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Mexico Economic Outlook

Although we anticipate a contraction of the economy for this year, in the medium term Mexico will end up with a lower level of relative protectionism, which may reactivate nearshoring

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The economy faces more persistent headwinds than expected

Economic weakness and lower interest rates

Economic activity	Economic activity deteriorates in the face of greater uncertainty; the tariffs impact an already weakened economy. GDP contraction in 2025 (-0.4%), with recovery in 2026 (1.2%).
Employment	Lower economic dynamism and low investment continue to hinder formal job creation, which weakens the growth of the total wage bill and endangers domestic consumption. This trend is expected to persist, with an estimated 0.1% drop in formal employment by the end of 2025.
Inflation	We expect inflation in services to moderate as the economy slows, offsetting the rise in goods inflation. We estimate inflation will be 3.9% by the end of this year and 3.5% by the end of 2026.
Monetary policy	Banxico will continue to cut the policy rate in light of the domestic economic deterioration. We anticipate a final 50 bp cut at this month's meeting, followed by four consecutive 25 bp cuts during 2H25.
Interest rates	Long-term rates will continue to respond to the rate-cutting cycle, but their decline will be gradual in the face of domestic and global risks. We expect the 10-year M-Bond yield to close the year at 8.7%.
Public Finance	The Historical Balance of Public Sector Borrowing Requirements will rise to 53.1% in 2025 from 51.4% of GDP in 2024
Exchange Rate	The exchange rate is very likely to be around 20.45 pesos per dollar by the end of 2025

Economic activity deteriorates amid heightened uncertainty; tariffs further impact an already weak economy.

The uncertainty regarding tariffs in the U.S. adds pressure to an economy already weakened by falling investment and fiscal consolidation. According to the most recent INEGI figures, GDP grew 0.2% QoQ in 1Q25 as a result of the recovery of the primary sector, with the industry and the tertiary sector showing contractions during the period (-0.1% QoQ, respectively). In the industrial sector, the deterioration of civil engineering construction continues, with a year-on-year variation of (-)27.5% in March. This is in the face of a decrease in public investment spending, which has averaged -30.0% y/y over the last six months. Manufacturing, on the other hand, extends its slowdown, after the negative shocks to production that were recorded in 4Q24 (hurricanes in the U.S. and the Boeing strike), with a downward outlook for 2Q25 due to the temporary suspension of operations by some companies and intermittent pauses in shipments to the U.S. result of the implementation of the new U.S. tariff scheme.

With regard to the tertiary sector, its slowdown is prolonged, given the lower growth of the segments linked to industry, and the loss of dynamism of the retail sector; The hotels and restaurants segment recorded twelve continuous months of declines as of March, with retail trade registering a year-on-year growth of 1.0%, the lowest figure since December 2024. We anticipate that retail sales will continue to lose ground, given the persistent slowdown in the real wage bill (due to job losses in industry) and the prolonged deterioration in consumer confidence in an context of uncertainty. According to IMSS data, the total wage bill increased by 3.6% y/y in March (seasonally adjusted), marking the lowest figure since June 2021. Meanwhile, the consumer confidence indicator registered a level of 45.5 in April, marking the lowest figure since May 2023.

Regarding gross fixed investment, it has not shown recovery after the reduction in government spending on public works (flagship projects of the federal government): As of February, it was 6.0% below its level two years ago (Jan-23), with the non-residential component registering a level 16.5% below that same threshold. The machinery and equipment segment, on the other hand, has lost dynamism since the end of 2024, in a context of high uncertainty derived from the implementation of the judicial reform and the new U.S. trade policy. As of February, investment in machinery and equipment was 3.5% below its level of two years ago, with a more pronounced slowdown since December.

We anticipate that economic activity will fall (-)0.4% in 2025, given the prolonged contraction in investment and the slowdown in consumption. The precipitous increase in uncertainty regarding the new tariffs in the U.S. and changes to the judiciary undermine economic agents' confidence in their short- and medium-term economic decisions. This is in addition to the slowdown that the economy had already been experiencing since 4Q24. We estimate a recovery by 2026, with GDP growth of 1.2% (Figure 1).

Lower economic dynamism and weak investment are slowing formal employment, putting household consumption at risk

The labor market continues to show mixed signals. While unemployment and informality rates have remained relatively stable, formal job creation reflects a marked slowdown. According to the National Employment and Occupation Survey (ENOE), the seasonally adjusted unemployment rate stood at 2.6% in April 2025, which has been below the historical average of 4.0% since 2005. Labor informality stood at 54.6% s.a., 2.7 percentage points below its historical average. These results contrast with the weakness of formal employment, whose annual growth rate was only 1.0% at the end of 2024, significantly below the average annual rate of 3.7% recorded between 2001 and 2023. This divergence is largely explained by the low growth of the Economically Active Population (EAP), which averaged just 0.1% per year between December 2024 and March 2025, well below the historical average of 1.9%. This has contributed to keeping the unemployment rate low.

The most recent data from the Mexican Institute of Social Security (IMSS) confirms the slowdown in formal employment. In May, a net loss of 45.6 thousand formal jobs was recorded compared to the previous month, with an annual growth of just 0.1%. From January to May, 134 thousand formal jobs were generated, 65.7% less than the average observed in the same period of the previous three years. This weakness has also impacted real wage and total wage bill growth. In May, real wages grew 3.1% annually, while the wage bill increased 3.2%, 1.6 percentage points below its historical average (2012–2024). This slowdown is directly related to low formal job creation, which in turn weakens household consumption.

Given the backdrop of expected economic growth, low investment, and growing uncertainty, the negative trend is expected to persist in the short term. An estimated 0.1% drop in formal employment is expected by the end of 2025 (Figure 2).

We expect services inflation to moderate as the economy continues to weaken, offsetting the rise in goods inflation

Due to recent supply shocks impacting agricultural prices, the recent rebound in goods inflation, and negative base effects from the lower weight of electricity prices following last summer's adjustment, year-on-year headline inflation increased temporarily in the second quarter after declining for the previous three quarters. After remaining below 4.0% annually between January and April, inflation rebounded to 4.4% y/y in May. We estimate that in June it will remain above that threshold, around 4.2% y/y, before moderating significantly in July to 3.4% y/y, supported by positive base effects. We anticipate that, after marked volatility in the second quarter – which would extend to the third quarter – inflation will average 3.8% y/y during the second half of the year and close the year at 3.9% y/y.

Core inflation averaged 3.6% y/y between November 2024 and March of this year, i.e., underlying inflation, which best reflects the trend of medium-term inflation, had already returned to the levels that prevailed before the increase in inflation in recent years. Although core inflation experienced a temporary increase during the second quarter, bringing the average to 4.0% y/y, we expect it to return to levels below 4.0% y/y and close the year at 3.8% y/y. This is due to the continued decline in services inflation, which will partially offset the rise in goods inflation in a context of economic weakness.

After showing continued stickiness to the downside, core services inflation declined more meaningfully in the second half of 2024. It fell from 5.2% y/y at the end of Q2 2024 to 4.9% at the end of Q4 2024. It declined even more sharply in Q1 2025, to 4.3% y/y. In May, it stood at 4.5% y/y, but given the current economic weakness and lack of demand-side pressures, it is foreseeable that it will resume a downward trend, allowing core inflation to fall from its current levels by the end of the year. Towards the second half of the year, we expect a consolidation of the process of recomposition between goods and services inflation, with the former still experiencing a further increase, but the latter showing a significant decline.

We estimate that, following the conclusion of the disinflation process this year, inflation will enter a new stage by 2026, reaching levels below the historical average since the adoption of the current target of 3.0% y/y. In this context, we anticipate that both headline and core inflation will end the year at 3.5% y/y, which we consider to be consistent with long-term equilibrium. While upside risks remain—such as possible new supply shocks or a phase of peso depreciation—downside risks have become more relevant. In an environment in which the negative output gap will widen, services inflation, and with it core and headline inflation, could decline at a faster rate than we currently project (Figures 3 and 4).

Banxico will continue to lower the reference rate in response to domestic economic deterioration. Meanwhile, the Fed will maintain its current monetary policy.

We anticipate that the Federal Reserve (Fed) will maintain its benchmark interest rate at 4.25%-4.50% throughout most of 2025. This decision is based on the deteriorating inflation outlook associated with the new U.S. tariff policy and the continued resilience of economic activity, which is driven by robust consumer spending and a stable labor market. The Fed is expected to remain patient in the coming months because the continued strength of the economy gives it the opportunity to wait to see more clearly the transmission of tariffs to final prices, seeking to prevent the increase in short-term inflation expectations from contaminating long-term ones. Towards the end of the fourth quarter, greater evidence of a slowdown in economic activity, together with well-anchored long-term inflation expectations, would allow the Fed to gradually resume the rate-cutting cycle, with a 25 basis point (bp) cut that would place the rate at 4.00-4.25% at the end of 2025. Monetary policy normalization would continue at a gradual pace during 2026, reaching a neutral stance of 3.0% towards the first quarter of 2027.

In Mexico, the domestic economic context justifies a different monetary policy path from that of the U.S. In the face of the current economic slowdown and core inflation returning to pre-pandemic levels, Banxico sped up rate cuts this year, implementing three 50bp reductions that brought the benchmark rate to its current level of 8.50%. We anticipate that there is still room to normalize the monetary stance further, as the ex ante real rate remains in clear restrictive territory, despite the reference rate having accumulated 275 bp of reductions since reaching its highest level in March 2023. Given the continued deterioration in growth prospects and the fact that Mexico has been relatively less affected by the current U.S. administration tariffs —thanks to the benefits of being part of the USMCA, which have helped avoid a marked depreciation of the exchange rate—, we anticipate that Banxico will continue to cut the policy rate uninterruptedly. We anticipate a final 50bp cut at this month's meeting, followed by consecutive 25bp cuts during the second half of 2025. With this, the rate would close this year at 7.00% and reach a neutral level of 6.50% in the first quarter of 2026 (Figure 5).

Long-term rates will continue to respond to the rate-cutting cycle, but their decline will be gradual in the face of domestic and global risks

The U.S. government yield curve reflects that the Fed will eventually resume the rate-cutting cycle, but it has also been reflecting the increase in global uncertainty resulting from the new economic policies announced in that country. This has been particularly evident in the performance of the 10-year Treasury bond yield, which stood at around 4.4% at the end of May, significantly above the 3.7% recorded in September last year. Since then, the main factor behind the increase in long-term nominal yields has been the increase in term premia, driven by a greater perception of risk associated with the uncertainty around the economic policies recently announced by the new administration. We anticipate that this uncertainty will persist over the next few quarters and, as a result, we expect the yield on the 10-year Treasury note to remain between 4.5% and 4.7% throughout 2025 and much of 2026, before resuming a downward trajectory that would take it to a level of 3.9% by the end of 2027.

In Mexico, we continue to anticipate that rates along the yield curve will continue to decline as Banxico's downward cycle progresses. Although long-term yields will remain highly correlated with U.S. Treasury bonds, they will also reflect local factors that have increased the country's risk premium since last year. These factors include the reform to the judiciary, which has created uncertainty about the institutional environment and could continue to put pressure on long-term rates as long as its implications for investment remain unclear. Additionally, the higher term premia observed globally due to the new economic environment in the U.S. suggests that the adjustment of the Mexican yield curve will be gradual. In our baseline scenario, we anticipate that the yield on 10-year M-Bonds will decline from its current level of 9.2% to 8.7% by the end of 2025 and to 8.2% by the end of 2026 (Figure 6).

The Historical Balance of Public Sector Borrowing Requirements will rise to 53.1% in 2025 from 51.4% of GDP in 2024

After knowing the 2026 General Economic Policy Pre-Criteria presented by the federal government to Congress, the Historical Balance of Public Sector Borrowing Requirements (HBPSBR) is expected to reach 53.1% of GDP by the end of 2025 vs. 51.4% in 2024. Although the proposed fiscal consolidation for 2025 is nearly two percentage points as the PSBR would go from -5.7% to -4.0% of GDP, the pressure on public expenditure and the shrinking fiscal space to cut it make us foresee that the PSBR will reach -4.3% of GDP by the end of the year. Given the expected fragility of public finances in the coming years due to the depletion of rainy funds, the expansion of social programs, governmental support to Pemex, public pensions and debt service, along with little room for tax revenue growth without a fiscal reform, the federal government will most likely have to make adjustments to discretionary spending to generate public deficits around 2.0% of GDP and thus prevent public debt (% of GDP) from resuming its upward trajectory. This will represent a complex fiscal policy challenge. If fiscal discipline were not enough and the federal government could only reduce the public deficit to levels of around 2.9% of GDP in the following years, then the debt could approach 58.3% of GDP in 2030. This possibility could lead rating agencies to reduce the sovereign credit rating and result in the probable loss of the investment-grade status.

As for the Mexican peso, it is anticipated that it will show a slight depreciation in the following months as it is affected both by the very likely lower rate differential between Mexico and the United States and by the national economic slowdown. The exchange rate is expected to be around 20.45 pesos per dollar by the end of 2025 after having reached 20.55 in January 2025.

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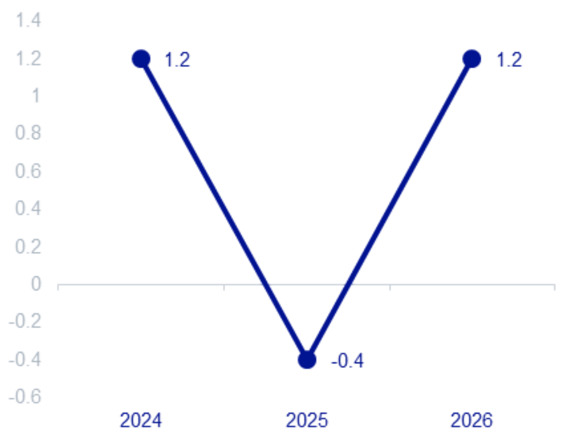
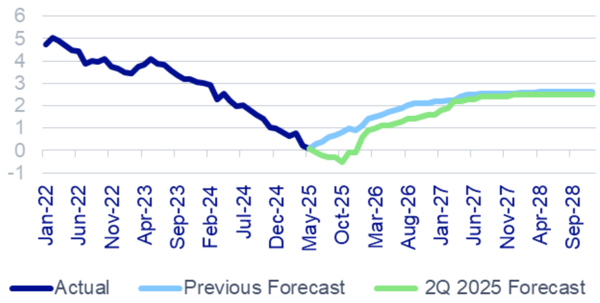
FIGURE 1. GDP
(ANNUAL % CHANGE, REAL, SA)



Source: INEGI, BBVA Research

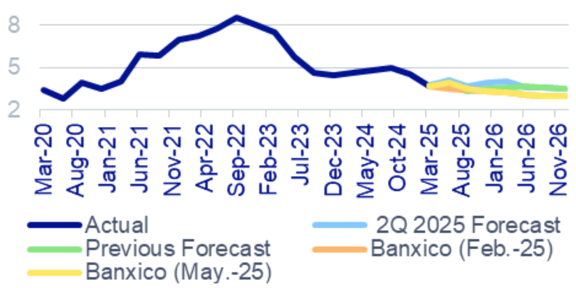
FIGURE 2. OUTLOOK FOR FORMAL EMPLOYMENT
(ANNUAL % CHANGE)



	25	26	27	28
Thousands, Eop				
2Q 2025 Forecast	(-)26	365	556	589
Previous Forecast	196	485	584	584
Annual Var., % Eop				
2Q 2025 Forecast	(-)0.1	1.6	2.5	2.5
Previous Forecast	0.9	2.2	2.5	2.5

Source: BBVA Research, IMSS

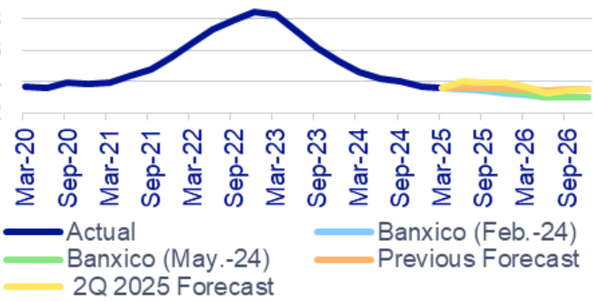
FIGURE 3. HEADLINE INFLATION
(ANNUAL % CHANGE)



	4Q25	4Q26	4Q27	4Q28
2Q 2025 Forecast	3.9	3.5	3.5	3.5
Previous Forecast	3.5	3.5	3.5	3.5

Source: BBVA Research, INEGI

FIGURE 4. CORE INFLATION
(ANNUAL % CHANGE)



	4Q25	4Q26	4Q27	4Q28
2Q 2025 Forecast	3.9	3.5	3.5	3.5
Previous Forecast	3.5	3.5	3.5	3.5

Source: BBVA Research, INEGI

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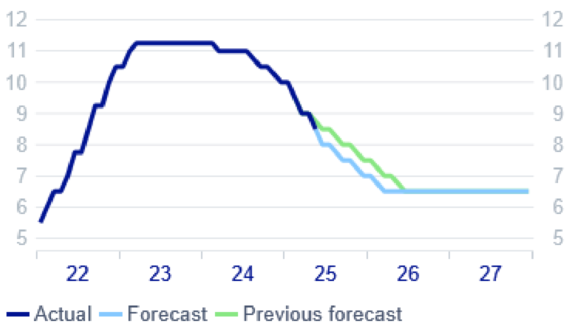
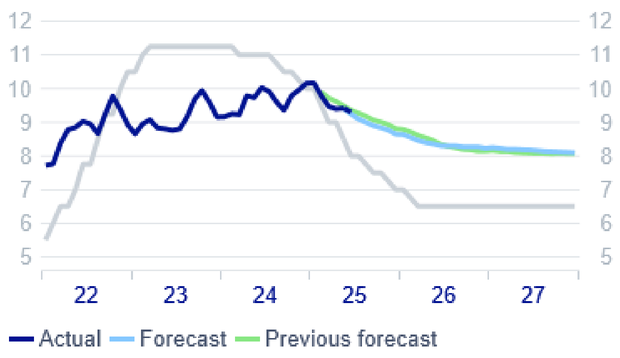
FIGURE 5. BANXICO POLICY RATE (%)



	25	26	27
2Q 2025 Forecast	7.00	6.50	6.50
Previous forecast	7.50	6.50	6.50

Source: BBVA Research / Banxico

FIGURE 6. 10-YEAR GOVERNMENT YIELD (%)



	25	26	27
2Q 2025 Forecast	8.7	8.2	8.1
Previous forecast	8.8	8.2	8.1

The gray line indicates Banxico's policy rate
Source: BBVA Research / Banxico / Macrobond

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