Prospects

Aperiodic – no. 25/087 – 13 March 2025

The point of view

Mexico: an economy endangered by US trade tensions

There has been yet another development in the trade war between the United States, Canada and Mexico. Despite the truce expiring and 25% import tariffs coming into force on 4 March, another one-month reprieve has been granted, expiring on 2 April.

Mexico has gone to considerable effort, reducing migrant flows by 66%, putting soldiers on the border, handing drug traffickers over to the US authorities and proposing to match US import tariffs on Chinese goods. The country is even considering withdrawing from the Trans-Pacific Partnership (TPP).

Mexican markets have proved relatively stable, with the peso even appreciating slightly, regaining some of the value it had lost since the US election. This reaction reflects the perception that these measures would be temporary and transactional in nature. The new one-month reprieve – first on vehicles and subsequently on all goods – has confirmed this view.

Mexican President Claudia Sheinbaum has maintained a cautious but firm stance, earning her a popularity rating of 85%. She had announced a gathering at Constitution Plaza to set out retaliatory measures but left enough time for a deal to be made, which is what ultimately happened.

With Trump's announcements often (deliberately) contradictory, his intentions remain hard to guess: he announced a one-month delay on 26 February only to confirm the entry into force of tariffs the very next day. Markets have assumed that this is a tactic to apply pressure to help renegotiate USMCA[1] in the United States' favour. Reactions and pressure from Wall Street and US carmarkers also influenced the decision to postpone the tariffs.

Although this new truce offers some respite, the persistent threat of import tariffs is creating uncertainty that is costly for Mexico. Mexico's goodwill and the high degree of integration of production chains between the two partners suggest that there is hope for a final deal in the form of a new USMCA. In the meantime, the uncertainty is punishing a Mexican economy that is slowing sharply: we take the opportunity to review the situation and the potential implications if import tariffs are imposed.

Mexico's growth is slowing

The Mexican economy went into recession in the final quarter of 2024, contracting by 0.6%, reducing annual growth in 2024 to 1.2%, well short of the beginning of the year forecast of 2.3%. The Bank of Mexico (Banxico) has downgraded its 2025 growth forecast from 1.5% to 0.6% because of the imposition of import tariffs.

The slowdown in the primary and secondary sectors since last summer (with industrial production down 2.6% in the second half of 2024) was exacerbated by weak activity in the tertiary sector, which had previously been supporting growth. Consumption is stagnating and confidence among businesses, and above all consumers, which was previously strong, is beginning to ebb. Growth is increasingly dependent on external demand.

[1] United States-Mexico-Canada Agreement.

The economic uncertainty is hitting investment particularly hard. Doubts over the future of free trade with the US, Mexican legal reform and high real interest rates (over 6%) are all having a severe impact. Imports of capital goods have declined, as has foreign direct investment (FDI) – which, moreover, is increasingly dominated by reinvestment rather than brand new investment. This highlights a degree of caution on the part of investors who, while they have not given up on the idea of nearshoring, are aware of the risks. Without a robust free trade agreement with the United States, the investment and growth promised in the Mexico Plan[2] may not materialise.

As regards the labour market, unemployment remains stable, but job creation and real wage growth are stalling despite disinflation. Funds sent by migrants to family and friends back home in Mexico (known as remesas) are also showing signs of slowing.

Meanwhile, the economic slowdown and restrictive interest rates have helped bring inflation down to 3.6% a year, back within the target range (3±1%) for the first time since 2021 despite peso depreciation. Banxico has eased its monetary policy, cutting rates by 50 bps in February, with a further 50 bps cut expected following its 27 March meeting. The central bank is more focused on the economic environment than on supporting the peso, making a rate hike in response to US tariffs an unlikely prospect. **Inflation is slowly falling but pressures remain**, notably in services. However, firmly anchored inflation expectations and the most recent numbers offer some room for manoeuvre.

Fiscal impact: less room for manoeuvre

A major slowdown or recession could have a significant impact on Mexico's already severely constrained public finances. The 2-3% growth forecast built into the budget, which looked optimistic back in November, looks even more so now (with Banxico forecasting growth of just 0.6%). The high deficit of 5.7% in 2024 and the refusal to take substantial steps to increase tax revenue to offset mounting spending pressures (notably for Pemex and social spending) make for an austere budget. Public investment has fallen sharply, down from 2.1% of GDP in 2023 to 0.8% in 2025, as has spending in some areas, notably healthcare[3].

Markets have welcomed Claudia Sheinbaum's pragmatism and commitment to prudent fiscal management. However, in the absence of major fiscal reform, this approach could prove insufficient. Reluctance remains high, which means the political cost would also be high. Yet without such reform, growing spending pressure could endanger Mexico's fiscal position and heighten fears of a rating downgrade. Moody's adjusted its outlook from stable to negative in November, while S&P maintained its stable outlook in December, highlighting Mexico's political stability and fiscal and monetary prudence.

External accounts: a resilient Mexico?

Mexico's external accounts still appear robust, with a current account deficit (0.3% of GDP) comfortably funded by net FDI in 2024 (1.7% of GDP). Imports and exports rose significantly in the second half of the year, partly as a result of frontloading in anticipation of US tariffs. A similar current account deficit is forecast for 2025, with a reduction in exports – especially if the US does impose tariffs – likely to be cushioned by a fall in imports because of weaker demand. Remesas and FDI inflows are also set to continue to decline.

The imposition of 25% import tariffs on all exports ($490 billion, equivalent to a quarter of Mexico's GDP, with the automotive sector alone accounting for $130 billion) would give rise to an additional cost of over $100 billion. Who could absorb such a cost? While depreciating the Mexican peso would be an initial mechanical response, that alone would not be enough and would bring with it collateral damage such as imported inflation.

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[2] Read our article: Mexique : guerre commerciale, premières salves, cessez-le-feu fragile – 12 February 2025.
[3] Read our article: Mexique – Budget 2025, « raisonnable » mais réaliste ? – 8 January 2025.

☑ **Our opinion –** *The Mexican economy is facing significant headwinds. Uncertainty caused by internal reform and the external political and trade environment is affecting economic performance, which was already disappointing at the end of 2024. Investment (both public and private) has taken a big hit and consumption is slowing considerably. Risks remain and will be only partly offset by more accommodative monetary conditions, themselves uncertain. The high level of value chain integration and Mexico's political goodwill suggest that there may be hope for a deal that would allow Mexico to recover and the Mexico Plan to come to fruition. This new round of negotiations will probably tend to favour the US, with more stringent local content requirements, stricter customs checks and higher tariffs on imports from Mexico (and Canada) of goods originating from China.*

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