

MEXICO

A FRAGILE RECOVERY

Thanks to a strong Q4 rebound, the contraction in real GDP was limited to 8.2% in 2020, the public deficit did not swell as much as expected, and 2021 growth prospects were given a boost. Yet the recovery is still fragile: private consumption and investment have both taken a lasting hit from the 2020 crisis, and the export sector will not benefit fully from the expected rebound in US growth. The crisis also exacerbated concerns about the vulnerability of public finances and the decline in investment, which will undermine medium to long-term growth prospects.

STRONGER-THAN-EXPECTED REBOUND

Real GDP contracted 8.2% in 2020. The economy was hard hit by the collapse of domestic demand due to lockdown measures and the drop-off in external demand, mainly from the United States (80% of total exports). Prospects continued to erode during the first three quarters (at the end of Q3, real GDP was expected to decline by more than 10% in 2020), but the strong Q4 rebound helped limit the decline in full-year GDP and to improve the growth prospects for 2021 and 2022.

Even so, the recovery is still fragile and GDP is unlikely to grow by more than 4% in 2021. Exports will be the main growth engine, fuelled by the rebound in the US economy and by the American Recovery Plan. In contrast, domestic demand will remain weak, undermined by the drop-off in activity in Q2 2020 (real GDP contracted 18.7% y/y), and by extremely limited government support. Public spending will barely increase again this year after the government reiterated its determination to pursue the austerity programme announced at the beginning of its mandate. After providing massive economic support in 2020¹, the central bank is also likely to make more limited interventions in 2021. Our scenario calls for the key policy rate to be maintained at the current rate of 4%.

THE HEALTH SITUATION IS STILL FRAGILE

The risks are on the downside due to the fragility of the health situation. The vaccination campaign has fallen behind initial targets, and the number of new daily cases is still relatively high. At the end of March, the number of people who had received their first dose of the vaccine was slightly below 5.5 million (less than 4.5% of the total population), while 750,000 had received their second dose (barely more than 0.5% of the population). According to recent government announcements, the vaccination rate should accelerate in the days ahead. The goal is to vaccinate half of the population with two doses by the end of the first half, and the entire population before the end of 2021. These targets do not seem to be very realistic given the difficulties the government has had in procuring the necessary doses and the pace of the vaccination campaign so far.

Moreover, the health emergency that was declared in February 2020 is still in effect, as well as the colour coding system² set up last May to indicate the level of restrictions in vigour in each state. After holding steady at about 5,500 new cases since June, the number of daily new cases rose continuously between mid-November and the end of January, peaking at 17,000 new cases. At that time, virtually all states were in the red zone. The number of new daily cases has fallen continuously ever since, to slightly below 4,500 cases at the end of March, when 8 states were still "orange", 3 were "green" and the other 21 were "yellow".

¹ The key rate was lowered by 300 basis points to 4%, and a series of economic support measures were set up during the summer for a total of nearly 4% of GDP.
² Green, yellow, orange and red, depending on the virus infection rate and hospital occupancy. Restrictions are at maximum levels in the red zones.

FORECASTS

	2019	2020e	2021e	2022e
Real GDP growth (%)	0.1	-8.2	4.0	2.7
Inflation (CPI, year average, %)	3.7	3.4	3.9	3.7
Budget balance / GDP (%)	-1.7	-2.3	-4.1	-4.8
Public debt / GDP (%)	46.4	50.8	52.3	54.5
Current account balance / GDP (%)	-0.2	2.5	0.9	0.5
External debt / GDP (%)	37.7	41.2	41.8	42.5
Forex reserves (USD bn)	180.0	195.0	203.0	209.0
Forex reserves, in months of imports	3.5	4.3	4.5	4.1

TABLE 1

e: ESTIMATES & FORECASTS
 SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

TWO SPEED RECOVERY

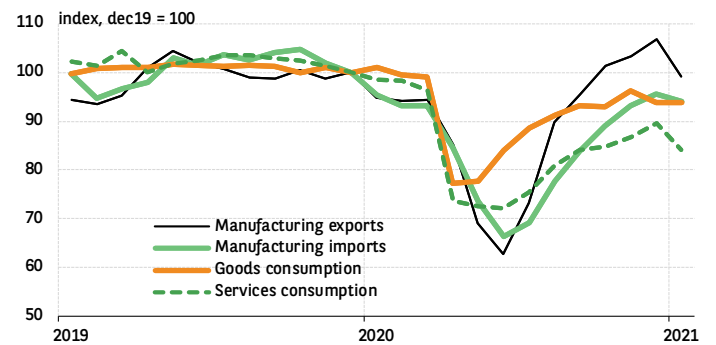


CHART 1

SOURCE: CENTRAL BANK

PUBLIC FINANCE CONCERNS

The public deficit was not as high as feared in 2020, at 2.3% of GDP, compared to 1.7% in 2019, thanks to a very tight grip on public spending (economic support measures barely totalled more than 1% of 2020 GDP), higher Q4 revenues (thanks to the increase in oil prices, and to a lesser extent, the rebound in growth) and the postponement of a financial transfer to Pemex, the state-owned oil company. Naturally, the public debt ratio did not increase as much either, at 50.8% of GDP, compared to 46.4% in 2019.

Despite this relatively good performance, the fiscal situation is still difficult and pressures could even worsen. Contrary to the government's 2021 fiscal targets (stabilisation of the deficit at about 2.5% of GDP over the next two years), we expect the public deficit to increase to 4.1% of GDP in 2021. As in its previous budgets, the government's forecasts seem to be overly optimistic and will be hard to reach, not only in terms of GDP growth, but also for Pemex's financial situation and oil production. The government's 2021 production target is 1.86 million barrels per day (mb/d). In 2020, the target was 1.95 mb/d, but in the end, production actually came to only 1.65 mb/d.

Given the feeble rebound in domestic demand, fiscal revenues are unlikely to rise much. Moreover, social pressure and the ongoing deterioration of Pemex's situation will probably require massive, recurrent government transfers in the quarters ahead, which should significantly increase spending as of 2021. Moreover, to offset the loss of revenue in 2020, the government has already drawn heavily on the oil sovereign wealth fund. The remainder will probably be used in 2021, but the remaining amount will not suffice (0.2% of GDP at year-end 2020, compared to more than 1.5% of GDP at year-end 2019). The remainder of available fiscal savings and any central bank transfers will not suffice to provide a sustainable solution, further reinforcing the need for fiscal reform.

Under these circumstances, public debt is expected to exceed 52% of GDP in 2021 and to continue to swell in 2022, bringing the public debt ratio to the highest level in more than 40 years. The deterioration in public debt dynamics, higher contingent risks pertaining to Pemex, the erosion of the sovereign wealth fund and the absence of structural reforms could make the government more vulnerable to changes in investor sentiment. Although public debt still has a favourable profile, with about 80% denominated in local currency, more than 30% is held by non-resident investors.

INVESTMENT DECLINES AGAIN

Structural fragilities, such as a low investment rate and the deterioration in business sentiment, existed well before the outbreak of the Covid-19 crisis and will continue to strain growth prospects in the short to medium term. Some of these weaknesses have even been exacerbated over the past 12 months, including a rather opaque economic policy and questions about the private sector's participation in certain key segments of the economy. The electricity sector reform that was approved in early March 2021 strengthens the role of state-owned companies to the detriment of the private sector, which could place a lasting damper on investment.

Investor mistrust could be strengthened by the outcome of June's elections, including legislative elections as well as elections for 15 state governors. According to the polls, the popularity of President Andres Manuel Lopez Obrador (AMLO) is very high (above 60% since the beginning of his mandate), and the president is personally implicated in the campaigns for the legislators as well as for the 15 gubernatorial candidates from his party. Morena, the presidential party, and its two allies, the centre-left PT and the centre-green PVEM, are expected to hold onto a majority of seats in the Chamber of Deputies (currently, the three coalition parties have 300 seats out of a total of 500). Given this configuration, the government should have no trouble implementing the reforms it is planning for the second part of its mandate.

GFCF

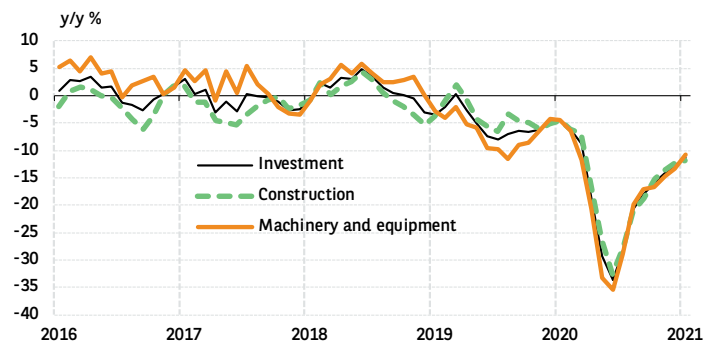


CHART 2

SOURCE: NATIONAL INSTITUTE OF STATISTICS AND GEOGRAPHY

In the medium term, the mistrust felt by local and foreign investors could spread to all sectors of the economy. We expect investment to decline again in 2021: the investment rate has already fallen from 23.6% of GDP in 2016 to 19.3% in 2020, according to the latest IMF figures. Similarly, net inflows of foreign direct investment (FDI), which have declined since mid-2018, are expected to contract again in 2021. All in all, despite the rebound in growth in the very short term, we do not expect Mexican GDP to return to the pre-crisis level (year-end 2019) before the end of 2022. The country's potential growth rate has been revised to 2%, from close to 2.5% at the end of 2019.

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