The Minimum Wage will increase 20% in 2020

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- **In a joint event, the President, representatives from the Ministry of Labor (STPS), the private sector, and the *National Commission for Minimum Wages* (CONASAMI), announced yesterday a 20.0% increase in the minimum wage (MW) for 2020, taking it from MXN$102.68 to MXN$123.22 per day**
- **This figure is higher than our estimate of a 10-15% increase**
- **In line with the government's policy that aims for a gradual recovery in wages, the increase was also above the 16.2% announced for 2019. As a result, the annual compound rate of increases since 2017 –when the magnitude started accelerating– stands at 14.0%**
- **In the case of the Northern Border the increase was 5.0%, with the wage floor set at MXN$185.56 from MXN$176.72 per day**
- **Wage dynamics in recent years suggest the effect of this increase in terms of pushing average wages higher will likely be more modest, a situation that could be exacerbated by the widening of the output gap**
- **Nevertheless, the effect on inflation going forward remains quite uncertain. All in all, we believe it will likely be manageable**
- **In our view, the announcement provides further support to our view that Banxico will keep easing monetary policy in a prudent manner and in 25bps steps, still recognizing risks to the outlook for core inflation**

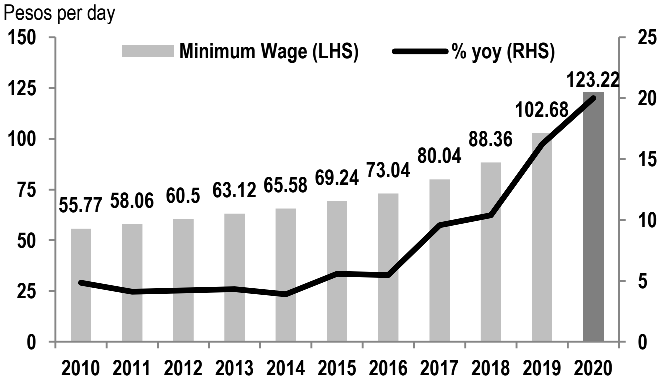
Minimum wages increase of 20.0% for 2020. Yesterday, in a joint event, President Lopez-Obrador, representatives from the Ministry of Labor (STPS), the private sector, and the *National Commission for Minimum Wages* (CONASAMI, in Spanish) announced an upward adjustment to the minimum wage (MW) starting January 1st, 2020. Since 2019, revisions have been differentiated in two regions. The first contemplates municipalities located 25km next to the northern border as well as some neighboring them, identified as the *Border Minimum Wage*. This will increase 5.0%, to MXN$185.56 per day (around USD$9.80) from MXN$176.72. The second, which is the minimum wage for the rest of the country will increase to MXN$123.22 from MXN$102.68 (+20.0%; around US$6.50), above our call of a 10-15% increase. In this latter case, the MXN$20.54 revision is composed of two factors: (1) A MXN$14.67 increase (+14.3%) in the *Independent Recovery Amount* –designed to compensate Mexican households from purchasing power losses–; and (2) considering the updated amount of MXN$117.35, a MXN$5.87 rise (5.0%) linked to inflation. In this sense, it is important to mention that average annual inflation since November 2018 stands at 3.81%, significantly below the 5.06% at the same moment of the previous year.

Increase slightly above that of 2019. This revision is the highest in recent years (see chart below on the left), in a context in which they have been accelerating their pace. In particular, the average increase during 2010-2016 was 4.6%. Meanwhile, during 2017-2019 it stood at 12.1%. In this latter period, the average inflation rate was 4.8% (using data for November), implying relevant real wage gains. Taking into account the planned hike for 2020, the compounded annual pace of growth since 2017 would be 14.0%.

Also similar to 2019, the share of the labor force impacted by the MW hike has been increasing. In this regard, and according to the *National Employment Survey* ("*Encuesta Nacional de Ocupación y Empleo"*, ENOE, in Spanish), as of 3Q19 around 24.4% of the labor force –excluding those not reporting their income– earned up to one MW, totaling around 10.9 million people. This is 4.4%-pts higher than in the same period of 2018, resulting in about 2.4 million more workers. As the absolute level of the MW keeps increasing it is likely going to be binding for more people, despite the negative effect that it could have on labor demand.

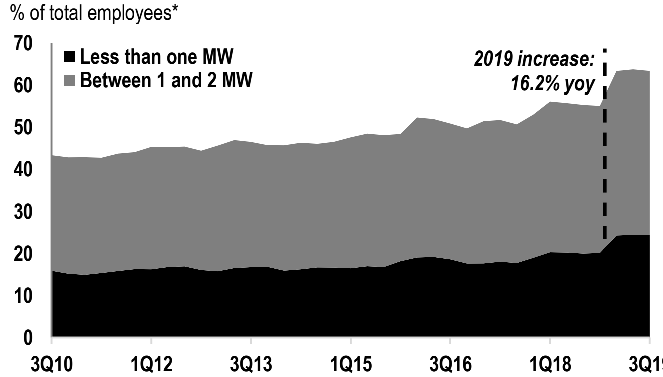
In this respect, we note that the share of the labor force earning between one and two minimum wages has increased to 39% currently from 35% one year ago (chart below, right). However, we do not have specific details about the distribution within this latter group, thus we cannot estimate the number of people that could be benefitted by the revision. The Labor Minister, Luisa Maria Alcalde, stated that around 3.44 million workers are estimated to improve their conditions due to the new MW.

Average minimum wage by year*
Pesos per day



*Note: From 2019 onwards, the amount and percentage increase refers only to the minimum wage that excludes the Northern Border, as both are differentiated
Source: Banorte with data from INEGI

Employees by income level*
% of total employees*



*Note: Excluding from the labor force those that do not report their income level
Source: Banorte with data from INEGI

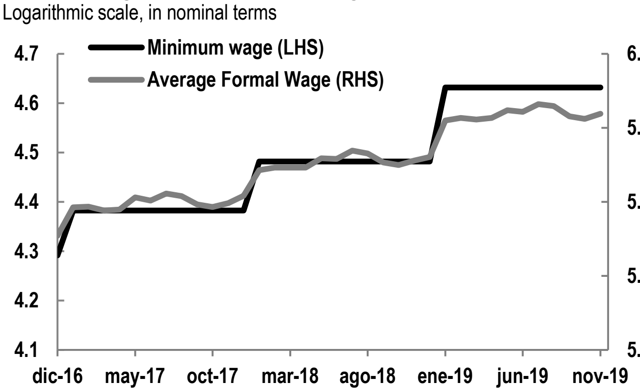
Uncertainty about the impact of higher wages has increased, but will likely be more modest than history suggests. There has been a lot of debate about the possible effect of the MW increase on employment and inflation, both of which could be driven by its direct impact on production costs and its indirect effect on pushing the wage distribution higher in the economy (the so-called "lighthouse effect"). In this regard, results from our previous work estimated that a 10% MW hike would increase twelve-month inflation by around 30bps. For details, see: "*Abnormal increase in minimum wage will have a marginal effect on inflation*", <pdf>, November 21st, 2017.

On the other hand, back in 2016 (which, to the best of our knowledge, is the latest update), Banxico proposed an econometric model estimating the direct- and indirect-effects of an increase in the MW on the "*Basic Formal Wage"* ("*Salario Básico de Cotización",* in Spanish) to estimate the latter's impact on inflation. For details, see: "*Salario Mínimo e Inflación*", <pdf>, June 2016 (only available in Spanish). Considering only the direct impact, Banxico estimated that a 10% increase in the MW would increase inflation around 150bps in the following 12 months and up to 170bps in 24 months.

Nevertheless, we warn that any estimation is highly uncertain and should be taken cautiously. It is our take that forecasts based on historical data could be skewed, as we have noted that MW increases have been having a more modest impact in the *Basic Formal Wage* (BFW) in recent years. This is relevant as it would arguably be one key factor driving the magnitude of the lighthouse effect, and eventually, pressures on inflation. In this respect, the chart below on the left shows both of these wages (in logs for scale), in which we highlight that a wider gap has opened between them, particularly after last year's increase.

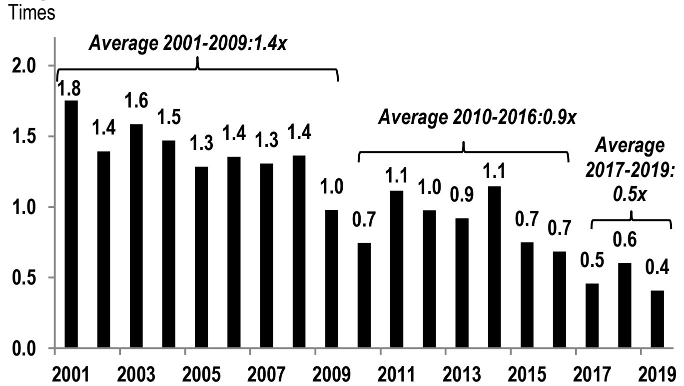
Moreover, this trend has been relatively persistent and has exacerbated. For example, the chart below on the right shows the BFW increase as a ratio of the MW hike each year since the start of the century (both in percentage terms). Based on this metric and until the 2008/2009 Financial Crisis, a MW increase was associated with an increase of about 40% *more* in the BFW. This diminished in the post-crisis period (2010-2016) to about one-to-one. Nevertheless, just in the last three years and when the pace has accelerated, it declined further, resulting in an increment of about 50% *less* in the BFW. Based on this, its most recent average sensitivity, and a very simple model[1], we estimate that the 20.0% MW increase for 2020 would result in BFW climbingre between 7.9-9.8% (in nominal terms). Although the MW increase was slightly higher than our expectations, it is our take that it should be manageable in terms of overall inflation dynamics, particularly when also taking into account the widening of the output gap (estimated at -1.7% of potential GDP as of 3Q19), which reduces demand-side price pressures.

Minimum wage and Basic Formal Wage
Logarithmic scale, in nominal terms



Source: Banorte with data from INEGI

Wage increases: BFW and MW*
Times



*Note: The measure presented is the ratio of the increase observed in the BFW divided by the announced increase in the MW. For 2019, the BFW is the year-to-date average until November.
Source: Banorte with data from INEGI

[1] OLS model with dependent variable being the BFW (in logs) and independent variables including: (1) Log of the minimum wage; (2) lagged dependent variable; (3) lagged inflation; (4) lagged output gap; (5) dummy for gasoline price hike in 2017; and (6) dummy for the 2017-2020 period.

Banxico to keep easing policy in a prudent manner. Despite elevated uncertainty about the possible impact in the outlook for prices, it has been quite clear for a long time by now, that the central bank sees wage increases above productivity gains as one of the main upside risks to inflation. In fact, this is currently in second place in the relative ranking of the balance of risks, in spite of headline inflation hovering virtually at Banxico's target (reaching 2.97% yoy at the end of November). The move lower in inflation, from 4.83% by year-end 2018, has been driven to a great extent by the non-core component, currently at a quite low level of 0.98%. In contrast, components such as other services within the core, more influenced by domestic wages, is running still relatively high (4.16%), showing some resistance to the downside despite the widening of the output gap.

In our view, the announcement and the dynamics observed in the main inflation components will keep most Banxico members prudent in terms of the pace of the easing cycle, preferring to cut the reference rate gradually (in 25bps steps). In this context, we continue expecting the central bank to lower the reference rate by 25bps in Thursday's policy decision, to end the year at 7.25%. Moreover, for 2020 we anticipate a 125bps accumulated reduction, front-loaded during the first semester, for the year-end rate to reach 6.00%. Although this is our base-case, we cannot rule out that the easing cycle could eventually be more modest, particularly if: (1) Core inflation keeps showing resistance to the downside or increases from here; and/or (2) the exchange rate depreciates strongly and inflation exhibits higher pass-through effects from currency weakness.

We will incorporate the estimated effect of this increase in our 2020 inflation forecast, which in our view remained as a key missing component. Despite of this, we continue believing that the outlook for prices remains benign, among others because of the Federal Government's commitment to keep energy prices constant in real terms. These are relevant for the outlook of non-core inflation, with an accumulated weight of gas, gasoline and electricity of almost 10% in the headline. We believe these should help inflation stay contained, despite some agricultural goods prices starting to show signs of mean-reverting after exhibiting very good dynamics this year.

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We, Gabriel Casillas Olvera, Delia Maria Paredes Mier, Alejandro Padilla Santana, Manuel Jiménez Zaldívar, Tania Abdul Massih Jacobo, Katia Celina Goya Ostos, Juan Carlos Alderete Macal, Víctor Hugo Cortes Castro, Marissa Garza Ostos, Miguel Alejandro Calvo Domínguez, Hugo Armando Gómez Solís, Gerardo Daniel Valle Trujillo, José Itzamna Espitia Hernández, Valentín III Mendoza Balderas, Santiago Leal Singer, Francisco José Flores Serrano, Luis Leopoldo López Salinas, Jorge Antonio Izquierdo Lobato, Eridani Ruibal Ortega and Leslie Thalía Orozco Vélez, certify that the points of view expressed in this document are a faithful reflection of our personal opinion on the company (s) or firm (s) within this report, along with its affiliates and/or securities issued. Moreover, we also state that we have not received, nor receive, or will receive compensation other than that of Grupo Financiero Banorte S.A.B. of C.V for the provision of our services.

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