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Creating Opportunities

Mexico Economic Outlook

November 2024

Higher-than-expected growth in 2H24; disinflationary process and steady rate-cut cycle to continue in 2025 despite more uncertain environment

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- **We maintain our growth estimate for 2024 at 1.2% and for 2025 at 1.0%;** the favorable impact of stronger growth in 3Q24 (and a higher public deficit in 2025) will be offset by the negative shock from the new tariffs.
- **Consumption shows momentum, with a share of spending driven by lower savings;** we anticipate a gradual slowdown ahead due to slower growth in real wage income.
- **Investment is losing ground due to lower public and private spending**; the slowdown will be accentuated in 2025 in a context of higher uncertainty due to the recently approved judicial reform and the anticipated changes in U.S. trade policy.
- **Formal employment intensifies slowdown:** We have revised our outlook for its short- and medium-term growth downward.
- **Headline inflation will have fallen only marginally by the end of this year (from 4.7% y/y to 4.5% y/y)** due to supply shocks; **but core inflation will have fallen substantially, from 5.1% y/y to 3.6% y/y**
- **We expect headline inflation to decline substantially next year (to 3.5% y/y)** as supply shocks fade, **and core inflation to slow further, to 3.4% y/y**
- **Banxico has ample room to accelerate the pace of rate cuts, but we expect it will not do so**, and although it will cut rates at all meetings in 2025, we now expect the monetary rate to close 2025 at 8.00%.
- **There is room for lower interest rates across all maturities**, but persistent higher risk premia could limit the potential downside at the long end of the yield curve.
- **We forecast the exchange rate to close 2024 and 2025 at 19.8 and 20.7 ppd, respectively.**
- **We estimate that public debt will increase to 52.7% at the end of 2025 vs. 51.0% of GDP in 2024.** Public deficits of around 2.0% of GDP are required in the following years to keep this ratio stable.

Economy beats expectations in 2H24; headwinds in 2025

Economic activity exceeded expectations with a growth of 1.1% q/q in 3Q24, driven by widespread momentum across major sectors (0.9% q/q in industry and 1.1% in the tertiary sector). Based on September data, the tertiary sector has solidified its position as the fastest-growing segment among the supply components, with a cumulative year-on-year increase of 2.3% over the first nine months of the year. By subcomponents, the services segment shows the greatest progress (professional and technical services 17.4%, financial 3.8%, transportation and storage 3.5%), while the trade segments show moderate performance (wholesale trade at 1.9% and retail trade at 1.6%). The industrial sector shows an accumulated year-on-year change of 0.9%, with differentiated performance across subcomponents. Construction reports a cumulative growth of 6.5% for the year so far (January-September), while manufacturing shows a cumulative growth of 0.2% over the same period. We anticipate that the weakness in the manufacturing sector has bottomed out, given the recovery in demand for durable goods in the U.S., in an environment of lower U.S. interest rates. We estimate that the tertiary sector could show signs of slowdown going forward, if the slow growth of real wage income continues.

In terms of private consumption, as of August, there was a cumulative growth of 3.3% (y/y%), driven by the imported goods segment (16.5% y/y). Next is the domestic services segment, with a cumulative year-on-year change of 1.8%, and domestic goods with a growth of 0.3% during the same period. We estimate that private consumption will face challenges going forward, as part of private spending is driven by lower savings. According to Banxico figures, the balance of household deposit accounts held by the financial system is 3.6% below its pre-pandemic trend (after having reduced the gap to 1.4% in March). Meanwhile, the real wage bill has deepened its slowdown, recording a real change of 5.8% y/y in October (sa), the lowest since December 2021.

As regards investment, its slow pace has continued, due to lower public and private spending. As of August, total gross fixed investment recorded a cumulative growth of 6.6% (vs. 17.7% during the same period of the previous year). Both the construction and machinery and equipment segments have underperformed, with cumulative growth of 7.6% and 5.2%, respectively, below the 18.3% and 16.9% growth observed during 2023 (y/y). By expenditure components, public sector investment recorded a growth of only 2.0% (after recording a change of 22.0% last year, during the same period), while private investment recorded a growth of 7.4% (vs. 17.2% in 2023). We anticipate that investment will continue to be the weakest component of domestic demand, in a context of greater uncertainty associated with the recently approved judicial reform and changes in tariffs in the U.S.

We estimate that 2025 will be a challenging year for economic activity, with high uncertainty regarding U.S. trade and immigration policy. The upward surprise in economic growth in 3Q24 represents a good starting point for GDP growth next year (along with the larger deficit projected for 2025); however, it is offset by lower growth in exports and gross fixed investment resulting from the imposition of tariffs on Mexican imports in the U.S. (10% in our baseline scenario). The effects offset each other, so we maintain our growth estimate for 2025 unchanged at 1.0%, and 1.2% for 2024 (Figure 1).

Formal employment slowdown intensifies, reducing short- and medium-term growth prospects.

The weakness in formal job creation observed since the beginning of the year has not only been confirmed but has intensified, even exceeding expectations at the end of the year. Despite this weakness, unemployment and informal employment remain stable.

According to the National Employment and Occupation Survey (ENOE), the seasonally adjusted unemployment rate was 2.7% in September, the latest data available. This level is 1.4 percentage points below the historical average (2005-2023). In fact, since November 2022, the unemployment rate has only reached 3.0% on one occasion, remaining below this threshold the rest of the time, marking the lowest levels in the historical series. Although an increase in labor informality levels might be expected, this effect has not translated into significant growth. Informal employment has remained stable, at 54.1%, its lowest level outside the exceptional pandemic period.

Data from the Mexican Social Security Institute (IMSS) indicates a consistent loss of momentum in formal employment creation throughout the year. In October, the cumulative level of formal employment was 38.9% lower than the average of the past three years. Additionally, that month's annual growth rate of 1.4% is the lowest since May 2021, reflecting a significant post-pandemic slowdown. As noted, this trend can be attributed to factors such as the slowdown in U.S. manufacturing, the completion of infrastructure projects, uncertainty surrounding internal reforms, and risks stemming from the recent U.S. election.

As for wages, the slowdown in employment has also had a negative impact. In October, real wages and total wage bill recorded an annual growth of 4.2% and 5.7%, respectively. This contrasts with the dynamics seen in previous years — for example, compared to October 2023, both indicators were 2.0 and 3.9 percentage points above their current level. Despite this visible slowdown, both indicators continue to exceed the historical average growth rate of 1.2% for real wages and 3.9% for the total wage bill. As this slowdown becomes more pronounced and levels tend to converge toward average levels, this may not be as good for consumption as it has been in previous years.

We expect employment to experience a moderate boost in November, followed by a negative adjustment in December due to seasonal factors. Therefore, we anticipate weak job creation for the remainder of the year, with expected growth of 1.8% at the end of 2024 (402,000 net jobs), representing a rate 1.9 percentage points below the average of the last three years (Figure 2).

Core inflation has continued to fall; services inflation has begun to break its stickiness to the downside

As a result of a bumpy road this year due to supply shocks that have put pressure on agricultural product prices, headline inflation has had ups and downs throughout the year and will end up moderating only marginally compared to the close of last year. Supply shocks have weighed on non-core inflation throughout the year and have kept the annual pace of increase in fruit and vegetable prices in double digits throughout 2024 (18.2% y/y in the first half of November). This has caused non-core inflation to accelerate from 1.4% y/y in December last year to 7.6% y/y in the first half of November. This has caused bumps in the road, which will prove temporary, in the disinflation process. In the first quarter, headline inflation rose from an average of 4.4% y/y in the fourth quarter of last year to 4.6%. In the second it increased to 4.8% y/y and in the third to 5.0% y/y. Although it has resumed a slowdown trend in the fourth quarter and stood at 4.6% in the first half of November, we expect it to close the year at 4.5% y/y and to average 4.7% y/y in the fourth quarter, the same level at which it closed 2023. We expect that next year, as supply shocks dissipate, and in a context of weaker demand and low core inflation levels, headline inflation will fall significantly to 3.5% y/y in December 2025.

In contrast, and more relevant for assessing the disinflation process, the annual pace of core inflation has decelerated for 21 consecutive months (until October), and this long trend is likely to continue uninterrupted in November. In the first half of this month, it stood at 3.58% y/y (-0.2 pp compared to the October level), its lowest level since the second half of May 2020. The decline in core inflation has maintained a good pace throughout the

year. In the first quarter, growth slowed (-)0.6 percentage points (pp), from an average of 5.3% y/y in 4Q23 to 4.7% y/y. In the second quarter, it eased by a further (-)0.5 pp to an average of 4.2% y/y, and in the third quarter, it fell by a further (-)0.2 pp to an average of 4.0% y/y. We expect it to moderate (-)0.3 pp further in 4Q24 to average 3.7% y/y, and we anticipate it will stand at 3.6% y/y at year-end, which will be the most favorable close since 2019 when it ended at the same level and 0.1 pp below the close of 2018. In other words, core inflation, which best reflects the medium-term inflation trend, will have already returned to the levels that prevailed before the inflation increase of recent years.

The decline in core inflation was made possible by a very favorable trend in goods inflation. The latter has declined from 4.9% y/y in December 2023 to 2.8% y/y in October 2024 and is expected to slow further to 2.6% y/y in November. Within this, both components have experienced a notable slowdown this year. Processed foods fell from 6.3% y/y in December last year to 3.6% y/y in October; other goods fell from 3.3% y/y to 1.6% y/y in the same period. As we anticipated, in a context of a slowing demand and labor market, and a slower pace of real wage growth, services inflation, which had not shown signs of slowing until a few months ago, seems to be starting to break its downward rigidity. In the first half of the year, services inflation averaged the same rate (5.3% y/y) as in the fourth quarter of the previous year. In the third quarter of this year, it moderated slightly to 5.2% y/y, but in October it stood at 5.0% y/y and in the first half of November at 4.9% y/y. The fact that the services component has slowed for ten consecutive weeks is a good sign, and the fact that the services component excluding housing and tuition has also slowed for ten consecutive weeks and that the decline has been of greater magnitude (from 6.2% y/y to 5.6% y/y) is another good sign. Going forward, the relative importance of the continuation of this process of services disinflation that appears to have begun will be increasingly important in order to achieve lower levels of core inflation—and, more importantly, the consolidation of the more moderate levels already reached—in a context where core goods inflation may have bottomed out and is expected to return to higher levels next year, closer to the target of 3.0% y/y (from the current 1.6% y/y). We expect core inflation to close this year at 3.6% y/y, with a slight further decline next year to 3.4% y/y.

With inflation improving and demand weakening, Banxico still has ample room to cut interest rates

In a context in which core inflation has already fallen to levels close to the average from 2010 to 2019 (3.6% y/y vs. 3.4% on average during that period of low and relatively stable inflation), and given the lags with which monetary policy operates, we consider that Banxico has acted with a delay in adjusting the excessively high ex-ante real rate. Consequently, the monetary stance will continue to weigh on economic activity in the coming quarters and is inadequate for current economic conditions. The ex-ante real rate remains very high (6.6% in October; foreseeably even a few tenths higher in November and December) and remains relatively close to its high in the current restrictive cycle (7.4%). This is in a context of continued deceleration and gradual convergence of core inflation with the target range, with well-anchored medium-term inflation expectations, with the Fed beginning an easing process and with domestic demand weakening.

The Fed began a rate-cutting cycle in September with the aim of preserving a soft landing. Although it has signaled that its strategy is “not to fall behind” in the rate-cutting cycle, the tariffs announced by the winner of the U.S. election could lead to a substantial, though temporary, increase in U.S. inflation starting in the second quarter of 2025. We anticipate that this will cause the Fed to pause its rate-cutting cycle for an extended period, after reducing rates by 25 bp in each of the next three meetings, leaving the rate at 4.00% starting in March. Should this expected pause in the rate-cutting cycle lead to an interruption in the monetary easing cycle in Mexico? We don’t think so. The central bank has shown signs that coincide with this. In fact, the decision to reduce rates now has the unanimous support of all members. Banxico cut its rate by 25 bp for the third consecutive time at this month's

meeting, to 10.25%. The decision was unanimous, with Deputy Governor Heath joining the majority that had voted to lower the interest rate at the two previous meetings. The stronger-than-expected pace of economic activity in the third quarter does not appear to have affected members' confidence in the inflation outlook. Banxico left the door open to rate cuts in upcoming meetings and indicated that the cycle has room ahead, in the context of weak growth dynamics expected for next year. Most will remain determined to continue the rate-cutting cycle over the coming months, but we now expect Banxico to cut the rate to 8.00% by the end of next year (vs. our previous forecast of 7.50%). We believe Banxico could be more cautious next year, as we expect the Fed to pause its cycle in 2Q25.

We believe there is ample scope to normalize the monetary stance given the favorable trend in core inflation and weakening domestic demand. The high level of the ex-ante real rate implies that, despite the rate cut cycle, monetary policy will continue to weigh on economic activity next year. Moreover, although volatility temporarily increased, financial markets have behaved in a relatively orderly fashion. This should give Banxico confidence to continue cutting rates, especially with long-term rates supporting monetary restriction. In this regard, we believe that larger cuts of 50 bp, rather than the more likely 25 bp would be a very welcome surprise and a sound monetary policy decision. However, we do not expect them. Instead, we expect a further 25 bp cut in December to 10.00/%, and while we continue to expect cuts at all meetings scheduled in 2025, we no longer expect Banxico to increase the pace of cuts at two of them, cutting the rate by 50 bp at one meeting in Q3 and another in Q4, and we now expect Banxico to take the rate to 8.00% by the end of 2025 (Figure 4). This forecast is below the expectations implied by market instruments (around 9.0%) and is now equal to the analyst consensus (8.00%). The update of our forecast is in response to the Fed's slower rate-cutting cycle and higher risk premiums due to possible protectionist measures by the new Trump administration.

The uncertainty around Trump's potential policies will limit the decline in long-term interest rates

Mid- and long-term Treasury yields have risen significantly over the past two months, driven by strong economic activity and heightened uncertainty around the economic effects of Trump's potential policies. The yield on 10-year Treasury notes, for example, reached 4.4% in recent weeks, after falling to 3.7% in mid-September. In addition to the relatively greater strength in economic activity, the perception among market participants and most economic analysts (including us) points to greater inflationary risks under Trump's potential trade, tax and immigration policies which, as discussed above, will likely mean fewer rate cuts next year. Despite this, the Fed likely retains the confidence to keep gradually lowering its policy rate in the coming months, so short-term Treasury yields, which are highly sensitive to monetary policy decisions, still have room to drop further. In contrast, higher risk premia related to the uncertain economic effects of Trump's policies will likely keep mid- and long-term yields at relatively high levels.

Mexico's yield curve also experienced a notable upward shift (Figure 5), in line with the U.S. curve despite greater certainty that Banxico will continue to cut its reference rate. Short-term yields (Cetes) have continued to reflect the cuts to Banxico's policy rate. However, long-term yields continued to reflect increased local uncertainty regarding the approval of deep constitutional reforms related to the judiciary power and the dissolution of different autonomous bodies (which partly explains the recent changes to the country's credit outlook by Moody's and HR Ratings), as well as the possible economic effects that Trump's potential protectionist measures will have on Mexico. As a result of this heightened perception of country risk, long-term interest rates in Mexico are now at levels higher than those that would be observed in an environment of greater certainty (10-year M-Bond yields have hovered around 10.0% over the last month, as shown in Figure 6).

Going forward, Banxico's still excessively restrictive monetary stance offers room for lower interest rates in all maturities, but the possible persistence of higher risk premia could limit the downside potential at the long end of the yield curve.

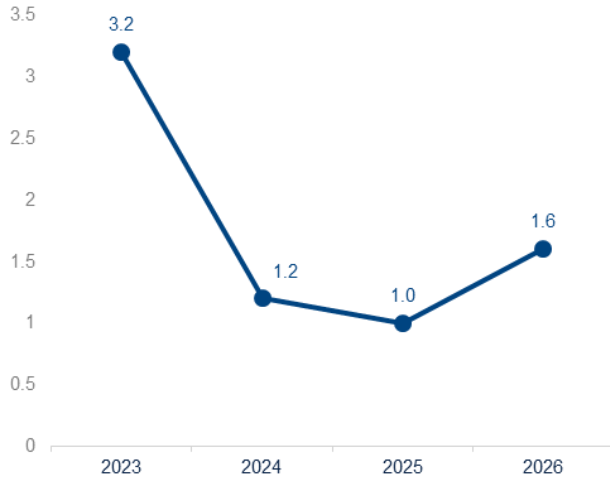
The historical balance of public sector borrowing requirements will increase to 52.7% of GDP in 2025, compared with 51.0% in 2024

After reviewing the 2025 economic package presented by the federal government to Congress, we forecast that the Historical Balance of Public Sector Borrowing Requirements (HBPSBR) will be 52.7% of GDP at the end of 2025 vs. 51.4% that the Finance Ministry forecasts. Although the proposed fiscal consolidation for 2025 is only two percentage points, as PSBR would go from -5.9% to -3.9% of GDP, the pressures on public spending and the shrinking fiscal space to cut it make us foresee that this consolidation will bring PSBR to -4.5% of GDP next year. Given the expected fragility of public finances in the coming years due to the exhaustion of contingency funds, the expansion of social programs, the financial support to Pemex by the federal government, public pensions, debt service and the limited room for growth in tax collection without a fiscal reform, the federal government will most likely have to make adjustments to discretionary spending to generate public deficits of 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 sufficient 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 57.9% of GDP in 2030 (Figure 7). This possibility could lead rating agencies to downgrade the sovereign's credit rating and possibly lead to the loss of investment grade.

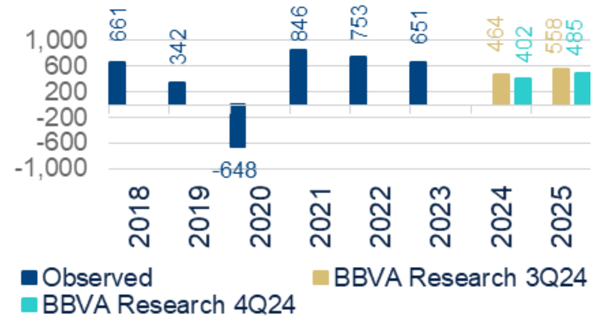
We anticipate that the Mexican peso will continue to show some volatility in early 2025 as it is subject to greater than normal uncertainty due to the protectionist trade policy that the U.S. could implement. We expect the exchange rate to most likely be around 20.7 pesos per dollar at the end of 2025 after having reached 21.4 in February 2025.

Figure 1. **GDP**
(Q/Q%, REAL, SA)

Figure 2. **JOBS AFFILIATED WITH THE IMSS**
(THOUSANDS AND Y/Y % CHG. EOP)



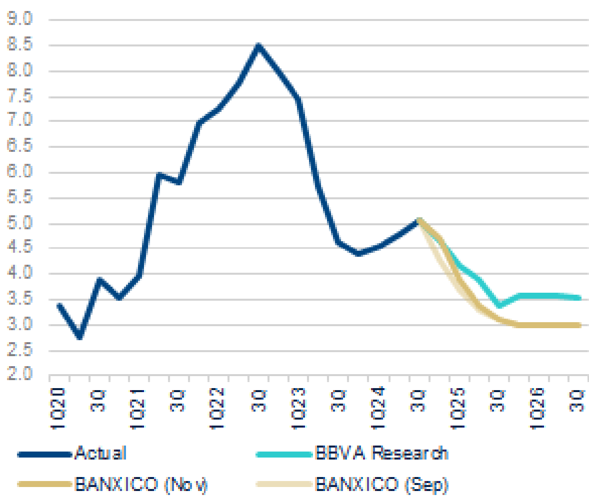
Source: BBVA Research / INEGI.



Forecast	2024	2025	2026	2027	2028
Thousands, Eop					
BBVA Research 4Q24	**402**	**485**	**572**	**603**	**629**
BBVA Research 3Q24	464	558	672	708	708
Annual Var., % Eop					
BBVA Research 4Q24	**1.8**	**2.2**	**2.5**	**2.6**	**2.6**
BBVA Research 3Q24	2.1	2.5	2.9	3.0	3.0

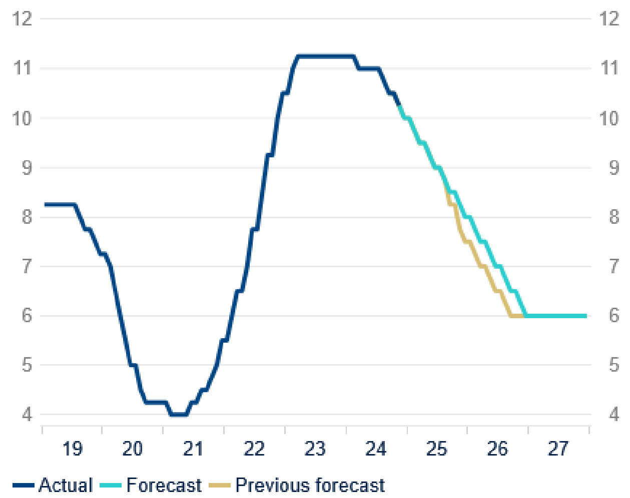
Source: BBVA Research / INEGI.

Figure 3. **HEADLINE INFLATION**
(Y/Y % CHG.)



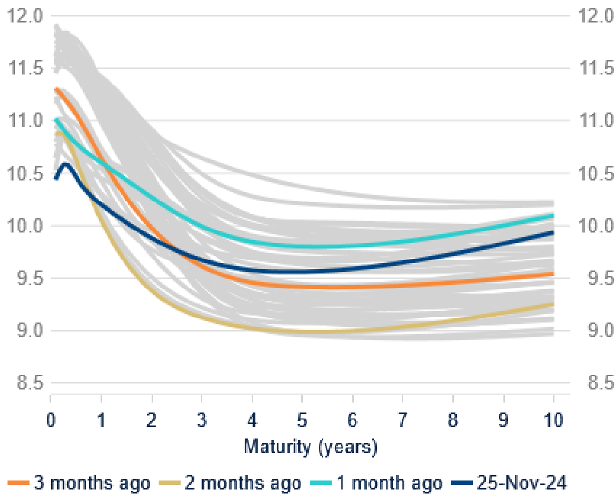
Source: BBVA Research / INEGI / Banxico.

Figure 4. **MONETARY POLICY RATE**
(%)



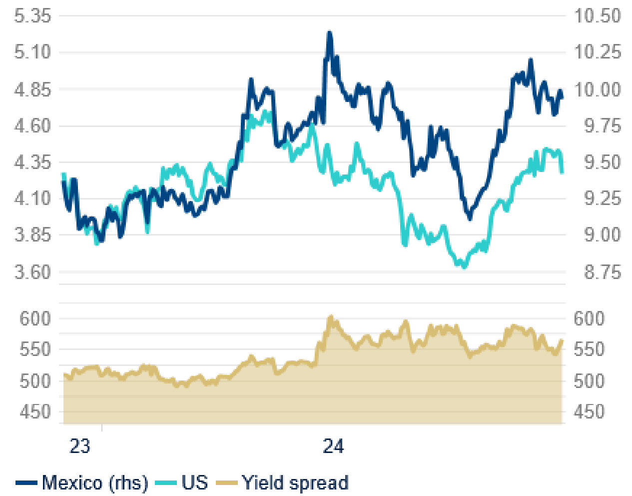
Source: BBVA Research / Banxico

Figure 5. **GOVERNMENT YIELD CURVE** (%)



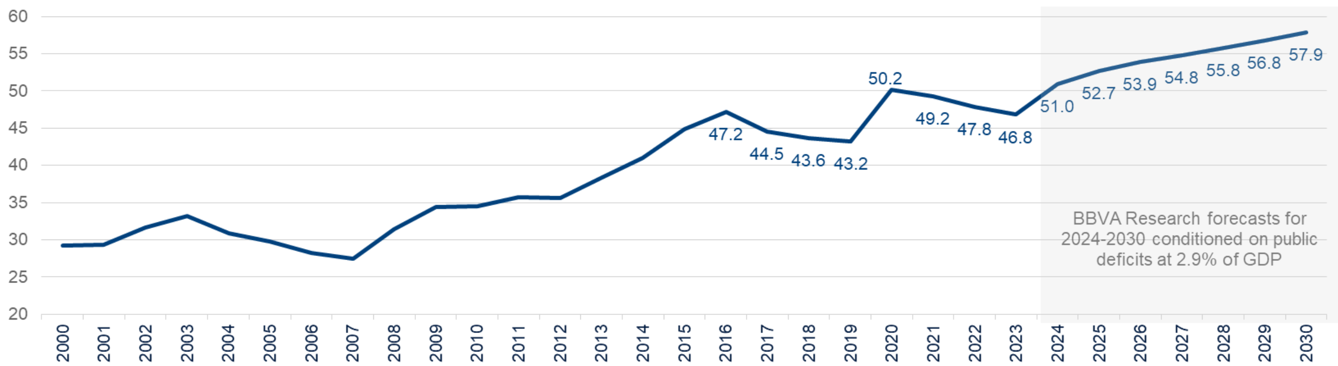
The gray lines indicate weekly curves over the past year; intermediate rates calculated with natural cubic spline interpolation. Source: BBVA Research / Banxico / Macrobond

Figure 6. **10-YEAR GOVERNMENT YIELDS AND YIELD SPREAD** (% AND BPS)



Source: BBVA Research / Macrobond / Treasury Department

Figure 7. **HISTORICAL BALANCE OF PUBLIC SECTOR BORROWING REQUIREMENTS** (% OF GDP)



Source: BBVA Research / SHCP.

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