MEXICO

IN THE EYE OF THE STORM

The outlook continues to deteriorate in Mexico, one of the countries most exposed to US economic policy. The Mexican economy is set to contract in the coming quarters, with weak domestic demand unable to offset the marked slowdown in exports. Mexico's Minister of the Economy has begun talks with Washington on a faster-than-expected renegotiation of the USMCA free-trade agreement. The aim is to reduce the short-term uncertainty surrounding bilateral relations between the two countries.

SLIGHT RECESSION IN SIGHT

Economic activity has held up better than expected in Q1 2025. GDP grew by 0.8% year-over-year in Q1 (after 0.4% in Q4). Details of GDP components are not yet available, but economic data suggest that growth was largely underpinned by buoyant exports (+3.6% y-o-y). This was achieved due to anticipation of the additional tariffs announced by the Trump administration. In contrast, other indicators (private consumption, industrial production, employment) point to a marked slowdown in activity. The monthly investment index also fell sharply (-7% y/y) in Q1.

The outlook is clearly bleak, with GDP expected to fall by 0.3% in 2025, making it one of the few emerging countries to record a recession in 2025... Exports are likely to suffer under the combined effect of the slowdown in the US economy (our central scenario forecasts a growth of 1.7% in 2025) and the increase in US tariffs.

We do not expect domestic demand to rebound in the short term. Household consumption will remain sluggish at best. Our forecasts could be revised downwards if a new tax targeting the remittances of foreign workers (a major source of support for private consumption, accounting for almost 3% of GDP in 2024) is adopted by the US Congress. Initially proposed at 5%, the tax is now expected to represent 3.5% of total remittances, following strong protests from the Mexican government. The tax would affect nearly 70% of Mexican workers on American soil (it does not apply to naturalized workers). Furthermore, the final adoption of this tax would further complicate diplomatic relations between the United States and Mexico.

In addition, the new measures presented by President Sheinbaum to encourage private investment under the "Mexico Plan" are likely to have limited impact. A few measures presented at the beginning of April are worthy of note, notably in the energy sector. The role of the public sector will remain predominant (as previously announced), but new opportunities for partnerships with the private sector have been presented. The effect on investment is likely to remain marginal, at least in the short term. The business climate has deteriorated significantly. In addition, the negative effects of judicial reform (which includes the dismantling of several autonomous regulatory bodies) and the uncertain evolution of relations with the United States have resulted in a wait-and-see attitude on the part of investors (domestic and foreign) that will take time to dissipate.

The authorities' leeway to support the economy is limited: on the one hand, the government is committed to consolidating public finances, and it is unlikely that any support measures will be announced; on the other hand, support from monetary easing is weak, real rates remain high and the use of credit is relatively limited.

PERSISTENT INFLATIONARY PRESSURES

In April, headline and core inflation indices came out at 3.9% y/y (after 3.8% and 3.6% respectively in March). For the third time in succession, the Central Bank cut its main key rate by 50 basis points (to 8.5%) at its May 15 meeting. It also indicated that further rate cuts are envisaged in the short term.

However, short-term inflation forecasts have been revised slightly upwards, to 3.6% and 3.1% for 2025 and 2026 respectively (compared with 3.4% and 3.0% previously), mainly due to a stronger-than-expected rise in inflation for consumer goods.

The risks remain high, especially if the Trump administration adopts a more aggressive stance towards Mexico, and particularly if it imposes higher tariffs.

FORECASTS

	2022	2023	2024e	2025e	2026e
Real GDP growth, %	3.9	3.2	1.5	-0.3	0.2
Inflation, CPI, year average, %	7.9	5.6	4.2	3.8	3.8
Budget balance / GDP, %	-4.3	-3.3	-5.1	-4.0	-4.0
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: INVESTOR CONFIDENCE WEAKENS

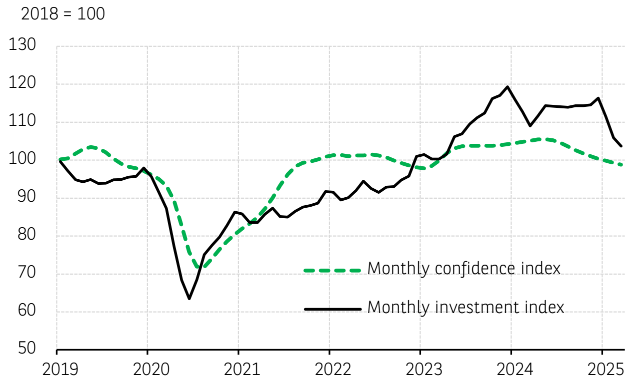

CHART 1

SOURCE: CENTRAL BANK, BNP PARIBAS

DEGRADATION OF PUBLIC FINANCES

In early April, alongside the preliminary presentation of the 2026 budget, the government revised its fiscal consolidation targets. Given the slowdown in activity, the expected reduction in the deficit has been downgraded from 5.1% of GDP in 2024 to around 4% in 2025 (previously 3.5%). Although the government's growth forecast seems overly optimistic (the government expects GDP growth of between 1.5% and 2.3% for 2025), this target looks achievable: tax revenues rose by 20% in Q1 relative to Q4 2024, thanks to recent measures to improve collection (on e-commerce in particular) and, to date, the reduction in public spending announced by President Sheinbaum is continuing.

In the medium term, however, fiscal consolidation is likely to become increasingly complicated. On the one hand, because interest payments will remain high (we estimate that they will reach 17% of government revenues in 2025, up from less than 12% in 2022), reflecting the prolonged rise in interest rates at which the government funds its needs. On the other hand, social spending and budgetary rigidities, a structural problem in the Mexican economy, will make it difficult to apply new austerity measures. The need to support the oil company, Pemex, and the government's determination not to implement any major tax reforms also represent major obstacles to fiscal consolidation.

RENEGOTIATION OF THE USMCA TRADE AGREEMENT, THE FOCUS OF ATTENTION IN THE MONTHS AHEAD

The outlook for risks in terms of growth and public finances is bleak, mainly due to uncertainty over US trade policy and bilateral relations between Mexico and the United States. As far as Mexico is concerned, tariff measures currently in force include an exemption for goods meeting the criteria defined in the trade agreement between the United States, Mexico and Canada (USMCA), while customs duties of 25% apply to all other products. In addition, specific customs duties, raised to 50% at the beginning of June, apply to steel-aluminum products and certain automotive products (light vehicles).

Around 80% of total Mexican exports, or 27% of GDP, are destined for the USA, and over 50% of total exports to the USA do not meet USMCA criteria and are therefore subject to customs duties. The effective rate of customs duties applied by the United States on imports of Mexican goods is therefore currently 12.1% (compared with virtually zero before the start of the second term).

This rate could fall if a greater percentage of exported goods was USMCA-compliant (by meeting rule-of-origin criteria, for example, or by clearing red tape). The margin seems significant for Canadian goods, but narrower for Mexico: according to US Census Bureau data, 48% and 47% of total goods imported by the USA were USMCA compliant in March and April 2025 respectively, after 45% in February (the average over the last five years is close to 50%). In Canada, on the other hand, the proportion of compliant goods jumped to 50% in March 2025, then 57% in April, after 33% in February (see graph), and the five-year average is close to 36%.

MEXICO: US IMPORTS WITH USMCA CRITERIONS

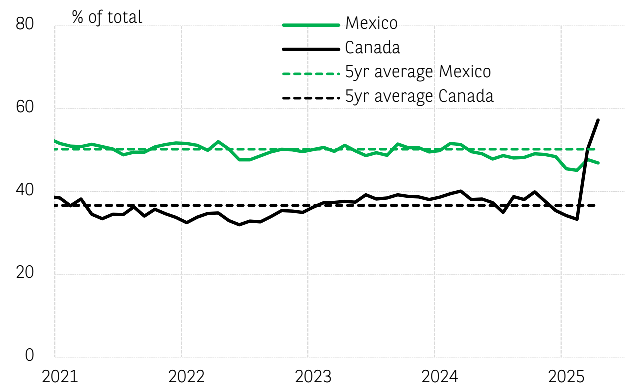

CHART 2

SOURCE: CENSUS BUREAU, BNP PARIBAS

Sectoral distribution is highly heterogeneous in both countries, with the exception of the automotive sector, where 84% and 90% of goods exported in 2024 were USMCA-compliant in Mexico and Canada respectively. Mexico's market share of US imports could ultimately decline.

In order to reduce the uncertainty surrounding the renewal of the USMCA trade agreement, Minister of the Economy, Marcello Ebrard, requested the opening of negotiations in May, even though they were scheduled to start in mid-2026.

In 2020, when the USMCA replaced the NAFTA, negotiations had been successful and strengthened the nearshoring process. The outlook is much less positive this time around for Mexico, given President Trump's stated preference for relocating production to the USA. In addition, Mexico's structural difficulties and deteriorating business climate will continue to severely limit investment in the country.

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