MEXICO

PRUDENCE

The economic dynamism seen in the first half of 2022 is waning. The rebound in private consumption is being held back by rising inflationary pressures, while exports are weakening due to slowing growth in the United States and global demand. Structural weaknesses in the economy (low investment, lack of infrastructure) are also limiting the growth recovery. Moreover, a deterioration in public finances is increasingly likely in the medium term. The very limited rise in fiscal income will not be enough to compensate for the necessary increase in government spending that is expected in the coming years. In addition, sovereign wealth funds have been used over the past two years and the government no longer has any reserves.

LOW ECONOMIC GROWTH DYNAMICS

The outlook for the Mexican economy remains mixed. After relatively robust performance in the first half of the year (real GDP grew by 1.8% and 2.0% year-on-year in Q1 and Q2, respectively), growth should slow in the coming quarters. First, a significant drop in exports is expected, reflecting the weak growth expected in the United States, in particular, and the slowdown in global demand in general. Net exports are expected to contribute negatively to real GDP growth over the next two quarters. The slowdown in exports should also result in a widening current account deficit.

Second, strong inflationary pressures and monetary tightening are weighing on the dynamism of domestic demand. Inflation has risen since the beginning of 2022, reaching 8.7% year-on-year in August. All inflation components are on the rise and inflation will remain high over the coming months. On 29 September, the Central Bank of Mexico raised its key interest rate by 75 basis points for the third time in a row (and for the eleventh time since the tightening cycle began in June 2021), bringing it to 9.25% (a total of 525 basis points). According to the Central Bank's projections, the rate of inflation might meet the target (between 2% and 4%) only in the last quarter of 2024. The press release also suggests that further rate hikes will be announced in the short term.

Finally, the government's decision to maintain its austerity policy during the 2020-2021 health and economic crisis (support measures represented just over 1% of GDP, among the lowest in emerging economies) has exacerbated the structural weaknesses of the Mexican economy (e.g. low productivity, a lack of infrastructure, and a downward trend in the investment rate), which will continue to restrict growth in the short term. Furthermore, the quality of the labour market has deteriorated since the beginning of the crisis (a rise in informal jobs and a drop in the female participation rate).

The reduction in the investment rate the loss of confidence of foreign and Mexican investors have also been exacerbated by several government initiatives put forward over the past two years (in particular, the project to reform the energy sector and the cancellation of the project to build the new Mexico City airport).

In total, the level of activity at the end of Q2 remained almost 2% lower than in Q4 2019 and it now seems that this level will not be reached before the end of 2023. Besides the level of GDP, growth dynamics also seem to have been affected in the longer term. According to Moody's, the rating agency, low investment, the lack of infrastructure and the high level of poverty will keep real GDP growth to no more than 2% over the next five years (the potential growth estimated by the IMF in December 2019 was over 2.5%).

FORECASTS

	2019	2020	2021	2022e	2023e
Real GDP growth, %	0.1	-8.1	4.8	1.8	1.3
Inflation, CPI, year average, %	3.7	3.4	5.7	7.9	5.9
Budget balance / GDP, %	-1.7	-2.8	-2.9	-4.1	-3.9
Public debt / GDP, %	46.4	53.1	51.3	50.1	49.8
Current account balance / GDP, %	-0.2	2.4	-0.4	-0.8	-0.9
External debt / GDP, %	36.6	42.6	34.6	37.6	38.1
Forex reserves, USD bn	180.0	195.0	202.4	200.0	198.0
Forex reserves, in months of imports	3.5	5.3	5.1	4.8	4.4

e: ESTIMATE & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

MEXICO: INFLATION AND POLICY RATE

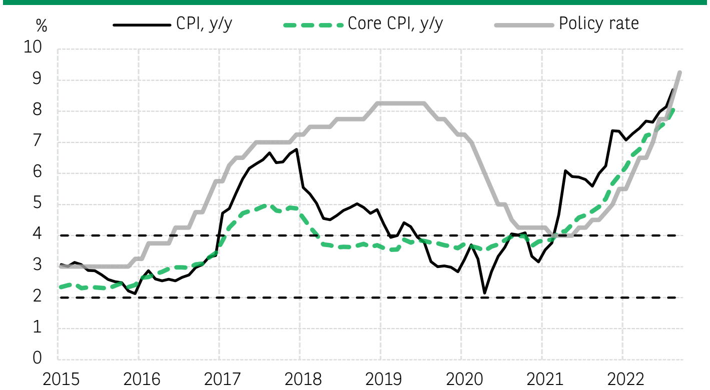

CHART 1 SOURCE: CENTRAL BANK, BNP PARIBAS

A SLIPPAGE RISK FOR PUBLIC FINANCES

On 8 September, the Mexican government presented its draft budget for 2023. As has been the case since the beginning of the administration, in 2018, the government intends to stick to the austerity policy to which it had committed in its election manifesto. The objective has been achieved for the time being: the deficit and public debt have remained generally stable since 2018, at around 3% and 50% of GDP, respectively, in both 2020 and 2021.

The assumptions used in the proposed 2023 budget are optimistic: the plan is based on GDP growth at 3%, an inflation rate of 3.2% on average over the year and oil production of over 1.8 billion barrels per day (an increase of almost 12% compared to the average daily production over the past 12 months). Public spending once again prioritises infrastructure projects chosen by the President (the Dos Bocas refinery and the Maya Train), to the detriment of spending on the most vulnerable households.

That said, the government should be able to maintain its budgetary targets until the end of its mandate in 2024, partly thanks to a rather conservative oil price assumption (USD 69 per barrel on average in 2023).

In the medium term, however, a slippage in public finances seems more and more likely. The prospects for improving revenues will be limited, in line with the expected sluggish economic growth. In addition, it has not been possible to implement the extensive tax reform that the government envisaged in 2021.

The robustness of public finances has, in fact, already been slowly deteriorating over the past five years. The government has had contradictory messages over its fiscal policy and its objectives have been difficult to achieve, such as the commitment to maintain a balanced budget, by significantly increasing expenditure and social benefits but without generating any real increase in income.

Moreover, since 2018, the government has gradually used up all the sovereign funds and fiscal reserves that it had in order to maintain a relatively low public deficit despite increasingly high spending. In particular, the Budget Revenue Stabilisation Fund (FEIP), the assets of which accounted for around 1% of GDP at the end of 2018, was cleaned out in 2020. The government no longer has any budgetary reserves that would protect it against future shocks.

Finally, the policies put in place since 2018 have led to more rigid public spending. In particular, as part of its energy policy, the government has repeatedly supported Pemex, the national oil company. Transfers, capital injections and investment support represented almost 1.5% of GDP in 2021. Over the next few years, support for Pemex should continue and represent almost 1.5% of GDP each year, according to estimates made by Moody's, the rating agency. At the same time, the government has reduced the Pemex profit-sharing tax to 40%, compared to 54% in 2022, and has included in its own accounts certain expenses related to Pemex (such as the construction costs for the Dos Bocas refinery).

Transfers also increased as a proportion of total public expenses (notably due to an increase in pensions) from 20% in 2018 to 22% in 2021, as well as as a share of GDP from 3.8% in 2018 to 4.4% in 2021. The subsidy for the most vulnerable elderly people, which has increased by 50% since the start of the mandate, is also expected to increase in the coming years, in line with the ageing population.

Finally, although the debt interest payment charge has remained relatively stable at around 12% of total budget spending since the start of the mandate, it is expected to increase in the coming months.

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MEXICO: INVESTMENT

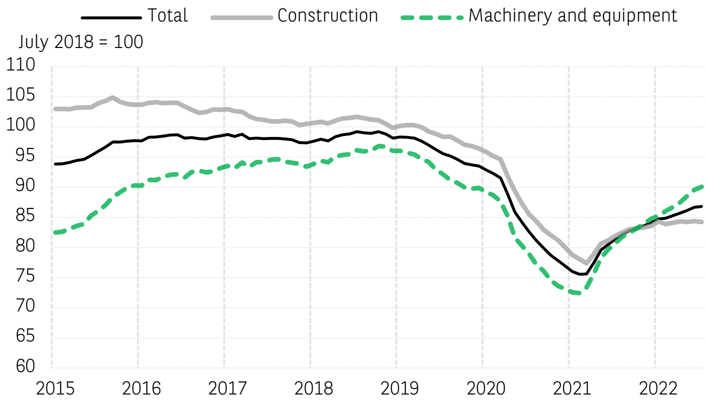

CHART 2

SOURCE: CENTRAL BANK, BNP PARIBAS