MEXICO

A CONSTRAINED ECONOMY

The Mexican economy is slowing down and the short-term outlook is not favourable. The constitutional reforms enacted in recent months (including the reform of the judicial system) are damaging the institutional framework and deterring investment. In addition, consumption could be hit hard by the fiscal consolidation plan announced by the government. Above all, Mexico is one of the most vulnerable countries to the US economic policy change. The new migration measures could significantly reduce money transfers from foreign workers, which significantly support the country's growth. The expected customs tariffs applied would also have severe consequences for the Mexican economy in terms of growth and inflation.

SLOWDOWN IN GROWTH

Activity has slowed in recent months (the PMI index was below 50 throughout the second half of 2024) and the outlook is still poor in the short term.

Political uncertainty, in the US and Mexico, will weigh on investment spending and private consumption. If the strengthened anti-immigration measures promised by the new US administration were implemented, resulting in a massive return to Mexico of citizens working on US soil, the transfers of foreign workers, an important support for private consumption, would be permanently affected. They have increased steadily over the past five years and are estimated to have accounted for nearly 3% of GDP in 2024. A 30% drop in these transfers would reduce GDP growth by nearly 0.75 percentage points. The fiscal consolidation promised by the government is also expected to reduce public spending.

Finally, exports will be affected by the political decisions made by the new US administration. All in all, GDP growth is expected to remain close to 0.5% in 2025, and remain well below its potential level in 2026 (estimated at 1.8% by the IMF).

FORECASTS

	2022	2023	2024e	2025e	2026e
Real GDP growth, %	3.9	3.2	1.5	0.5	1.2
Inflation, CPI, year average, %	7.9	5.6	4.7	3.8	3.8
Budget balance / GDP, %	-4.3	-3.3	-5.1	-4.4	-4.2
Public debt / GDP, %	46.9	46.5	49.1	51.5	53.2
Current account balance / GDP, %	-1.2	-0.3	-0.1	-0.1	-0.3
External debt / GDP, %	41.9	33.3	31.0	32.0	33.0
Forex reserves, USD bn	194.0	207.0	214.0	219.0	226.0
Forex reserves, in months of imports	4.8	4.1	4.3	4.5	4.2

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

MEXICO: PERSISTANT INFLATION PRESSURES

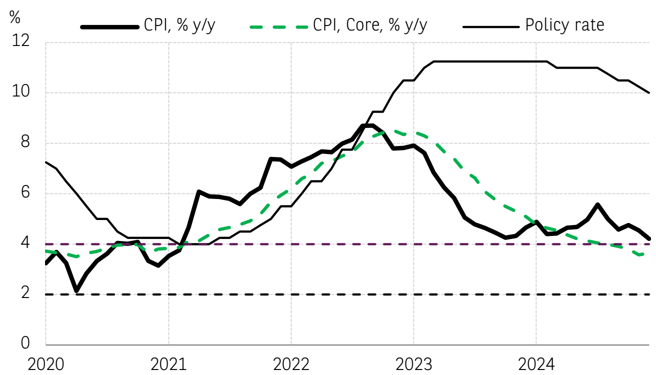

CHART 1

CENTRAL BANK, BNP PARIBAS

PERSISTENT INFLATIONARY PRESSURES

Inflation fell steadily in the second half of 2024, dropping to 4.2% in December. However, inflationary pressures can still be felt, with wages rising by nearly 10% in 2024, following successive minimum wage increases (+135% in real terms since AMLO became President of Mexico in 2018), and production prices continuing to rise by a rate of more than 5%.

Inflationary pressures will be sustained by wage increases during the coming months, as the new President of Mexico, Claudia Sheinbaum, has taken up the "fourth transformation" measures and is planning a number of minimum wage increases during her term of office. As a result of these efforts, she wants the minimum wage to be equal to 2.5 times the basket of essential goods by 2030 (compared to 1.8 currently). With this in mind, the minimum wage was raised again, by 12% on 1st January 2025 in the free zones on the northern border.

According to the latest estimates by the Bank of Mexico, the inflation target (3%) will only be hit in Q3 2026.

The Bank of Mexico cut its key interest rate five times in 2024, taking it down to 10% by December. In its statement, it indicated that this rate could continue to come down in the coming months if disinflation continued. However, a number of members noted the risk posed by the new US economic policy, which could constrain Mexican monetary policy. The effects on inflation are still difficult to quantify: on the one hand, tariffs would weaken the peso, which would increase import prices, producer prices, and finally inflation (reinforced by the likely rise in US inflation, which would be reflected in value chains). But, on the other hand, the recessive effect on growth could accelerate the process of disinflation.

DETERIORATING PUBLIC FINANCES

The public deficit has increased substantially over the past five years, rising from -2.7% of GDP in 2020 to 5.1% of GDP in 2024. As she promised in her election campaign, President Sheinbaum announced a fiscal consolidation policy, with the budget adopted by the Chamber of Deputies aiming to bring down the public deficit to 3.5% of GDP in 2025. This process is expected to take longer, however. This is because of, on the one hand, the seemingly overly optimistic growth assumptions used in the budget (around 2.5% of GDP), and on the other hand (and above all), the rigid public spending and the financial support required by PEMEX, the national oil company. By adding access to social transfers to the constitution, a measure adopted by the Senate at the end of last October, this rigidity is now even greater. Even though the details of this reform are not yet known, including how it is going to be implemented, the government's ability to make spending adjustments will be reduced even further in the coming years. In addition, the President's plans around adopting a large-scale tax reform (which would streamline expenses and improve collection) are still vague.

Interest payments have increased in recent years and are expected to account for 15% of the country's revenue in 2025 (compared to 12% in 2018), reflecting the sustained rise in the rates used by the government for financing itself. The refinancing and market risk is low in the short term for the government (maturities are long and foreign currency exposure is still limited), but the latter is still vulnerable to a shift in investor sentiment (30% of the peso-denominated public debt is held by foreign investors).

MEXICO : ACCELERATING PUBLIC FINANCE DETERIORATION

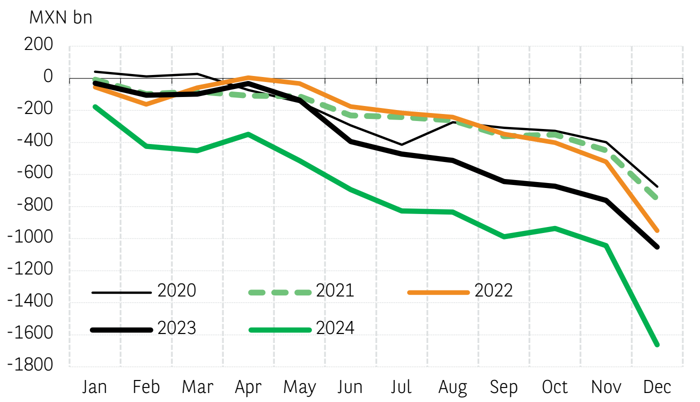

CHART 2 SOURCE: SECRETARY OF FINANCE AND PUBLIC CREDIT, BNP PARIBAS

POLITICAL RISK HITS FORECASTS HARD

Mexico, the United States' main trading partner (15% of imports) ahead of China (13%), is one of the most vulnerable countries to the US economic policy change.

As promised during his election campaign, Donald Trump announced several measures relating to Mexico as soon as he took office on 20 January. Rather than the scale of the trade deficit (estimated at nearly USD 170 billion for 2024), Trump expressed strong concern about the flow of illegal immigrants and drug trafficking from Mexico to the United States. A national emergency has been declared at the border, drug cartels will now be classified as terrorist organisations and asylum seekers will have to stay in Mexico (and no longer in the United States) while waiting for their claim to be processed.

In particular, a 25% increase in customs tariffs could affect all imports from Mexico from 1st March. An increase is also expected to be applied to Canadian (25% as well) and Chinese (10%) products.

This announcement can be interpreted as a desire to open negotiations on revising the USMCA trade agreement between the three countries (USA, Canada and Mexico) now, as opposed to the scheduled start date in Q4 2025. In addition, rather than revising it, Trump will likely want to renegotiate the agreement, just as he did during his first term of office (the road to signing the USMCA in 2020 began with revising the NAFTA in 2017).

In Mexico, the government's intentions are clear. Since the UMSCA was signed in 2020, Mexico has also gradually imposed tariffs on some products from Asia. At the same time, a number of measures have been put in place to regulate the flow of illegal workers to the United States and drug trafficking, but the effects are harder to measure. Finally, a few days before 20 January, President Sheinbaum presented the so-called "Plan Mexico" intended to reassure the US administration, by announcing measures aiming to reduce Chinese involvement at all stages of production, particularly in the automotive sector. The details are not yet known, but, in her speech, the President mentioned "import substitution", the need to "increase foreign direct investment in order to create value added" and "ramping up".

The aim is to significantly increase the share of Mexican value added in exports, which is still low. The plan also seeks to secure nearshoring opportunities that are currently not particularly prominent. Alignment on customs tariffs on China was also suggested.

Despite these announcements, Mexico's bargaining power is low and there is still a lot of work to be done. None of the structural difficulties of the Mexican economy were mentioned in the plan (low productivity, a lack of infrastructure and low public spending on R&D, in particular). In addition, all of the economic policies initiated during AMLO's term of office (and adopted by the current administration), such as reforming the energy sector (increased State involvement, lack of transparency and restrictions on private investors, particularly foreign investors), seemingly run counter to the commitments requested by Trump. The constitutional reforms undertaken last year (particularly the reform of the judicial system, which is weakening the institutional framework) have made the country even less attractive to investors. Most importantly, these reforms are out of line with the criteria for acceding to the USMCA.

That said, even though the negotiations promise to be tough, our central scenario is still that an agreement will be reached and the USMCA will be renewed. Mexico appears to be the most vulnerable country, but the imposition of tariffs would in fact have potentially far-reaching macroeconomic consequences for all countries involved.

The integration of the US and Mexican economies has increased considerably in recent years, particularly since Trump's first term of office. Mexican exports to the United States now account for nearly 85% of the country's total exports (i.e. nearly 30% of GDP). They have diversified and make up a growing share of the value chains connected to the United States. In the automotive industry, for example, intermediate goods cross the US-Mexico border several times before the final assembly of a vehicle, meaning imposing high customs tariffs at each stage of manufacturing would be extremely costly for both countries.

Hélène Drouot
helene.drouot@bnpparibas.com