MEXICO

ELECTION YEAR ON THE HORIZON

Mexico's economic activity is expected to slow in the next few quarters under the combined effect of the slowdown in the US economy and the continuation of high interest rates. Beyond 2024, growth could be supported by a new driver, nearshoring, the effects of which are starting to be seen in export and investment data. The next administration, to be elected in June 2024, will therefore face the challenge of implementing the structural reforms necessary to take full advantage of this new relocation strategy and maintain financial support for Pemex, while limiting the slippage in public finance.

SLOWDOWN IN 2024

Surprisingly, Mexican economic growth rose in the first two quarters of 2023 (real GDP rose by 3.7% y/y in Q1 and Q2), buoyed by the resilience of the US economy. In addition, robust transfers of foreign workers (up by more than 9% y/y since the beginning of 2023) helped bolster consumer spending, despite continued high inflation (down to 4.6% y/y in August after reaching a high of 8.7% y/y in September 2022). Core inflation (6.1% y/y in August) is also slowing, but more moderately, despite a continued restrictive monetary policy. The central bank has kept its key interest rate unchanged at 11.25% since March, and plans to leave it at this level in the coming months due to "persistent inflationary pressures".

GROWTH IN INVESTMENT, THANKS TO NEARSHORING

Another growth driver may have been underestimated in recent quarters and could support growth in the medium/long term: the effects of nearshoring, i.e. the relocation of production and marketing activities to a country geographically close to the company's country of origin. Globally, the phenomenon has accelerated significantly due to disruptions and shortages in value chains following the Covid-19 period, followed by the war in Ukraine. As for US companies, the relocation of value chains to neighbouring countries dates back even further; this began with the US disengagement from the Trans-Pacific Partnership (TPP) in 2017 and the beginning of the trade tensions with China in 2018.

Barely visible to date, the effects of nearshoring are starting to emerge in macroeconomic data.

First, since 2018, the market shares of Mexico and Canada have increased gradually, while China's market share has decreased significantly (Chart 1). Recently, Mexico has even become the USA's biggest trading partner, ahead of Canada. More specifically, Mexico exports manufactured goods to the United States (mainly the automotive and electronics sectors, but also medical devices and supplies) and mainly imports energy (as a reminder, Mexico has been a net importer of energy since 2016).

Second, the very recent momentum in investment reflects the effects of nearshoring: total investment remains relatively low (around 19.5% of GDP), but has risen very rapidly over the past few months (over 20% on average and y/y over the first 7 months of the year according to the series of monthly indices, while the average is -0.3% in 2018-2022). Investment in imported machinery and other capital goods has been particularly dynamic since the beginning of 2023 (up almost 25% on average y/y). In July, investment in imported machinery and other capital goods was 35% higher than its pre-pandemic level, compared to only 5% for total investment

Foreign direct investment (FDI) has also grown at a steady pace over the past few quarters. "New" FDI rose by almost 30% in 2022 to more than USD 18 billion, a level not seen for nearly ten years.

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth, %	-8.1	4.9	3.0	3.5	1.3
Inflation, CPI, year average, %	3.4	5.7	7.9	5.6	4.5
Budget balance / GDP, %	-4.1	-3.8	-3.8	-3.3	-5.0
Public debt / GDP, %	50.8	47.8	46.9	46.5	49.1
Current account balance / GDP, %	2.4	-0.4	-1.3	-0.4	-0.4
External debt / GDP, %	55.5	47.5	42.9	34.8	35.2
Forex reserves, USD bn	195.0	202.4	194.0	207.0	217.0
Forex reserves, in months of imports	5.3	5.1	4.8	4.1	4.1

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

SHARE OF US TRADE

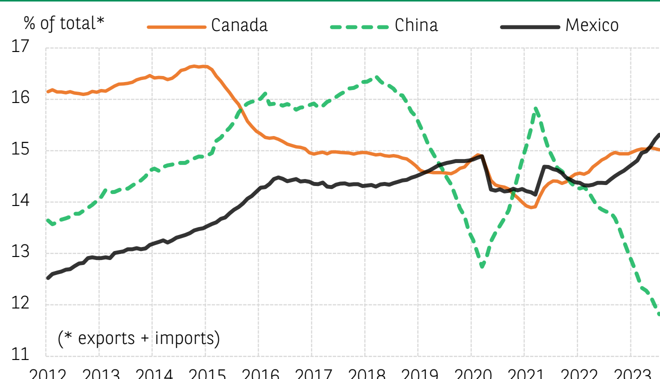

CHART 1

SOURCE: US CENSUS BUREAU, BNP PARIBAS:

Unsurprisingly, the strongest growth comes from the US and Canada.

In the very short term, the effects of nearshoring will only partially offset the effects of the expected slowdown in the US economy in 2024. Although manufacturing production has risen sharply since 2021, nearshoring is not the explanation for everything. Exports and industrial production have started to slow down since the beginning of the year. Overall, GDP is not expected to rise above 1.5% in 2024.

In the longer term, the Mexican economy seems to be in a transition period. In the long run, the effects of nearshoring should improve the growth outlook. But the weaknesses of the Mexican economy remain: several years of underinvestment (in infrastructure, education and en-

ergy) are having a significant impact on potential growth.Lack of commitment to the energy transition could also prevent the country from taking full advantage of the opportunities represented by nearshoring.

Lastly, relations with the United States and economic and fiscal policy (in particular concerning reform of the energy sector) implemented during the next term of office (the next general election is scheduled for June 2024) will be decisive.

FISCAL AND ELECTION STRATEGY

In mid-September, the current government presented its latest budget. As is often the case in Mexico during election years, this latest budget has turned out to be expansionist, leaving a large share to the increase in public spending. This confirms the ambition of the current president, Andres Manuel Lopez Obrador (AMLO), who will not be standing, to keep his party (Morena) in power during the next presidential mandate.

In concrete terms, the budget proposal predicts a lower deficit for 2023 (at 3.3% of GDP, whereas initial estimates were based on 3.5% of GDP), but a significant increase for 2024, at 4.9% of GDP. The government is expecting a slight decline in revenues to 21.3% of GDP in 2024 (estimate for 2023 is 21.7% of GDP), due to lower income from oil revenues. The increase in the deficit is mainly due to the increase in public expenditure: in addition to the increase in interest costs, the priorities are identical to those of the previous budgets (at least since the beginning of the AMLO Presidency, in 2018): significant increase in "social spending" (nearly +8% compared to the 2023 budget), and in particular, pensions (+30%), in accordance with the Morena party's central campaign issue. And lastly, despite multiple government announcements, infrastructure spending is expected to fall slightly (estimated at 2.6% of GDP in 2024, after reaching 2.8% in 2023). However, the government's key projects (especially the two railway projects, the Maya Train project and the Interoceanic Corridor of the Isthmus of Tehuantepec project) will see their allocation increase.

Our deficit estimate is close to the authorities' estimate: the optimistic assumptions made by the government (GDP growth for 2024 in the range of 2.5%-3.5%, inflation of 3.8%, oil production estimated at around 2 million barrels per day) are offset by the conservative assumption regarding the oil price (at USD 56.7 per barrel for the WTI on average for the year, while futures prices stand at USD 80).

CLEAR SUPPORT FOR PEMEX

For the first time, the budget also details the planned support for the oil production and exploitation company Pemex. Up until now, support has been piecemeal, and the budget changed over the year to take into account the payments made. This time, the budget proposal states that firstly, the royalties paid by the company to the government will only represent 35% of revenues (compared to 40% up until now, and 65% when AMLO became President), i.e. a loss of revenues estimated at USD 2.5 billion, and secondly, direct transfers will amount to nearly USD 8.25 billion. And lastly, the government has already indicated that additional payments could be made if necessary. According to Fitch estimates, commitments for 2024 amount to more than USD 11 billion, so new payments are very likely.

MEXICO: INVESTMENT INDEX

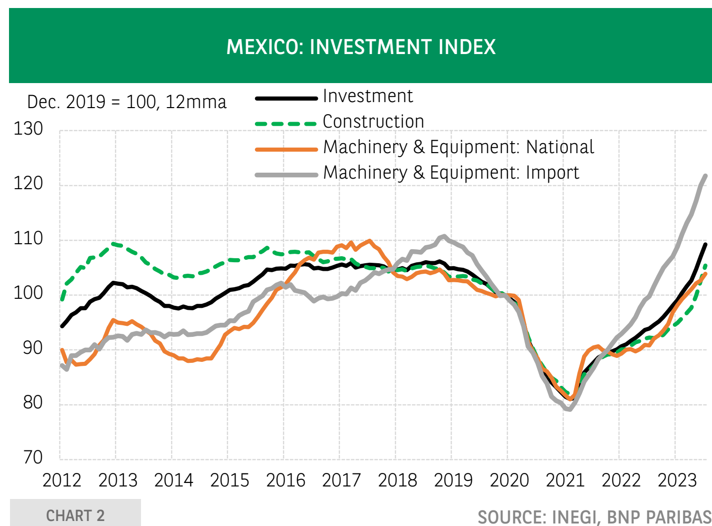

CHART 2 SOURCE: INEGI, BNP PARIBAS

Regular government support over recent years has significantly reduced the contingent public debt associated with Pemex.

This public debt is currently valued at 6% of GDP (whereas it represented almost 10% of GDP in 2020). According to statements made by the various parties, to date, support for Pemex should not be called into question by the next government.

According to official estimates, public debt is expected to rise to 48.8% of GDP in 2024 (after reaching 46.5% in 2023). The first estimate put debt at 49.9% of GDP, but the government has benefited from a "technical" reduction in the debt-to-GDP ratio (as is the case every 5 years, GDP has been rebased to 2023). Although the question of debt sustainability will not arise in the short term for Mexico, the sustained increase in social spending and the various infrastructure projects started, left to the discretion of the next government, will increase sovereign risk in the medium term.

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