MEXICO

RECOVERY LACKING IMPETUS

The direct consequences of the war in Ukraine on the Mexican economy should remain limited, because trade links are almost non-existent. However, indirect consequences could have a significant impact on an economy that has already been weakened by the Covid-19 crisis. Higher commodity prices will increase inflation pressure and worsen the current account deficit in Mexico, which has been a net importer of energy since 2015. In addition, supply chain disruption arising from the conflict and new coronavirus variants could drag down exports. The investment outlook is continuing to deteriorate as discussions about reforming the energy sector continue.

LIMITED ECONOMIC GROWTH IN 2022

Although economic growth rebounded in 2021 (with GDP rising by 5.4% after falling 8.3% in 2020), this did not take Mexico's economic activity back to pre-Covid levels and the short-term growth outlook is relatively weak. The government and the central bank have also downgraded their 2022 growth forecasts recently, to 3.4% (from 4.1% in 2021) in the government's case and to 2.4% (from 3.2% in 2021) for the central bank. However, these figures are still too optimistic in our view. We expect real GDP growth of 1.2% in 2022 and 1.4% in 2023. At that rate, Mexico's economic output will not reach end-2019 levels again until the end of 2023.

The direct consequences of the conflict in Ukraine should remain relatively limited. Mexico's exports to Russia and Ukraine account for only 0.1% of its total exports, and its imports from those countries make up only 0.3% of the total. Exports to Europe have increased in the last 10 years but remain fairly limited, accounting for 5% of Mexico's total exports in 2021. The Mexican economy is more open than other Latin American countries – followed by Chile in second place – but its exports consist mainly of manufactured products (over 80%) and are mostly exported to the US (over 75%).

The risks remain clearly on the downside. Firstly, although vaccination rates have increased – with 62% of the population having received two doses by the end of March – Mexico remains vulnerable to potential new waves of infection. At the global level, rising Covid-19 case numbers in China and the measures taken to address them could further delay the re-establishment of supply chains.

Secondly, commodity price inflation has accelerated significantly since the end of February, creating a negative supply-side shock that could cause financial volatility for emerging market countries. The Mexican economy is highly financially integrated, and so, vulnerable to a sudden shift in sentiment among investors, both domestic and foreign. Mexico has also been a net importer of energy since 2015, which means that its current account balance will deteriorate in 2022.

INEVITABLE RISE IN INFLATION

Inflation had already risen significantly before the conflict between Russia and Ukraine broke out, because of several shocks arising from the pandemic such as supply shortages, delays in industrial production systems and supply chains, higher prices for certain commodities and a rebound in consumer spending. Inflation averaged 5.7% in 2021 but rose to over 7% on average in the first three months of 2022.

Inflationary pressure is likely to continue for at least the next few months because of supply shortages. Government subsidies aimed at offsetting the rise in commodity prices will not be enough to absorb the shock entirely. On average, inflation is likely to average 7.1% in 2022, and we expect further rate hikes in the near term. Mexico's central bank has already raised its key interest rate five times in 2021 and once in February 2022, taking it to 6.0%.

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth, %	0.1	-8.3	5.4	1.2	1.4
Inflation, CPI, year average, %	3.7	3.4	5.7	7.1	5.3
Budget balance / GDP, %	-1.7	-2.3	-2.8	-4.1	-4.5
Public debt / GDP, %	46.4	50.8	50.8	50.5	50.6
Current account balance / GDP, %	-0.2	2.4	-0.4	-0.7	-0.7
External debt / GDP, %	37.7	43.1	39.4	39.1	38.5
Forex reserves, USD bn	180.0	195.0	202.4	208.1	206.5
Forex reserves, in months of imports	3.5	5.3	5.1	4.8	4.4

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

MEXICO: PRODUCTION & CONSUMPTION OF ENERGY

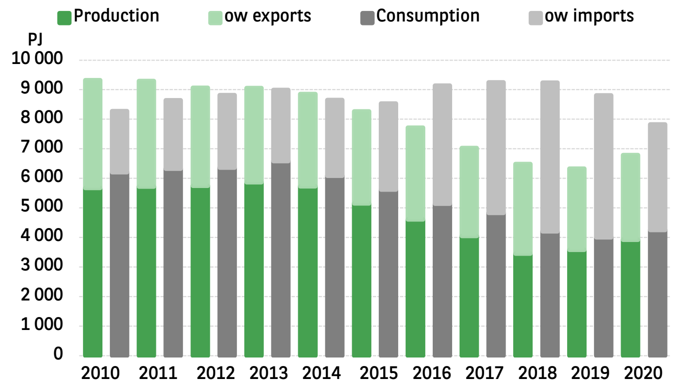

CHART 1

SOURCE: SECRETARY OF ENERGY

LITTLE IMPACT ON THE PUBLIC-SECTOR DEFICIT IN THE NEAR TERM

The budget deficit and public sector debt levels have remained moderate in the last two years. Firstly, economic support measures amounted to only 1.1% of GDP in 2020, one of the lowest figures among emerging economies. Secondly, the government tapped Mexico's sovereign budgetary income stabilisation fund (FEIP), reducing the fund's assets to around 0.1% of GDP by the end of 2020 as opposed to almost 2% at the end of 2019. The public sector deficit equalled only 2.8% of GDP in 2021 (versus 2.3% in 2020) and debt remained contained at 50.8% of GDP in both 2020 and 2021.

Higher commodity prices are likely to have a limited impact on public finances in 2022. This year's budget means that diesel subsidies – with the government promising to limit the increase in consumer diesel prices to 5% – should be offset by additional revenue arising from royalties paid by the national oil company PEMEX. According to the government's announcements, surplus revenue should be used to replenish the FEIP sovereign fund.

However, medium- to long-term developments in public finances are a source of concern. Despite the president's commitment to continuing fiscal consolidation, spending is likely to increase significantly in the next few years. In addition, PEMEX's financial position has continued to deteriorate and repairing it will require large-scale, long-term financial support from the government, despite higher oil prices.

INVESTMENT OUTLOOK STILL WORSENING

Finally, the investment outlook remains relatively weak in the short and medium term. Investment has fallen significantly since mid-2018 and in the first few months of 2022, it remained much lower than its pre-Covid level in December 2019 (chart 2). Investor confidence has been damaged by an unpredictable economic policy, the lack of government support in the last two years and the current debate about energy reforms. This is likely to remain the case at least until the current president's term of office ends, which is scheduled to be in 2024[1].

Energy sector reforms, first proposed by the government in March 2021, are on the table again, and the approach taken is likely to have a major influence on investor sentiment in the short and medium term. Broadly speaking, the president has proposed an overhaul of the electricity sector, which was part of his election manifesto. According to the March 2021 bill, state-owned electricity company CFE would increase the proportion of the country's electricity it supplies from less than 40% today to 54%, at the expense of private sector operators. The proposal also includes the cancellation of contracts under which private sector companies generate and supply electricity, and of renewable energy generation contracts. In addition, the president intends to scrap corporate governance arrangements at CFE and PEMEX, giving the government sole decision-making power.

In the next few months, a number of debates about this reform are scheduled to take place in Mexico's Congress. The Senate and Supreme Court will also rule on the president's proposal, made in October 2021, to amend the parts of Mexico's constitution that mention private sector involvement in the energy sector. It seems unlikely that the bill will be enacted in its current form, but the extent of any forthcoming amendments remains unclear. If the final version is only slightly different from the one put forward by the president, this would increase the downside risk in several areas. If existing contracts with the private sector were cancelled, this would create reputational risk as well as the risk of legal action in Mexico and abroad, and there would also be a risk that private sector investment (domestic and foreign) would decline over the long term. Aside from its impact on the energy sector itself, the bill could pose a risk for public finances if government spending on CFE and PEMEX were to increase significantly again.

MEXICO: INVESTMENT INDEX

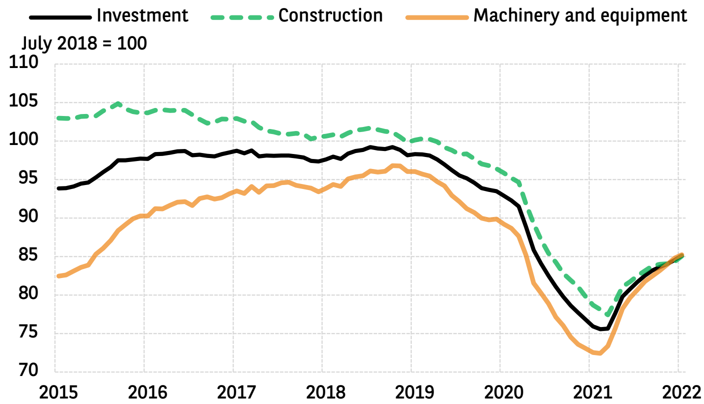

CHART 2 SOURCE: NATIONAL INSTITUTE OF STATISTICS AND GEOGRAPHY

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1 The president held a referendum in April to decide whether he should see out his term of office. The question asked was «Do you agree that the president should have his mandate revoked due to loss of confidence or that he should continue in the Presidency of the Republic until his period concludes?» Over 90% of people voting said that he should continue, but turnout was very low at less than 20%.