

## Mexican Monetary Policy Dilemmas

- Banxico's latest *Quarterly Inflation Report* shows inflation to be both higher and more persistent than previously anticipated, leading to upward revisions to its forecasts. And with the output gap closing, assessing the extent to which price pressures reflect supply disruptions and demand effects is critical to calibrating monetary policy.
- Our take is that the data increasingly supports the view that inflationary pressures can no longer be attributed solely to external shocks and supply chain disruptions.
- Going forward, inflation will depend on key drivers of potential output—investment and labour market recovery, especially job growth in the formal sector. We see challenges ahead on both fronts.
- We will publish revisions to our forecast on December 8th that will likely feature lower 2021 and 2022 GDP, higher inflation for both years, and potentially a higher terminal rate forecast for Banxico.

### MEXICO: INFLATION, GROWTH AND POTENTIAL OUTPUT

There is a broad consensus that global inflation pressures are largely driven by supply side shocks—particularly disruptions in the production of key inputs. And until recently, central bankers characterized the inflation spike as “transitory”. That last point is no longer the case, with Fed Chair Powell [stating](#) “I think it’s—it’s probably a good time to retire that word [transitory] and try to explain more clearly what we mean.” There is a meme in Mexico that goes, “the pandemic is starting to feel like a Netflix series, when you think the end is coming, a new season is announced.” To some degree, this applies globally to central bank views of inflation.

On December 1, Governor Diaz de Leon presented his final [Quarterly Inflation Report \(QIR\)](#) as Head of Banxico (and started his last month as governor, having performed admirably). In this latest report, Banxico kept its year-end inflation forecast at 6.8% (as announced in its November MPC meeting). However, a comparison with the previous inflation report (August) shows how inflation has proven to be both higher and more persistent than was anticipated (chart 1). Since the last quarter, Banxico's 2021 year-end headline inflation projections increased 110 bps while core inflation expectations increased 50 bps.

At the same time, on the heels of the Q3 sequential basis GDP contraction, Banxico also cut its 2021 growth forecast by 80 bps and raised its 2022 forecast by 20 bps, so that its forecasts for 2021 and 2022 now stand at 5.4% y/y and 3.2% y/y, respectively, from 6.2% y/y and 3.0% y/y in the previous *QIR*. It's worth noting that the upward revision to the 2022 growth forecast is still 90 bps below the growth assumption for the Federal Government's [budget](#) for next year. Highlighting the material level of uncertainty the economy faces, the balance of inflation risks seen by the board is almost a mirror image of itself in its downside and upside (table 1).

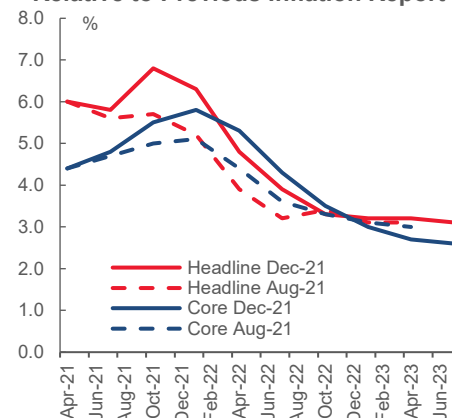
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Chart 1

Change in Banxico's Inflation Forecasts Relative to Previous Inflation Report



Sources: Scotiabank Economics, Banxico.

Table 1

Balance of Inflation Risks According to Banxico Board

Upside	
I	External cost and price pressures
II	Supply chain disruptions
III	Persistent core inflation
IV	MXN depreciation
V	Commodity price increases
Downside	
I	Larger than anticipated output gap impact
II	Social distancing weighing on services activity
III	MXN appreciation
IV	Costs not translating to CPI given slack
V	Lower than anticipated energy prices

Sources: Scotiabank Economics, Banxico.

**Banxico's "central scenario" envisions the output gap being virtually shut by the summer of 2023 (negative output gaps of -0.3, -0.2 and -0.1 are projected for the last 3 quarters of 2023).** Social distancing and mobility restriction policies have hit sectors disproportionately and have also driven a re-allocation of spending in services towards goods (chart 2). In addition, the recovery has not only been uneven by sectors (services, particularly entertainment and tourism have been weakest), but also regions. The south and centre have underperformed the export-oriented Bajío and North. Similarly, while investment has also been weak since 2018, infrastructure investment in the South of the country is now outperforming other regions, supported by AMLO's priority infrastructure projects (Dos Bocas and Maya Train, among others).

**On December 17, a day after the December MPC meeting announcement, Banxico will publish its Report on Regional Economies.** The report will include a survey of company executives on planned price changes (to gauge whether rate hikes and communication shifts from Banxico since September have anchored expectations). The report will also include Banxico's updated read on how the economy is recovering, both by regions and by sectors. This could contain guidance on whether the Board still sees price shocks as primarily supply-disruption-driven.

**Our take is that the data increasingly supports the view that inflationary pressures can no longer be attributed solely to external shocks and supply chain disruptions.** Two factors inform our views:

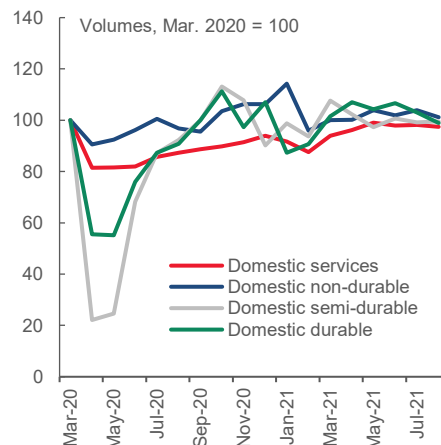
- First, the re-composition of demand towards goods, and away from services has coincided with the primary and secondary sectors in the economy recovering at a much more robust pace than the tertiary sector. In several components, output levels in the primary and secondary sectors already exceed pre-pandemic levels.
- Second, producer price inflation for the primary and secondary sectors has been very strong for over 18 months, and demand in those sectors has recovered quickly, with output gaps being virtually shut in many cases.

The combination of closed output gaps, strong demand recovery, and producer price shocks lead us to believe that Banxico's September survey showing that 55% of producers planned to increase prices by 6% or more likely reflected both supply and demand side factors.

**Going forward, gauging the size of the output gap is critical. In this respect, the Mexican economy went into recession one year before the rest of the world, with the Mexico City airport cancellation the trigger for an eight-quarter period of stagnation and recession.** The mobility restrictions/social distancing associated with the pandemic introduced in Q2 2020 exacerbated the recession. Current total domestic good's consumption volumes represent around 93% of their level at the end of 2018—right before stagnation/contraction kicked in (chart 3). However, compared to when social distancing measures were introduced in Mexico (March–April 2020), consumption levels have essentially recovered pre-crisis levels.

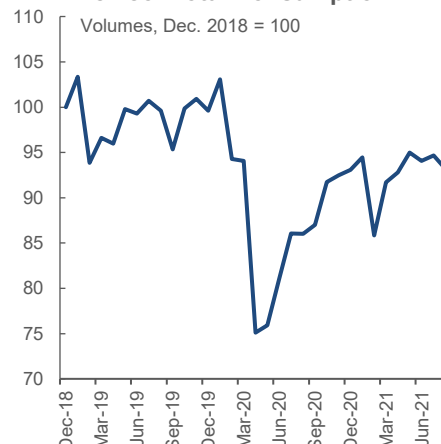
**A key question is how three years of low investment have affected potential.** Recent Brazilian experience provides some insight into this question. When the Brazilian economy was hit with a private sector confidence shock in the second half of the Rousseff administration, the decline in investment contributed to a decline in output that has not been recouped to this day. For example, the volume of Brazil's industrial production remains about 15 percentage points below pre-shock levels (chart 4). For Mexico, assessing the extent to which the decline in formal employment generation and investment has translated into a permanent decline in output is

Chart 2

**Mexico: Domestic Consumer Demand**


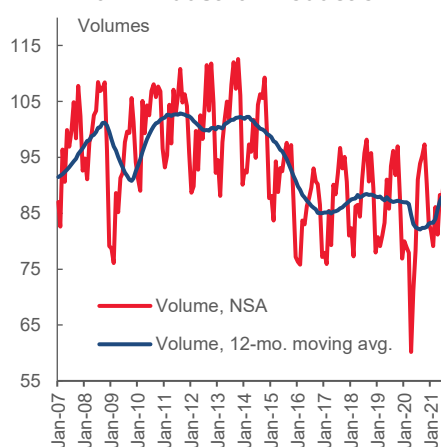
Sources: Scotiabank Economics, INEGI.

Chart 3

**Mexico: Total Consumption**


Sources: Scotiabank Economics, INEGI.

Chart 4

**Brazil: Industrial Production**


Sources: Scotiabank Economics, Bloomberg.

essential to determining where potential output lies going forward (chart 5). Our sense is that, given the drop in investment, Mexico's potential growth rate, which was previously 2.0–2.5%, is now in the 1.5–2.0% range.

**Labour market developments are equally important. Formal job creation in the 2010–2018 period averaged over 650k jobs per year, about the number of new workers joining the labour force each year attributable to demographic factors (chart 6).** However, the cancellation of the Mexico City airport, and the ensuing shock to private investment confidence, reduced average formal job creation over a 12-month span to 420k. And since the start of the pandemic, with the unprecedented shock to growth in Mexico, the average monthly change in formal jobs has been -210k, despite the strong rebound in H1-2021. Moreover, formal job creation stalled in Q3-2021 (chart 7), which we attribute to the shock from the last wave of the pandemic, and the coming into effect of the law which restricts the use of outsourcing. While we expect job creation to strengthen into Q4, we also think that, unless private sector confidence recovers, the structural pace of formal job creation will be closer to 450k per year, rather than the 650k we had seen with the investment to GDP ratio at 23%.

**Banxico also published the calendar for its planned 2022 Monetary Policy Announcements in the QIR (table 2). It is noteworthy that once again there is some distance between the planned Banxico policy meetings and Federal Reserve meetings.** One potential signal the Board may want to send is that, having started its tightening cycle well before the Fed, and likely having moved materially closer to neutral monetary policy settings, Banxico does not see a need to follow the Fed once the US central bank kicks off its own rate cycle.

**Table 2**  
2022 Policy Announcement Calendars for the FOMC & Banxico

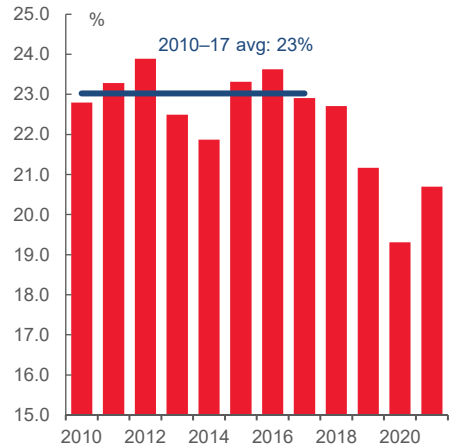
	Banxico MPC	FOMC
Jan-22		26
Feb-22	10	
Mar-22	24	16
Apr-22		
May-22	12	4
Jun-22	23	15
Jul-22		27
Aug-22	11	
Sep-22	29	21
Oct-22		
Nov-22	10	2
Dec-22	15	14

Sources: Scotiabank Economics, Federal Reserve, Banxico.

**Nominee Veronica Rodriguez Ceja had her committee level hearing for the confirmation of her nomination as Governor of the Central Bank of Mexico (the recording can be viewed [here](#)).** As was to be expected, the hearing was relatively free of controversy, and the nominee mostly adhered to her script, stating that she will follow Banxico's mandate to keep inflation in check and defend the central bank's autonomy and laws. In a hearing with little controversy, the most noteworthy exchanges occurred when senators asked whether her experience satisfied the required 5 years of tier-1 experience related to monetary policy, to which she replied prickly with the non sequitur that Banxico's role was not to stabilize capital flows. Overall, however, her hearing went smoothly, as should have been expected. The Senate floor ratification vote is expected today (December 2), and the base case

Chart 5

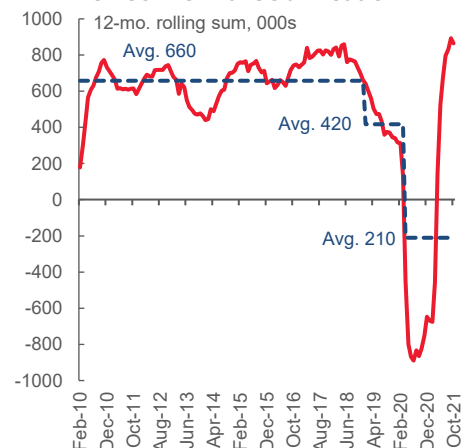
Mexico: Total Investment as % of GDP



Sources: Scotiabank Economics, IMF.

Chart 6

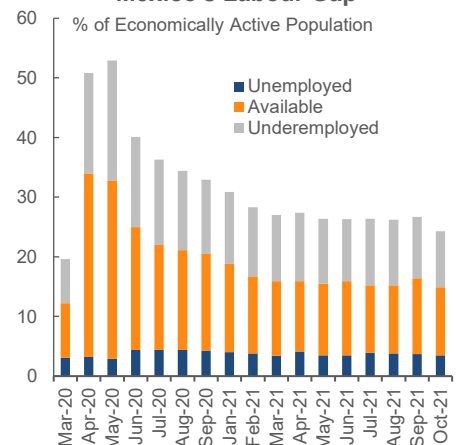
Mexico: Formal Job Creation



Sources: Scotiabank Economics, Bloomberg.

Chart 7

Mexico's Labour Gap



Sources: Scotiabank Economics, IMCO.

seems to be that her nomination will not face material hurdles (given the tone of the hearings, she could even be supported by some opposition Senators, including from the PRD).

**We will publish revisions to our forecast on December 8.** Changes will likely include lower 2021 and 2022 GDP, higher inflation for both years, and potentially a higher terminal rate forecast for Banxico—although not as high as the 7.25–7.5% currently priced into the TIE curve.

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