Regional Economic Report
January – March 2023
Summary

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In a complex external environment of the first quarter of 2023, Mexico's economic activity continued expanding, supported by the growth of both services and industrial production. The outlook, however, remains uncertain. In this context, economic activity is estimated to have expanded in all regions during the first quarter of 2023, after the weakening observed in the Northern and Central regions during the previous quarter. For the first time since the onset of the pandemic, economic activity in all regions is estimated to have remained above the levels observed during the first quarter of 2020.[1]

From a sectoral perspective, economic activity growth in all regions during the reported quarter appears to have been supported by the reactivation of the tertiary sector, reflecting the improved performance of trade and, except for the Southern region, of tourism. Similarly, some industrial activities would have supported the above expansion, albeit heterogeneously across regions. Although mining increased in all of them, manufacturing expanded only in the North-Central and Southern regions, and construction in the Northern one. Regarding primary activities, agricultural and livestock product production increased only in the Central region.

Due to its geographic location, the Northern region is closely integrated with the US economy, particularly with its border states. In this regard, Box 1 shows evidence of the economic integration of Mexico and US border cities. It also reveals that these cross-border metropolises are more integrated with each other than with other regions of the United States. Links with other Mexican regions are weaker. Meanwhile, labor market in all regions remained strong during the reported quarter. In this regard, Box 2 estimates the slope of the Phillips curve using microeconometrics techniques with a city-level panel data. The results suggest that, while lower slack in the labor market is relevant, other factors such as supply-related shocks have tended to be more important determinants of core inflation.

In all regions, annual headline inflation declined between the fourth quarter of 2022 and the first quarter of 2023, mainly as a result of decreases in non-core inflation, although core inflation also decreased, albeit more gradually. So far in the second quarter, the decline in non-core inflation was accompanied by a sharper decrease in core inflation, such that headline inflation in the Northern, North-Central, Central and Southern regions continued decreasing, registering levels of 5.52, 6.39, 5.49 and 6.30%, respectively, in May. However, in all regions, core inflation remained at high levels and continued facing considerable pressures as a result of the pandemic-related shocks and the military conflict in Ukraine. Also, slack conditions in the economy have been tightening as economic activity has recovered. In all regions, annual non-core inflation decreased between the fourth quarter of 2022 and the first quarter of 2023, and has declined further so far in the second quarter. This result was driven by the lower levels of inflation observed in all regions in agricultural and livestock products and in energy prices.

An upward risk to non-core inflation is the potential materialization of phytosanitary emergencies in the

[1] The Northern region includes Baja California, Chihuahua, Coahuila, Nuevo León, Sonora and Tamaulipas; the North-Central region considers Aguascalientes, Baja California Sur, Colima, Durango, Jalisco, Michoacán, Nayarit, San Luis Potosí, Sinaloa and Zacatecas; the Central region includes Ciudad de México, Estado de México, Guanajuato, Hidalgo, Morelos, Puebla, Querétaro and Tlaxcala; and the Southern region includes Campeche, Chiapas, Guerrero, Oaxaca, Quintana Roo, Tabasco, Veracruz and Yucatán.

agricultural and livestock products sector. In the context of the most recent outbreak of avian influenza that occurred in some states between the end of 2022 and the beginning of 2023, Box 3 shows the results of an econometric exercise indicating that such outbreaks indeed generate upward pressures, particularly on egg prices, and that these pressures are greater when they occur in the main egg-producing areas. In addition, based on certain estimates, other shocks, such as the increase in yellow corn prices, also contributed to the increase in egg prices in recent years. Although inflationary pressures have eased, shocks to inflation might have been differentiated across cities. In this regard, Box 4 analyzes if CPI items' markets are spatially integrated. The results suggest that, for a significant proportion of markets, the relative prices of CPI items across cities would resume their long-term levels, given that markets are integrated and arbitrage pricing opportunities are exhausted.

Based on the information gathered during the program of interviews with business agents, in all regions, the diffusion indices of expectations for the demand for products they offer, for personnel hired and for investment in fixed assets, for the next twelve months remained in the expansion zone. Except for demand-related expectations in the Northern and Southern regions, the indices remained at levels higher than those of the fourth quarter of 2019. However, said indices showed a differentiated behavior at the margin among regions during the reported quarter.

The interviewed business agents highlighted the following risks to regional economic growth. On the downside: i) that public safety indicators deteriorate; ii) that inflation persists at high levels; iii) that extreme weather events occur, affecting economic activity. Among upside risks, they mentioned: i) that public spending, particularly investment in infrastructure projects, is higher than expected; ii) that public safety is strengthened; and iii) that more favorable conditions are observed, both domestically and internationally, promoting higher levels of private investment.

Economic activity is anticipated to continue expanding in all regions over the next twelve months. However, if the global economy decelerates, especially the US economy, those regions more specialized in exports of manufacturing products, such as the Northern and Central regions, could be affected to a greater degree. The possible lower dynamism of exports could be compensated, at least partly, by the impact of the nearshoring process to supply the North American market. In line with the consulted business contacts, said process would not only continue driving foreign direct investment, mainly in the Northern region, it would also generate spillover effects on other activities such as business tourism and the supply of materials for the construction of industrial sites. Box 5 delves into the business perception of this phenomenon, and suggests that the relocation process has continued to benefit firms in Mexico, although the interviewed business agents anticipate that its impact will unfold gradually.

To take advantage of the opportunities offered by the nearshoring process, and in view of the risks faced by regional economies, especially that of a greater global economic slowdown, it is important to reinforce the domestic sources of growth and generate conditions that favor investment. Specifically, it is necessary to continue strengthening the rule of law, and to keep fighting insecurity and corruption. In addition, it is essential to continue supporting human capital formation in order to generate a labor supply that satisfies the hiring needs of firms and allows higher wages for workers. The construction or improvement of infrastructure to provide inputs and energy in the states could also contribute to regional growth, allowing companies to lower their costs and become more efficient regarding their use of energy. Finally, in view of the challenges posed by climate change for the regional economies, it is essential to implement climate change mitigation and adaptation actions, particularly in those entities and sectors most exposed to its impact.