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Emerging Insight

Mexico: Loose fiscal policy in 2024 = Hawkish Banxico (trip notes)

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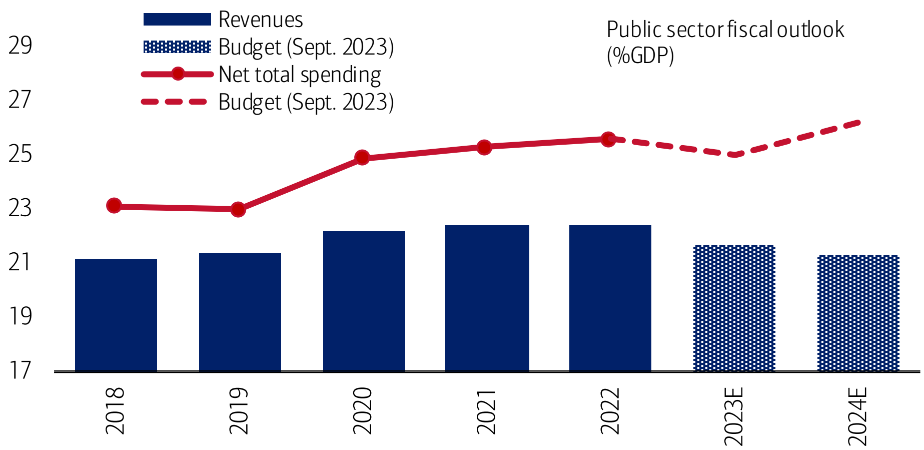
Key takeaways

- Fiscal concerns are top of mind for investors, something that was not the case before the 2024 budget was released.
- Banxico remains hawkish, more so after the fiscal package announced for 2024, which could boost growth and inflation.
- Interest rates will remain under pressure given the fiscal deterioration and a hawkish Banxico.

By Carlos Capistran and Christian Gonzalez Rojas

Chart of the day: Public revenues and expenditure
Fiscal deficit is set to widen considerably in 2024



Source: BofA Global Research, MoF

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Mexico: Loose fiscal = hawkish Banxico

We did an in-person trip to Mexico, meeting central bank board members and staff, officials from the Ministry of Finance, Pemex, local analysts, and local investors. Our main takeaway is that concerns on the fiscal side on Mexico are back. The administration presented the 2024 budget to congress on September 8, and it pencils in a noticeable fiscal deterioration for the public sector with expenditure increasing 8% yoy in real terms, with a 1.2% of GDP primary deficit and a 5.4% overall deficit (Chart of the day). A looser fiscal policy will give further impulse to the economy and therefore will pressure inflation, which will keep the central bank (Banxico) concerned.

Fiscal concerns are back in town

Fiscal concerns are top of mind for investors, something that was not the case before the 2024 budget was released on September 8 (see 2024 budget: notable fiscal deterioration on higher expenditure). The budget increases expenditure and the fiscal deficit considerably. Expenditure increases 8% yoy in real terms in 2024, the primary deficit is set to -1.2% of GDP and the broadest measure of deficit (the Public Sector Borrowing Requirements, PSBR) is set at -5.4% of GDP (these measures are for the entire public sector, so they include Pemex).

The Ministry of Finance (MoF, Hacienda) claims the higher deficit expected in 2024 is a one-off and that a lower-than-expected debt-to-GDP in 2023 gives them space to be more aggressive in 2024. Our perception is that the next administration would need to cut expenditure considerably for this to be a one-off, potentially sending the economy into a recession. Therefore, it is unlikely that this is a one-off. It will depend on the willingness of the next administration to return to fiscal prudence and in part on the checks and balances that the new Congress provides.

Mexico has a fiscal responsibility law which in principle prevents a procyclical fiscal policy, except this time around the government is using the drop in oil prices (USD 56.7/bbl oil price estimated in the budget) to posit a deficit (and Congress is likely to approve it given that Morena and allies have a simple majority). The fiscal responsibility law also, in principle, would require the new administration to do a substantial fiscal consolidation in 2025, so there could be either a fiscal cliff in 2025 (probably since 2H 2024) or, if the new administration wants it and the new Congress allows it, more fiscal deterioration. According to the Fiscal Responsibility Law, the fiscal deficit excluding investment in Pemex and its subsidiaries must be zero. However, there are several escape clauses that allow deviations. Exhibit 1 lists the conditions to have a deficit.

Exhibit 1: Conditions to have a deficit according to Mexico's Fiscal Responsibility Law

One of the conditions to have a deficit is the expectation of a 10% decline in oil prices

An increase of more than 25% in the interest bill relative to the budget of the previous fiscal year derived from an increase in interest rates.
The use of more than 2% of the previous fiscal year's budgeted programmable spending to reconstruction efforts driven by natural disasters once the Natural Disasters Fund has been depleted.
The expectation of the need to use 2% of the previous fiscal year's budgeted programmable spending to implement reforms that generate a future improvement in the fiscal deficit via higher revenue or lower spending.
The expectation of the need to use 2% of the previous fiscal year's budgeted programmable spending to pay liabilities corresponding to previous fiscal years
The expectation of a 2.5% real drop in non-oil tax revenue relative to the previous fiscal year's budget derived from the expectation of a negative output gap.
The expectation of a 10% decline in oil prices relative to the previous fiscal year's budgeted oil price.

Source: BofA Global Research, MoF

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We believe we need to wait until the results of the June 2024 federal election to see if the next administration will be willing and able to cut expenditure and the deficit. Recall that the budget for 2025 is drafted by the incoming administration and is due by November 15, 2024. The composition of Congress will also be key, as it approves the budget via simple majority. All-in-all there are no elements to say this is a one-off situation, and it could be the beginning of a fiscal deterioration.

For next year, the higher deficit will increase issuance significantly. Our impression is that there will be a strong preference to issue local debt. The government is seeking to marginally increase the share of local currency debt to 84.6% in 2024 from 84.0% expected in 2023. Using a back of the envelope calculation, we estimate Mexico would need to issue about USD 12bn in foreign currency debt and MXN 1.7tn in local currency in 2024, higher than the USD 5bn issued in foreign currency and MXN 1.2tn in local currency this year (Exhibit 2). This is within the issuance ceiling of USD 18bn for foreign currency debt and MXN 1.9tn for local currency debt submitted in the budget.

Exhibit 2: Mexico public sector bond issuance

We expect issuance of about USD 12bn in foreign currency and MXN 1.7tn in local currency debt in 2024

	2023 YTD	2023 Remaining	2023 FY	2024
Gross issuance	**3,516**	**1,673**	**5,188**	**3,416**
Local	3,354	1,632	4,987	3,144
External	161	41	202	272
In USD	9	3	11	16
Amortizations	**2,556**	**1,391**	**3,947**	**1,551**
Local	2,476	1,351	3,826	1,478
External	80	41	121	74
In USD	4	3	7	4
Net issuance	**960**	**282**	**1,242**	**1,865**
Local	879	282	1,160	1,667
External	81	0	81	198
In USD	5	0	5	12

Source: BofA Global Research, Hacienda

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Fiscal impulse keeps Banxico hawkish

We expect Banxico's first cut in June 2024 and our conviction in our out-of-consensus call was strengthened after the trip. Banxico remains concerned about Mexico's tight labor market, the pressure on wages and the overheated economy. After the revision to growth in the most recent monetary policy report, Banxico acknowledged that the output gap is positive. Moreover, Banxico expressed caution given that about 70% of the reduction in inflation is explained by the non-core component, which is at a historical low. A reversal of non-core inflation to historical average could put significant pressure of inflation, and higher oil prices are a concern in this regard. Banxico sees a core inflation that is about twice the target as still very high.

According to our conversations with staff members and the board, the 2024 budget took Banxico by surprise and some argue it is a gamechanger. The budget was seen as a fiscal impulse, which could boost growth but also puts pressure on inflation. In our view, this increases the likelihood that Banxico will need to remain on hold for longer. In fact, for the first time in a while, we noted some fiscal concerns within Banxico, with some policymakers believing that the risk of a downgrade could not be ruled out. This, in their view, could complicate monetary policy.

The board signaled that cutting rates is not even yet on the table. The most recent hawkish minutes were part of Banxico's strategy to counter the market narrative that cuts could take place in the near term. The board stressed that a restrictive policy for the entire horizon would be appropriate. Finally, when asked about pressure to cut on the back of other central banks in LatAm launching their easing cycles, Banxico pointed out that Mexico's context is very different.

The staff was less hawkish than the board member we met, but they are not dovish and had not yet incorporated the budget into their views. Still, the staff pointed out that the balance of risks was to the upside and remained very cautious about the evolution of commodity prices. There is uncertainty about the neutral rate, with both the board and staff pointing there are reasons to believe it may have changed. However, the direction and magnitude are still unknown.

On FX, Banxico said that a strong MXN helps it do its job but that it is not in favor of intervening in the market. Banxico said it was not sending any signal to the market by cutting the hedging program. It sees the current level of reserves as adequate, even if the IMF and Banxico decide to start reducing the FCL. However, when asked about what mechanism Banxico could use to build reserves, they answered that the put option mechanism used in the past has proved to work well. In our view, it is not in Banxico's baseline to begin a reserve accumulation program. Finally, the Banxico desk believes positioning in FX is long and positioning in rates is neutral.

Pemex will be supported under any scenario

Pemex is heavily relying on government support. The 2024 budget includes an USD 8.2bn transfer to Pemex and cuts the royalty (DUC) from 40% to 35%. Collectively, the transfer and the DUC reduction are just enough for Pemex to cover the USD 11bn amortizations due in 2024. Both Pemex and Hacienda noted that the reduction in DUC is not permanent, as it is part of the revenue law, which is renewed every year. Hacienda argued that it likes the flexibility to increase or decrease the royalty. However, Pemex argued that a permanent reduction in DUC had been an ongoing discussion. This would require a change in the Hydrocarbons Revenue Law.

In our view, while Hacienda is committed to supporting the company, there is still no clear path to a sustainable solution for Pemex. When asked about the use of any potential oil revenue windfall, Hacienda said they would prefer that Pemex uses it to lower its liabilities, but that they cannot enforce that. Pemex said that it would use the windfall to increase investment, which it reduced in their budget to accommodate the low oil price set by the Ministry of Finance. Therefore, our view is that Pemex will most likely continue to depend on the government for support.

Pemex believes the current spread against the sovereign is too high given the government support, but also acknowledged that it is largely driven by Pemex's high debt. Pemex said that nothing stops it from tapping the market and that it would like to keep the door open to market access, but that market conditions are not favorable now.

Finally, the economic team of the opposition expressed strong willingness to also continue providing support to Pemex. They argue that the main reason why Pemex has so much debt is that the government has taxed it heavily in the past. Therefore, it is fair for the government to support Pemex while it tries to take care of its structural problems. Still, the opposition believes that Pemex has a policy issue and thinks that the participation of the private sector in Pemex is an important part of the strategy.

A complicated political outlook ahead

Politics will become complicated in 2024. Mexico will have a large federal election in June 2024. For now, most investors are focusing on the presidential race but, according to political analysts, the most important element of the election in 2024 could be Congress. They argue that it is Congress that will define the rules of the game and an absolute majority could open the door for radical policy swings. The general perception in Mexico is that the election will not be tight, but political analysts believe the election could become tight. This, in our view, increases political risks in 2024. Political analysts argue there are several elements that can move the needle

. On the political front, they see the future of Marcelo Ebrard and Movimiento Ciudadano as key events. They also believe that FX depreciation could be a politically important event if the race is tight. An MXN depreciation on the back of Banxico launching the easing cycle could trigger unwelcome political attacks against Banxico.

The next administration will have a tough start, as fiscal buffers are almost non-existent, expenditure from the current infrastructure programs will disappear, there is little room to cut expenditure and there are pressures on the expenditures side from many social programs started during this administration, high interest rates and Pemex. Hacienda policymakers said they believe that at some point revenue measures will be needed.

We also meet with the economic team from the main opposition coalition. The team prefers a weaker MXN and lower interest rates. They argue that a strong peso hurts competitiveness, putting downward pressure on exports, hurting the purchasing power of remittances, and tourism. The opposition believes growth in Mexico is too low. The main driver, in their view, is lack of investment. They believe that Mexico needs more private investment, which would require boosting investor confidence and strengthening the rule of law. A virtual circle would allow lower interest rates and a weaker exchange rate. The opposition team expressed concern about the increase in the deficit, which goes against the conservative policy that the government had been pursuing. This will put pressure on the first year of the administration, should they win, as a fiscal consolidation would be necessary. Regarding the energy sector, they are strongly in favor of allowing private investment to return. They argue that centralization of CFE and Pemex has led to lost capacity and financing problems. Opposition aides also believe the Congressional result is almost as important than the presidential election.

Nearshoring is a reality, but there are constrains

Nearshoring is a reality and is giving an impulse to Mexican exports and manufacturing and construction. The main challenge seems to be energy but there are others. For now, it is helping growth (and pressuring prices). Mexico recently surpassed China to become the country with the largest share of US imports.

Energy is a problem in Mexico, especially given nearshoring. Energy transmission is the biggest problem in the short-term, but energy generation is an issue in the medium-term. To keep up with energy demand, Mexico would need to invest heavily. The silver lining is that the damage to the energy sector is reversible without a constitutional amendment.

Remittances would likely be resilient

Remittances are still supporting consumption, but do not fully explain the resilience of the Mexican economy. Banxico believes that remittances are explained by labor market dynamics in the US (e.g., more Mexicans entering the labor market, the low unemployment rate) and the resilience of the US economy. If the US decelerates, remittances would be affected, but Banxico believes the drop would be mild. In our view remittances will likely be more cyclical than what most people expect, amplifying Mexico's cycle.

LDM Strategy: A complicated outlook

In our view, the outlook for local markets in Mexico is becoming challenging. The main takeaways from our trip were a stronger conviction that Banxico will remain hawkish and concerns that fiscal risks may be higher than initially expected. This, coupled with pressure from US rates in the belly and back-end of the curve, complicate outright receivers despite the seemingly attractive levels.

In our view, the best expression to position for a lower back-end once US rates stabilize are flatteners between the front-end and belly. This allows to remain neutral to the level of the curve, avoids exposure to fiscal risks that could put pressure in the back-end, benefit from a hawkish Banxico, and earns positive carry.

The outlook for the exchange rate is more nuanced. A more hawkish Banxico means that the wide interest rate differential may continue to provide short-term support to the peso. However, our core view continues to be that the Mexican peso (MXN) remains overvalued, largely driven by carry (see Keep calm, but don't carry on with MXN), and vulnerable to a risk-off shock (see The Kryptonites to the Super Peso). Mounting concerns about the fiscal outlook, as well as potential political noise on the back of elections in both Mexico and the US in 2024 are also medium-term risks. Lastly, long MXN positioning continues to be heavy and could act as a shock amplifier should the market transition into a carry-unwinding mode.

News and Views

Brazil: August Total Tax Collections fell 4.1% yoy, in real terms

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Total Tax Collections reached R$172.8bn in August (down from R$153.4bn in July), according to the Brazilian Internal Revenue Service (IRS). The result was in line with market expectations of R$172.5bn. Year-over-year, total tax revenues increased 0.3% in nominal terms (vs -0.4% in July), though declined 4.1% in real terms (vs -4.2%).

- **To follow:** This print was the third consecutive negative result in real terms. These prints had been influenced by changes in tax legislation and atypical payments in both 2022 and 2023, especially the Corporate Income Tax (IRPJ) and the Social Contribution on Net Income (CSLL). The exemptions granted in the Tax on Industrialized Products (IPI) and on contributions to Social Security (PIS/Cofins) also influenced the result. Ahead, a muddle through in activity threats tax collections performance.

Mexico: Retail sales were slightly above expectations in July at 5.1% yoy nsa

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Retail sales were slightly above expectations in July at 5.1% yoy nsa (E. 4.9%, BofA 6.7%). At the margin, retail sales increased 0.2% mom sa (E. 0.2%, BofA 0.9%), a deceleration from 2.2% the previous month. Employment in retail decreased 0.6% mom sa (vs +1.0% in June), while real wages remained unchanged for the second month in a row. Wholesale sales also increased at the margin 1.3% mom sa, from 0.7% mom in June, although they are still contracting -3.3% yoy nsa.

- **To follow**: Consumption in Mexico remains strong, and the increase in wholesale sales anticipates strength will likely continue, which puts pressure on prices and hence on Banxico.

Mexico: Headline inflation was below expectations in 1H September at 0.25%

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Biweekly headline inflation in 1H September was below expectations at 0.25% (E. 0.27%, BofA 0.39%). However, core inflation was above expectations at 0.27% (E. 0.25%, BofA 0.24%). The surprise in core inflation is mostly explained by higher-than-expected education prices inflation at 2.91% (elementary school) and higher than expected non-food merchandise inflation at 0.27% (automobiles). The main drivers to the downside in non-core were lower than-expected fruits and vegetables inflation at 0.53% (orange) and lower than expected energy inflation at -0.23% (household gas). In annual terms, headline inflation is now at 4.44% from 4.60% yoy while core inflation is now at 5.78% from 5.96% yoy a fortnight ago.

- **To follow**: Inflation keeps falling, but the level of core remains high with pressure on services, Banxico is likely to remain on hold for many months waiting for inflation to keep falling and for inflation pressures to ease.

Mexico: Monthly GDP surprised to the downside at 0.15% mom sa in July

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Monthly GDP (IGAE) in July surprised to the downside at 0.15% mom nsa (E. 0.26%, BofA 0.35%), from 0.50% mom sa in June. By components, the main driver to the downside was agriculture with -0.22% mom sa (vs -1.00% in June), while services decreased -0.07% mom sa (vs +0.37% in June). On the other hand, industry rose 0.45% mom sa (vs 0.78% in June). On annual terms, IGAE increased 3.19% yoy nsa (E. 3.60%, BofA 2.97%). Year-to-date, IGAE has increased 3.6%, with the construction sector growing 12.6% ytd (and 25.6% yoy).

- **To follow**: This print already reflects the new 2018 base. The economy is still growing above 3% but at the margin the deceleration in services is now becoming more noticeable.

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