CAPITAL ECONOMICS

LATIN AMERICA ECONOMICS UPDATE

Mexico: strong wage growth to curb fall in inflation

- **Headline inflation in Mexico will continue to fall back over next couple of years, but strong wage growth means that it won't return to Banxico's 2-4% tolerance band until late-2024. Against that backdrop, we think the central bank will deliver two more 25bp interest rate hikes, to 11.50%, and will not turn to loosening until the very end of this year. Our interest rate forecasts lie well above the consensus and what is priced into financial markets.**

- Notwithstanding a slight pick-up in January, headline inflation in Mexico has eased from its peak of 8.7% y/y in September to 7.9% y/y. And the mid-month inflation figures suggest that it eased further in February. (See Chart 1.) That said, inflation has been slower to fall back than the central bank, Banxico, had anticipated and policymakers delivered a larger-than-expected 50bp hike, to 11.00%, in February.

- The disinflation process still has further to run for three main reasons. **First, food inflation should continue to ease**. Agricultural price inflation – included in the non-core category – dropped back from the rates of 15-17% recorded through most of 2022, to 9.9% y/y in January. Based on the historical relationship with global agricultural prices, it should continue to fall (see Chart 2), although persistent drought conditions in Mexico threaten a rebound in agricultural inflation late this year.

- Core food inflation, which has been steady at 14.1% y/y for the past three months, should also start to come down. More than three-quarters of core food products are recording falling inflation, including those that have contributed the most to stronger headline inflation over the past couple of years (such as breads, tortillas, milk and beverages).

- **Second, energy inflation will remain in check**. Fuel inflation in Mexico has been weaker than in many other parts of the world after the government turned to subsidies to stabilise prices. And, as crude oil prices have fallen, the government has been able to scale back support without causing local fuel prices to surge. Our forecasts for crude prices imply that fuel inflation will remain contained over the course of this year.

- Similarly, after being liberalised in 2017, the government re-introduced a cap on LPG prices in mid-2021. Global natural gas prices have continued to decline recently with Henry Hub prices now at their lowest level since Q3 2020. We recently revised down our forecasts for gas prices and the result is that natural gas inflation in Mexico is likely to remain negative throughout this year.

- **Third, core non-food goods inflation will continue to drop back**. Pressures stemming from global factors, such as supply shortages and shipping costs, are fading. And the rally in the peso, which is currently at its strongest level since 2018, will push down imported price inflation – even if we think the currency will ultimately lose some ground. Producer price inflation in Mexico is consistent with a 3%-pt decline in core non-food goods inflation over the coming months. (See Chart 3.)

- **The main cause for concern is services inflation, which hit a fresh 20-year high of 5.5% y/y in January and rose further in the first half of February**. (See Chart 4.) Rising housing inflation, due to higher "domestic service" inflation, as well as strong education inflation, due to schools raising tuition fees at a faster pace in the new academic year, are partly to blame. Among "other" services, airfares and tour packages have played a role. But price pressures have also strengthened in areas such as medical care, hairdressing and dry cleaning.

- **The underlying driver of services inflation appears to be tight labour market conditions leading to strong wage growth**. The unemployment rate has dropped to 2.9%, its lowest level since 2005. (See Chart 5.) And this has pushed up wage growth (See Chart 6.) – in line with the past relationship between the unemployment rate and wage growth (i.e. the Phillips curve, see Chart 7). Early indicators for January point to a further pick-up in wage growth at the start of this year. As Chart 8 shows, there is a good relationship between wage growth and services inflation.

- **Wage pressures are being fuelled further by the sharp increases to the minimum wage that have been implemented during President López Obrador's time in office**. (See Chart 9.) After the 22% increase at

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the start of 2022, close to 35% of workers in Mexico were being paid the minimum wage. That share dropped back over the course of last year, suggesting that the minimum wage increases fuelled faster wage increases across the workforce. The minimum wage was raised by another 20% in January.

- Throughout most of the past couple of years, wage rises have been more than matched by increases in productivity. The result is that unit labour costs – that is, the cost of labour needed to produce one unit of output – have declined, implying that firms have been able to absorb higher labour costs. **But the improvement in labour productivity appears to have run its course – productivity *declined* over the second half of last year – at about the same time that services inflation surged**. (See Chart 8 again.)
- A slowing economy, combined with fading inflation pressures, should take some steam out of the labour market, causing wage growth to soften. That said, we anticipate only a modest rise in unemployment to around 3.5% by the end of this year which would be consistent with wage growth remaining strong, at around 6% or so. **On past form, that points to services inflation easing to around 4% y/y, compared with a pre-pandemic average of closer to 3%.**
- Overall, we expect headline inflation in Mexico to continue falling back over the course of this year. **But with services inflation likely to ease relatively slowly, we doubt that headline inflation will return to Banxico's 3±1% target range until end-2024**. (See Chart 10.) Our forecasts for inflation to average 6.0% this year and 4.8% in 2024 (previously 5.5% and 4.0% respectively) lie well above those of the consensus and Banxico's own projections. (See Chart 11.)
- **While the minutes from Banxico's last Board meeting suggested that the end of the tightening cycle is near, we now think that policymakers will opt for two more 25bp interest rates, to 11.50%** (previously we thought there would be a final 25bp hike this month). The hawkish tone of Fed Chair Jerome Powell's testimony to Congress yesterday also supports the case that Banxico will tighten a bit further".
- **What's more, it will probably take a bit longer than previously envisaged for Banxico to turn to loosening**. We've pencilled in the first interest rate cut for December (to 11.25%) and for rates to be lowered to 9.25% by end-2024 (previously 10.25% and 8.25% respectively). Our forecast is higher than that priced into financial markets. (See Chart 12.)

Chart 1: Consumer Prices (% y/y)

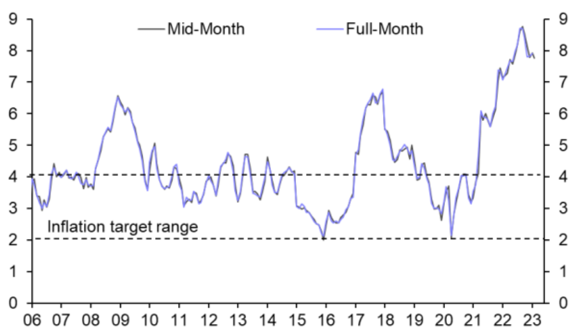


Chart 2: S&P GSCI Agricultural & Agricultural CPI (% y/y)

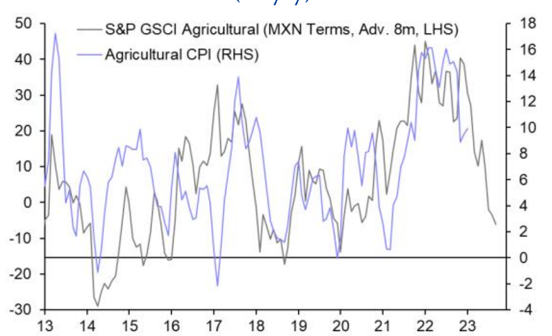


Chart 3: Final Goods PPI (ex. Oil) & Core Non-food Goods CPI (% y/y)

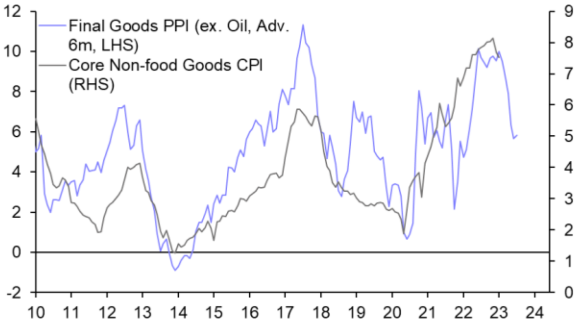
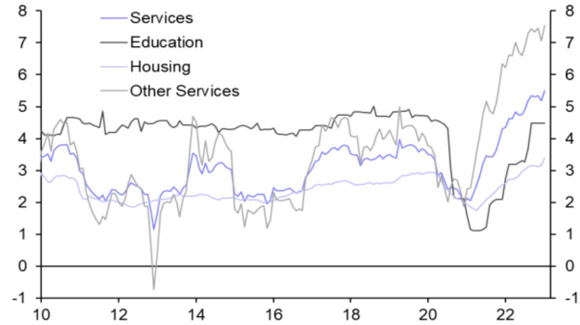


Chart 4: Services Consumer Prices (% y/y)



Sources: Bloomberg, Banxico, CEIC, Refinitiv, Capital Economics

Chart 5: Unemployment Rate (%)

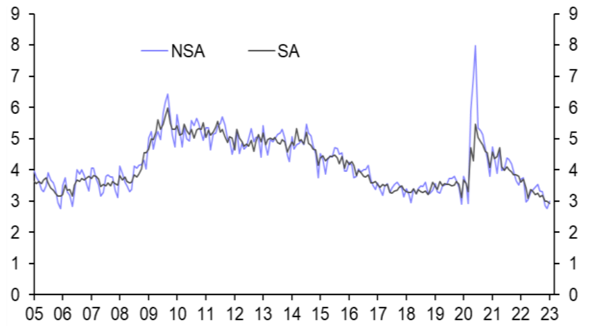


Chart 6: Wages (% y/y)

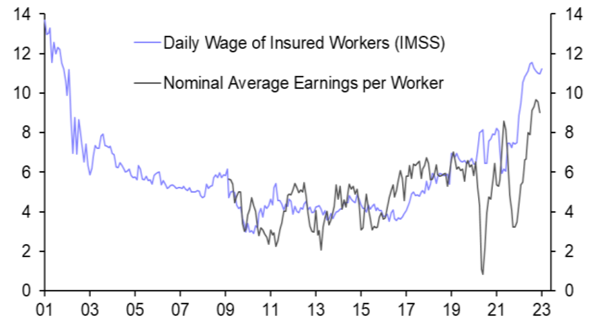


Chart 7: Phillips Curve (2009 – 2022)

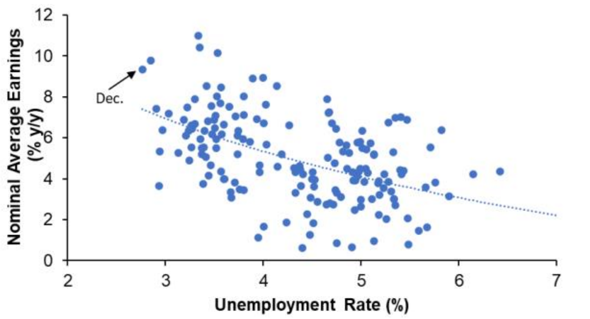


Chart 8: Services CPI & Nominal Average Earnings (% y/y)

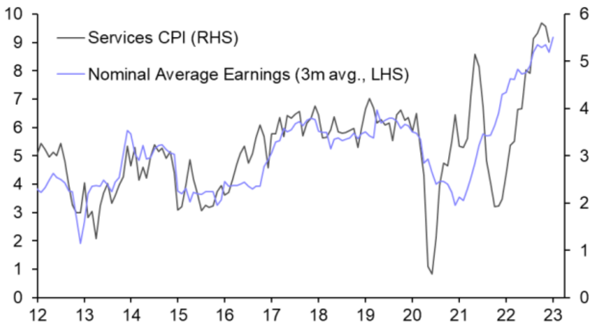


Chart 9: Minimum Wage (Daily, MXN)

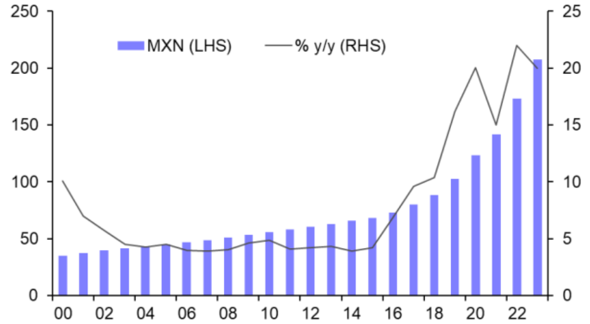


Chart 10: Consumer Prices (% y/y)

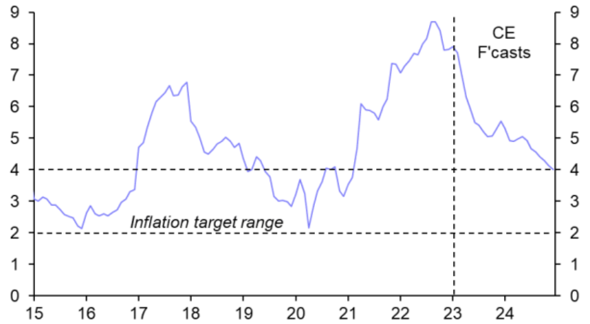


Chart 11: Inflation Forecasts (%)

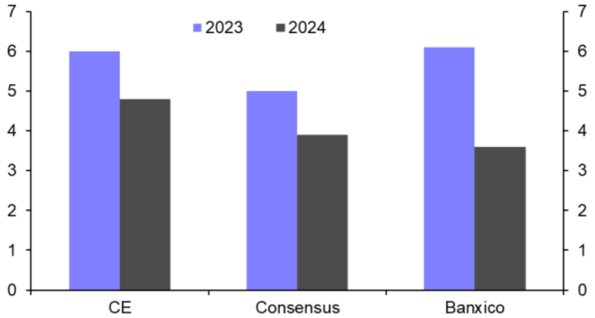
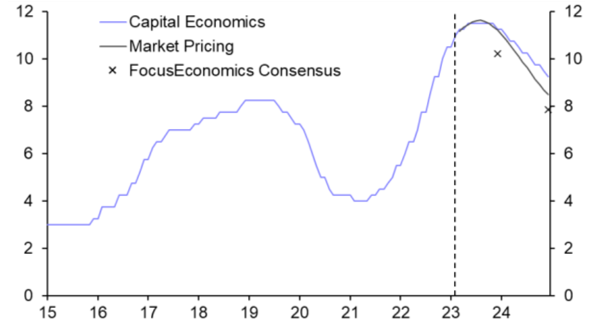


Chart 12: Policy Rate (%)



Sources: Bloomberg, Banxico, CEIC, Refinitiv, Capital Economics