MEXICO

PUBLIC FINANCES INEVITABLY DETERIORATE

Mexico's medium-term economic prospects continue to deteriorate. The robust recovery already seems to be running out of steam, while the economy's structural weaknesses (low investment and competitiveness) have been exacerbated by the Covid-19 crisis and by the government's lack of fiscal support. Yet economic policy is unlikely to change much over the next two years. Following mid-term elections, the governing coalition managed to maintain a simple majority in the Chamber of Deputies. And the government's 2022 budget proposal confirms its determination to maintain austerity through the end of its mandate in 2024. Considering the relatively optimistic assumptions retained by the government, including financial support for the state-owned oil company Pemex, it seems inevitable that the public finance situation will deteriorate before the end of President AMLO's term.

POLITICAL CONTINUITY

Mexico's attractiveness and competitiveness continue to deteriorate. According to the Mexican institute for competitiveness (IMCO), the competitiveness of the Mexican economy has declined continuously since 2018, and the country has dropped from 31st place to 37th out of a ranking of 43 countries.

According to the IMCO, the country has regressed in 5 out of the 10 categories evaluated (environment, social cohesion, political climate, international relations and innovation). The report also underscores how the numerous gaps between Mexico and the other countries in the selection are getting wider, and can only be absorbed if the country "continually" seeks to attract new investment.

Yet the country's attractiveness is unlikely to improve significantly before the end of the term of President Andres Manuel Lopes Obrador ("AMLO") in 2024. Economic policy will probably remain fairly muddled. Last June's mid-term elections gave the presidential coalition (comprised of Morena, the party of President AMLO, and the two centrist parties PT and PVEM) a simple majority in the House of Deputies, with 275 seats out of a total of 500. Consequently, it should be rather easy to pass the new budget bill without forming a new coalition. Following the elections, the Minister of Finance and the Central Bank Governor were replaced by persons close to the president.

Last July, AMLO announced that he would present the House of Deputies with a constitutional reform project that would guarantee that the Federal Electricity Commission (CFE) has a minimum stake of 54% in the country's electricity production.

This proposal follows numerous initiatives by the president since the beginning of his mandate that aim to control and reduce the private sector's stake in the electricity sector in particular, and in the energy sector as a whole, rolling back efforts to open up the market since 2013. Yet the governing coalition no longer has a qualified majority (two thirds of the seats), so a new coalition would be necessary to pass this reform. Large-scale reforms in other sectors now seem less probable before the end of his term, especially since Mexico's Supreme Court has rejected the vast majority of reform proposals made so far.

All in all, the lack of visibility over economic policy is placing a heavy strain on both domestic and foreign investment (in the energy sector and in other sectors), as well as on the country's attractiveness since the beginning of AMLO's mandate.

ECONOMIC GROWTH SLOWS

After a vigorous recovery between Q4 2020 and Q2 2021, fuelled by a strong base effect but also by the robust rebound in the US economy, Mexico's GDP growth is expected to slow as of Q3 2021. The third wave of the Covid-19 pandemic was extremely severe, with more new cases than during the first two waves, which eroded domestic demand.

Yet health restrictions are gradually being lifted, thanks to the acceleration of the vaccine campaign (35% of the population has received two doses of the vaccine at the end of September, compared to only 15% in early July), and the continuous decline in new cases since mid-August, which should support the services sectors in the last months of the year.

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	0.1	-8.3	6.0	2.5
Inflation (CPI, year average, %)	3.7	3.4	5.4	4.6
Budget balance / GDP (%)	-1.7	-2.3	-4.4	-3.5
Public debt / GDP (%)	46.4	53.7	52.3	54.5
Current account balance / GDP (%)	-0.2	2.5	0.8	-0.3
External debt / GDP (%)	37.7	41.2	41.8	42.5
Forex reserves (USD bn)	180.0	195.0	201.0	209.0
Forex reserves, in months of imports	3.5	4.3	4.5	4.1

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

INVESTMENT

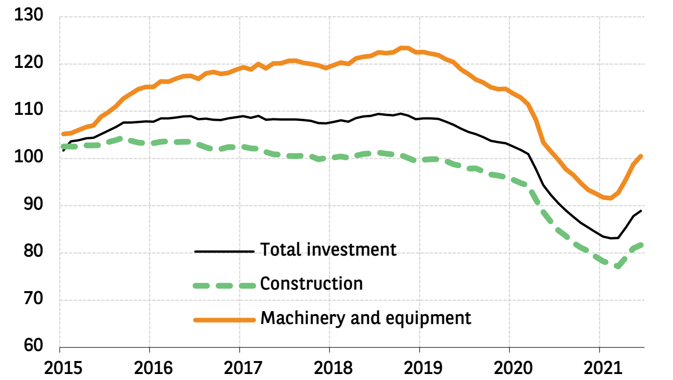

CHART 1 SOURCE: INEGI

Mexico will continue to report "two-speed" growth throughout 2022: domestic demand will remain in a lasting slump, notably due to structurally weak investment and a fragile labour market, while exports are expected to be dynamic throughout the year. All in all, after 6% growth in 2021, GDP is expected to rise only 2.5% in 2022. At this pace, GDP will not return to the pre-Covid level of year-end 2019 before mid-2023, and private investment will not return to the 2019 level before 2024.

At the same time, rising commodity prices and the shocks due to supply chain disruptions are placing upward pressure on inflation. Inflation peaked at 6.1% y/y in April, the highest rate since 2018, before easing to 5.6% y/y in August. In the months ahead, inflation is expected to remain above the central bank's target range of 3%, give or take 1%. At its September meeting, the central bank raised its key rate by 25 basis points to 4.75% (after key rate increases in June and August). The central bank's press release placed emphasis on inflation expectations (currently at 6% for the end of the year), so several more key rate increases are expected in the months ahead.

2022 BUDGET PROPOSAL: PUBLIC FINANCES DETERIORATE IN THE MEDIUM TERM

Like it has since the beginning of President AMLO's mandate, the government continues to give priority to the stability of the public debt ratio. Through the end of his term in 2024, the public debt ratio is expected to hold at about 51% of GDP (the same as in 2021), after peaking at 53.7% of GDP in 2020. The government is targeting a deficit of 3.1% of GDP in 2022 (after 3.2% in 2021). We think it will have a hard time meeting this target, and we are rather expecting a deficit of 4.4% in 2021 and 3.5% in 2022.

Spending will continue to rise as it has over the past three years, which underscores the government's priorities, notably for big infrastructure projects such as the Maya train across the Yucatan and the Tehuantepec Isthmus rail corridor. For the moment, it does not seem to be taking any measures to support private domestic demand, which has been hard hit by the Covid-19 crisis.

As to revenues, the fiscal reform project has been postponed (which rules out any new taxes or increases in existing tax rates), and the government is instead giving priority to improving tax collection and reducing tax evasion (which targets small and very small enterprises in particular).

Another priority is to improve the financial situation of Pemex, the state-owned oil and gas company. It will be difficult to implement the proposed solutions, however, without them having a lasting impact on public finances. The first proposal is to lower the corporate tax rate paid by Pemex from 54% to 40% (compared to 65% in 2019), which would reduce oil revenue as a share of total revenue to 9% in 2021 and 8% in 2022. Several capital injections are also planned: they would have a neutral impact from a financial perspective if they were used to reimburse Pemex's debt, but not if they were used to finance new capital investments. Moreover, since the government has already pledged not to raise taxes, fewer and fewer funds will be available for these capital injections (sovereign funds, for example). Lastly, the government recently announced that it had purchased USD 7 bn in foreign reserves to cover part of Pemex's maturing debt (for a cumulative total of USD 7 bn by year-end 2022), via new capital injections. Once again, this operation will be hard to repeat, since government deposits with the central bank have diminished continually since the beginning of AMLO's mandate.

GOVERNMENT DEPOSITS AT THE CENTRAL BANK

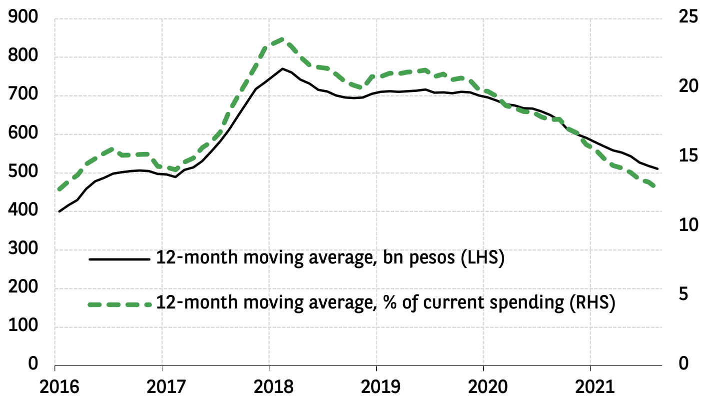

CHART 2 SOURCE: CENTRAL BANK

Lastly, the macroeconomic assumptions retained in the 2022 budget seem to be overly optimistic once again. The government is forecasting GDP growth of 6.3% in 2021 and 4.1% in 2022. It has probably overestimated Pemex's oil production capacity as well. It is forecasting 1.83 m barrel/day in 2022, compared to a forecast of 1.75 m b/d in 2021, and average oil production of only 1.68 m b/d in the first eight months of the year.

To summarise, the government's 2022 budget proposal calls for a structural increase in spending (on infrastructure projects and recurrent support for Pemex, which is probably underestimated), without seeking a veritable increase in revenue. It is also highly likely that spending has been underestimated while revenue increases have been overestimated. Under these conditions, it seems highly unlikely that the country will maintain a balanced budget through the end of AMLO's term. Moreover, Pemex's fragile financial situation is a structural problem that will continue to erode public finances in the future.

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