The Mexican Economy in 2022: Outlook and Challenges

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HSBC’s 10th Annual Mexico Opportunities Forum

February 28th, 2022

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1. International context
   a. Uneven recovery
   b. High global inflation
   c. Tightening of global financial conditions

2. Domestic context
   a. Inflation
   b. Economic activity

3. Monetary policy outlook

4. Conclusions
Economic recovery, inflation, and monetary and financial conditions

INTERNATIONAL CONTEXT
A challenging global economic outlook

• At the beginning of 2022, the world faces a challenging economic outlook, characterized by:

1. An uneven and uncomplete economic recovery across countries, regions and economic sectors.

2. A high global inflation phenomenon.

3. The prospect of the start of a tightening cycle of global monetary and financial conditions.

4. The economic and financial uncertainty derived from the current situation in Ukraine.

• The outlook is particularly challenging for those emerging economies that currently experience a weak recovery and/or do not have strong macroeconomic fundamentals.
Uneven recovery

- The world economic recovery is still incomplete.
- There is heterogeneity in the speed of recovery across countries and regions.
  - Some countries are currently experiencing high growth rates, while others have weak macroeconomic fundamentals.
- Mexico is among those countries where the recovery has been somewhat slow, yet it has solid macroeconomic fundamentals.

Gross Domestic Product
Index 4Q-2019 = 100, s.a.

Source: Own calculations using data from IMF.
Global inflation

- High inflation is a widespread global phenomenon.
  - It has affected multiple countries and regions.

- Mexico’s inflation rate is not higher than that of other countries which had similar inflationary dynamics before the pandemic.

- The inflation gap between Mexico and the US is minimal.

Source: Own calculations using data from IMF.
Markets expect higher interest rates in advanced economies

- Global monetary and financial conditions are expected to tighten in the near future.
- This might represent an underlying force in favor of the US dollar and other currencies of advanced economies.

Reference Rate and OIS Implicit Trajectories ¹/  
Percentage

Source: Bloomberg. 1/OIS: interest rate swap between a fixed and a floating rate where the fixed interest rate is the effective overnight reference rate. 2/For the United States effective overnight rate, we are using the mean of the Federal Funds rate range (0.0% - 0.25%).
Mexico maintains solid macroeconomic fundamentals

- Unlike other countries, Mexico opted for a conservative fiscal policy during the pandemic.
  
  In 2021, the Mexican primary balance was low relative to other countries.

- Mexico has registered manageable current account levels in the last three years, compared to previous years.

Note: Mexican primary balance for 2021 uses data from SCHP report “Economía y las Finanzas Públicas” fourth quarter of 2021.
Inflation and economic activity

DOMESTIC CONTEXT
Inflation in Mexico

- The inflationary phenomenon has continued in Mexico, although headline inflation appears to have reached a maximum in November 2021. In turn, core inflation should also reach a maximum in March or April of 2022.

**Explanatory factors that have been more persistent than originally anticipated:**

1. High international levels of commodity prices.

2. Changes in global and local consumption patterns of households.

3. Supply restrictions: bottlenecks in production processes, global shortages of essential inputs, logistical problems, etc.
GDP, employment, consumption, investment and credit

ECONOMIC ACTIVITY: A MAJOR CHALLENGE
GDP gap

- To calculate trend GDP, we fit the following regression:
  \[ \ln(y_t) = \alpha + \beta t + \epsilon_t \]

  Where \( y_t \) is real GDP, \( t \) is time, \( \epsilon_t \) is an error term, and \( \alpha = 16.14 \) and \( \beta = 0.0058 \) are parameters.

- These calculations imply an annual trend growth of 2.32%.

- The percentage difference between actual GDP and its trend was -11.9% in 4Q-2021.

Source: Own calculations using data from INEGI

The Mexican Economy in 2022: Outlook and Challenges
Employment gap

- Total employment already reached a level consistent with its long-run trend. In contrast, formal employment (registered at IMSS) still exhibits a gap.

- The recovery of formal employment (IMSS) has occurred at a higher pace relative to previous crises.

- Although formal employment (IMSS) has already recovered its pre-pandemic level, economic policy should aim at recovering the trend level, that is, the number of jobs that would have existed in the absence of the pandemic.
Consumption

- A gap remains in private consumption at the aggregate level.
  - Services continue to lag strongly compared to February 2020 levels, reflecting the effect of the pandemic.
  - Consumption of goods has already recovered. However, the implied higher demand has been satisfied with a higher proportion of imports.

- Unlike 2008-2009, a crisis of nondurable goods consumption is not currently happening.

- The favorable performance of nondurable consumption may be due to:
  - Remittances
  - Payroll
  - Consumer confidence
  - Social transfers

Source: Own calculations using data from INEGI.
Investment

- Mexico’s investment shows a lack of dynamism in the medium term, with a significant deviation from its long-run trend.
  - The investment lack of dynamism started to be evident around 2015.

- Private investment follows the same pattern as total investment.

- Public investment remains way below its historical maximum level. However, public investment started to grow during last year reverting a decreasing trend that lasted for more than a decade.
  - During the pandemic period, public investment has performed better than private investment.

Source: Own calculations using data from INEGI.

The Mexican Economy in 2022: Outlook and Challenges
Bank credit and private investment

- Credit to firms lags behind its trend trajectory.
  - This lag started to be clear after 2017.
  - This lag is more pronounced in the case of credit for individuals with business activity.

- The investment gap has increased since 2016-2017 in line with the credit gap.

Source: Own calculations using data from Banco de México.
Monetary policy faces a dilemma

MONETARY POLICY CONSIDERATIONS
México's monetary policy stance at the beginning of 2022

- The deviation of headline inflation from the central bank’s target in Mexico reached similar levels to that in Chile, Hungary and Peru. Nevertheless, at the start of 2022, Mexico had one of the least accommodative monetary stances in the world.

Note: Prepared with information from the Report "Indicadores de Política Monetaria e Inflación Mundial" as of 10-14 January 2022 from Banco de México.
Mexico’s monetary stimulus was small in 2020 and it was reduced in advance of the rest of the countries in 2021.

- Mexico’s ex-ante real interest rate remained above the average during the entire pandemic period.
- In 2020 the majority of central banks across the globe reduced their nominal interest rates aggressively. This led to observe negative levels of the real interest rates, which stimulated economic activity.
  - Mexico’s reduction of the interest rate was relatively small during 2020.
- In 2021 the majority of central banks were patient and left interest rates constant at historically low levels, while inflation expectations rose.
  - This translated into an even larger monetary stimulus in 2021 with real interest rates falling even more negative than in 2020.
  - Mexico reduced its monetary stimulus in advance of the rest of the countries in 2021.
  - In February 2022 the gap between Mexico’s monetary stance and that of the rest of the countries is wider than a year ago.

Mexico’s Ex-ante Real Interest Rate %

1 The ex-ante real rate is approximated as the difference between the monetary policy rate and the median of the 12-month inflation expectations extracted from the Survey on the Expectations of Specialists in Economics of the Private Sector published by Banxico.

2 The ex-ante real rate is calculated as the difference between the monetary policy rate and the mean of the 12-month inflation expectations published by Consensus Forecast.

The blue diamond corresponds to the average ex-ante real rate, while the red circle represents the median ex-ante real rate of 30 countries.

Source: Own elaboration with data from Banxico and Consensus Forecast.
Monetary policy dilemma:

High inflation and global financial conditions suggest to keep tightening monetary policy.

However, extreme tightening could affect economic recovery and worsen the lack of medium-run dynamism that the country is already experiencing.

The inflationary phenomenon is mainly explained by factors related to the pandemic.

- Inflationary pressures will be reduced as progress is made in controlling the pandemic.
- Domestic monetary policy can't do much against global price pressures.

The tightening of monetary policy is costly.

- The risk of a recession driven by tight monetary policy should not be ignored.
- A recession could induce macroeconomic and financial instability, thus risking the achievement of the inflation goal.

Mexico is currently better positioned to face a Fed tightening cycle.

- Non-resident holdings of government debt is low.
- The current account exhibits a moderate deficit.

Monetary policy affects a number of economic margins such as credit, consumption, investment, and financial markets.

The Mexican Economy in 2022: Outlook and Challenges
Conclusions

• The world faces a difficult economic situation with high inflation, an uneven recovery, the prospect of monetary tightening in advanced economies and, more recently, a worsening of geopolitical conflicts.

• Inflation in Mexico is high and is above the goal established by the central bank, although it does not stand out as being particularly high in relation to the global inflationary phenomenon.

• The Mexican economy suffers from a lack of dynamism in the medium term, especially in the case of investment. Also, recovery is incomplete. Like investment, bank credit to firms also shows a lag with respect to its trend.

• Monetary policy faces a dilemma. High inflation and the prospect of less accommodative global financial conditions suggest to respond with a tightening of monetary policy. However, an excessive tightening might affect the economic recovery and worsen the lack of medium-term dynamism in Mexico. In turn, this could generate unwelcomed economic and financial consequences affecting those capital flows which respond to changes in the economic outlook.

• Looking forward and taking into account the prospect of Federal Reserve adjustments in the near future, Mexico’s interest rate should look to maintain financial stability and simultaneously should avoid to constitute an additional factor that contributes to the deterioration of Mexico’s economic outlook.