside).

In the corresponding policy meeting minutes, most board members seemed willing to consider a rate cut in September. One board member argued that the inflationary environment will allow them to continue discussing reference rate adjustments but acknowledged that a gradual approach will need to be maintained. Another member noted that the difference between the interest-rate gap and the inflation gap is one of the highest among the main emerging economies and is the largest if core inflation is considered. Looking forward, the member thinks it is appropriate to continue with a data-dependent approach in which gradualism prevails, but not ruling out pauses between cuts and not proportional to the expected decline in inflation for the remainder of the year. Finally, a third member downplayed the currency depreciation risk given a low pass-through to prices and weak activity having the opposite effect on inflation. The same member argued that reference-rate cuts aligned with the central scenario must not be postponed, as there is that excessively slow easing might pose unnecessary costs for the economy.

A lower core inflationary gap and fading impact of the supply shock on non-core inflation increase the odds for further easing. Headline inflation fell to 4.99% YoY in August (from 5.57% in July) aided by the easing of the supply shock in the volatile non-core index (fruits & vegetables), while core inflation fell to 4.00% (from 4.05%). We note core annual inflation entered the central bank's target range of 3+/-1%. A lower core inflationary gap (target of 3.0% and peak of 8.66% in the first half of November) amid a still very restrictive stance (real ex-ante rate of 6.99%) should put a rate cut on the table for most board members in the next monetary policy meetings, in our view.

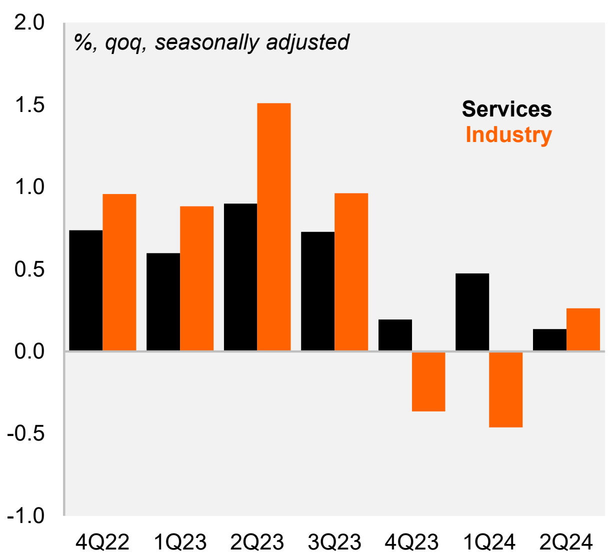
Moreover, weaker activity prints could reduce board member concerns about the disinflationary process of services inflation. Using seasonally adjusted figures, GDP expanded at a soft 0.2% qoq/sa in 2Q24, dragged by a soft services sector (0.1%). Industrial production expanded 0.3% qoq/sa, supported by construction output (1.9%) but with weak manufacturing production (-0.2%). Finally, primary production fell by 0.2%.

Soft GDP in 2Q24



Source: INEGI, Itaú

..dragged by services sector



Source: INEGI, Itaú

Changes to the judicial reform appear unlikely to quell concerns

The judicial reform was approved and concluded its legislative process. Following several changes relative to AMLO's original initiative, the reform's core remained unchanged in the version approved by Congress: that is electing judges by popular vote. An extraordinary election would take place in 2025 in which all supreme court judges and around half of other judges would be renewed by popular vote, suggesting that the ruling party and coalition could capture the top court at the beginning of Sheinbaum's administration. The rest would be renewed on the same date as a federal election (the next is scheduled for 2027). Other changes involve the creation of committees from the judicial, legislative and executive powers to evaluate candidates. However, there doesn't seem to be clear guidance for committees to objectively select the candidates. On the contrary, minimum experience and age is reduced for several judge positions. The reform's implementation will take place under President-elect Claudia Sheinbaum's term, that begins on October 1.

Weaker activity outlook

We revised our 2024 GDP growth forecast down again to 1.4% (1.6% in our previous scenario), mainly reflecting weaker-than-expected activity in the year. Activity is unlikely to pick up significantly during the rest of the year, considering an expected retrenchment of fiscal spending and softening of the U.S. economy. Still, we note the depreciation of the currency could give some support to activity through the manufacturing sector and remittances (as a determinant of private consumption).

Our currency forecast is now at 19.0 pesos to the dollar, compared with our previous scenario of 18.6 pesos to the dollar. Our end-of-year inflation forecast of 4.3% remains unchanged. While a higher currency puts pressure on the inflation outlook, it is mitigated by a weaker outlook and recent downside inflation surprises.

Lower core inflationary gap, a weaker outlook for economic activity and the imminent beginning of the Fed's easing cycle will likely lead most Banxico board members to vote for a rate cut in the September meeting. We expect a 25-bp rate cut in each of the remaining meetings of the year, reaching an end-of-year level of 10.00%. While our call has a risk of another pause if persistent episodes of market volatility emerge this year, stemming from the domestic or external scenario, the deterioration in the activity outlook for next year and a swifter easing cycle by the Fed could open the door for larger cuts by Banxico next year.

Andrés Pérez M.

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	**1.4**	1.6	**1.5**	1.7
Nominal GDP - USD bn	1,298	1,129	1,318	1,463	1,794	**1,931**	1,946	**1,908**	1,936
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	**14,593**	14,707	**14,305**	14,517
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	**19.0**	18.6	**19.3**	19.3
Trade Balance - USD bn	5.4	34.2	-10.8	-26.9	-5.5	**-10.0**	-10.0	**-15.0**	-15.0
Current Account - % GDP	-0.3	2.4	-0.3	-1.2	-0.3	**-0.4**	-0.4	**-0.6**	-0.6
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**	50.2	**50.6**	50.6

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

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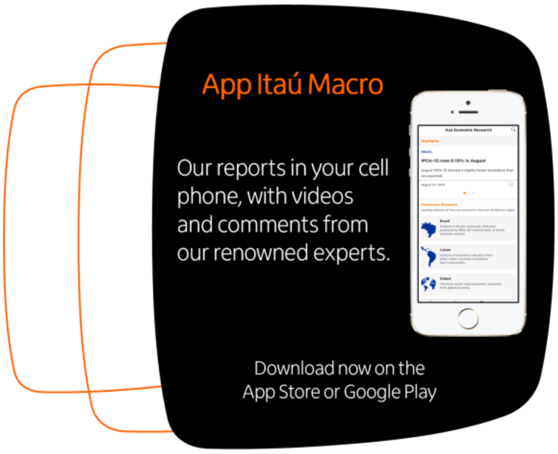

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