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Mexico Update

Gus Faucher Chief Economist
Stuart Hoffman Senior Economic Advisor
William Adams Senior Economist
Abbey Omodunbi Senior Economist
Kurt Rankin Economist

THE PNC FINANCIAL SERVICES GROUP | The Tower at PNC Plaza | 300 Fifth Avenue | Pittsburgh, PA 15222-2401

Tight Fiscal Policy, Energy Sector Headwinds to Result in Weak and Protracted Recovery

Mexican real GDP will not recover to its pre-crisis level until late 2022, over a year behind the U.S. recovery

Headwinds to growth from tight fiscal policy and state-centric energy policies

Mexico is emerging from a much more severe economic crisis than U.S's. Monthly real GDP plunged over 20% (seasonally adjusted, unannualized) from February to May, and recovered roughly three quarters of the drop through December, leaving output 5% below its pre-recession peak at year-end 2020. By comparison, U.S. real GDP was just 2.5% below its pre-crisis level in the fourth quarter of 2020.

After an 8.2% contraction for all of 2020, Mexican real GDP will likely grow 4.0% in 2021 and 3.0% in 2022, only returning to its pre-crisis level in late 2022—more than a year after PNC forecasts for U.S. real GDP to recover to its pre-crisis level. Risks to Mexico's recovery are to the downside due to limited vaccine supplies and the large role international tourism plays in the economy. These weak recovery prospects are especially disappointing considering that Mexico's recession began well before the pandemic. Construction and business capex began to fall in mid-2018, and real GDP in mid-2019, as falling output from the state-owned oil company Pemex, economic policy uncertainty, high interest rates, and a soft patch for manufacturers in USMCA supply chains reduced industrial production. A number of economic policy decisions have contributed to the severity of Mexico's downturn and to its weak recovery prospects. Mexico's government's provided the least fiscal stimulus of any major emerging market economy in response to the crisis, far less than the U.S. or other developed economies (See Chart 1). Energy policies are another drag—limitations on the role of private businesses in both conventional and renewable energy production are reinforcing the drag from falling Pemex output. Harder to quantify, but still important, is the generally unpredictable nature of economic policymaking, which has depressed business sentiment and weakened investment.

These policies are the headwinds holding back Mexico's recovery. An inadequate fiscal stimulus caused domestic demand to fall more and recover more slowly than in other countries. Falling energy production means less demand for capital goods from the energy sector, less public revenue (the oil industry provided one-fifth of government revenues in 2019, but those revenues fell 40% from 2019 to 2020), and lower spending on public investment and services.

CHART 1: MEXICO PROVIDED FAR LESS FISCAL STIMULUS THAN OTHER MAJOR ECONOMIES

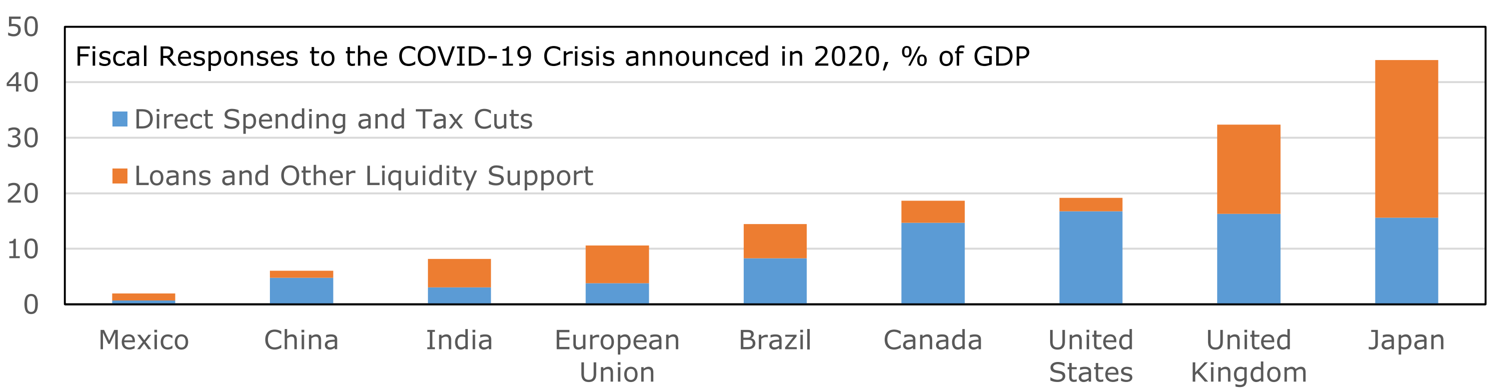

Chart source: IMF Fiscal Affairs Department

In a slow recovery, manufacturing and skill-intensive sectors to outperform

There are bright spots for parts of Mexico's economy. Manufacturing output grew at a 4% annual rate between the end of the Great Recession and its recent peak in 2018, and will continue to grow faster than the rest of the economy during the coming recovery as U.S. supply chains diversify out of China (See Chart 2). And rising educational attainment—the share of Mexican young people enrolling in postsecondary education rose from one-third in 2000 to two-thirds by 2020—will fuel growth of higher-paying, skill-intensive jobs and the domestic consumer sector. But these bright spots are not enough to raise Mexico's overall growth potential.

The Bank of Mexico cut its policy interbank rate a cumulative 4.25 percentage points between the start of its rate cut cycle in August 2019 and February 2021, most recently cutting it 0.25 percentage point to 4.00% on February 11. Even after this, Mexico's policy rate is high by emerging market standards, above Brazil's (2.0%) and China's (2.2%), and matching India's, where inflation averaged 2 percentage points higher than in Mexico over the last 10 years. On a forward-looking basis, Mexico's real (inflation-adjusted) policy interest rate is 0.5%, versus a negative real rate of -2% in the United States.

Mexico's rate cut cycle is probably over; first hike likely in late 2021 or early 2022

As in the United States, Mexican inflation dipped in the spring of 2020, then accelerated as a recovering economy, supply chain dislocations, and rapid swings in consumer demand pushed up prices of food and manufactured goods. Inflation will rise further into mid-year 2021 due to the base comparison with early 2020, when the economy was in free fall, then slow in the second half of 2021 as base effects fade and supply chains normalize. Domestic inflationary pressures will be modest on net in 2021 and 2022. Elevated unemployment and labor market slack will more than offset inflationary pressures from higher commodity prices and the double-digit annual minimum wage hikes passed by the Lopez-Obrador administration. With core inflation likely to stay near the Bank of Mexico's 3% target, economic conditions outside of Mexico will largely decide the course of Mexican monetary policy. Long-term interest rates rose markedly in the United States and other developed countries in early 2021 as vaccine headlines and another huge U.S. stimulus plan brightened the economic outlook; higher advanced economy interest rates spilled over to raise long-term interest rates in Mexico as well. As long-term interest rates in advanced economies rise further, the Bank of Mexico will likely hold its policy rate at 4.00% through late 2021, then begin raising interest rates in late 2021 or early 2022.

PNC forecasts a stable peso in 2021, modest depreciation in 2022

The Mexican peso plunged to a record low of 25 per U.S. dollar when financial markets melted down in the spring of 2020, then gradually recovered to near its 2019 average of 20 per dollar by early 2021. The peso then depreciated somewhat in the first quarter of 2021 as stock market volatility increased and advanced economies' long-term interest rates rose, sapping demand for riskier emerging market currencies, including the peso. PNC forecasts for the peso to recover and close 2021 at 20 per U.S. dollar, then depreciate to 22 per dollar by year-end 2022 as Mexican economic growth slows to its 2%-3% long-run trend.

CHART 2: MEXICAN IMPORTS GAINED MARKET SHARE FROM CHINA DURING THE TRUMP ADMINISTRATION'S TRADE WAR

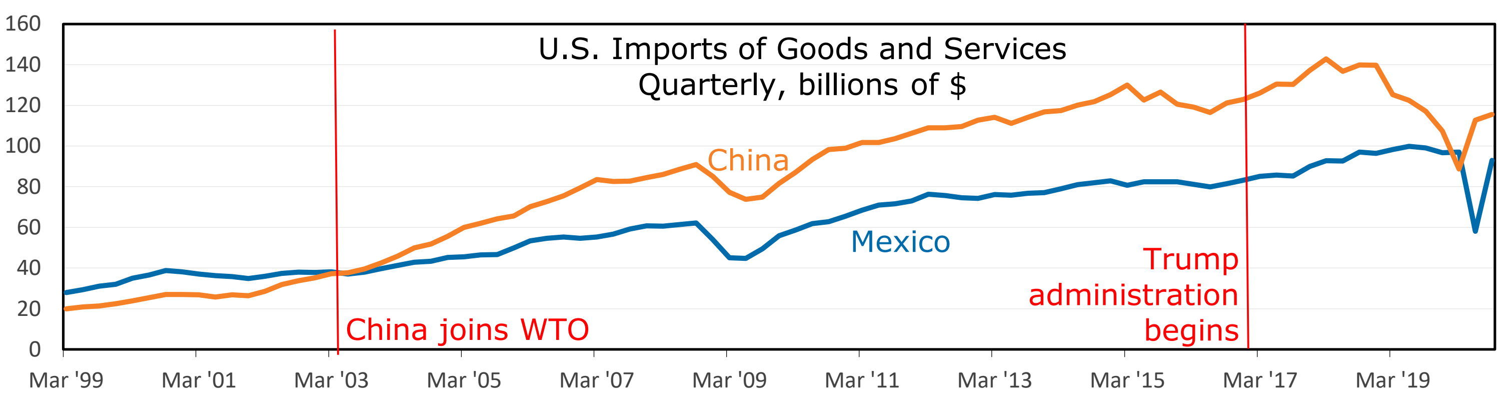

Table sources: Bloomberg, China National Bureau of Statistics, People's Bank of China, PNC Economics

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