International Trade

25% tariffs on Mexico are unlikely to be long-term; however, if they persist, the impact will negatively affect both economies

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1. Trade policy

The probability of 25% tariffs being imposed on Mexico and Canada is very low. If they are implemented, they would be short-term.

On February 1, the White House announced that it would impose tariffs of 25% on imports (it does not say all imports, which leaves open the question of whether they will be selective) on Mexico and Canada and 10% on China (in addition to those it already faces). The White House statement does not clarify the date of entry into force.

President Trump considers tariffs to be a key element in increasing tax revenues. From our perspective, tariffs could have the opposite effect in terms of revenue if the economy slows because of them and/or because of the impact of a Federal Reserve reacting to inflationary pressures (possibility of higher rates) or if long-term rates incorporate higher inflation risks (higher long-term rates increase debt service). In any case, it is not a substitute for a "like-for-like" drop in direct taxation, and historical evidence shows that tariffs are not an efficient revenue collection instrument. Trump argued that "instead of taxing our citizens to enrich other countries, we are going to impose tariffs and tax foreign countries to enrich our citizens." He is likely to do something about this, as he has ordered the government to investigate the "feasibility of establishing […] an External Revenue Service (ERS) to collect tariffs […]." suggesting that the plan is for some tariffs to become permanent.

25% tariffs on Mexico and Canada

- The White House has urged Mexico and Canada to implement stronger measures against illegal immigration and drug trafficking. The threat of higher tariffs is intended to encourage negotiations on these issues, with the possibility of canceling the tariffs if Mexico and Canada take appropriate action. So far, the Mexican government has expressed a strong desire to cooperate on matters related to migration and drug trafficking, a stance acknowledged by former President Trump and officials in his administration.

- The fundamental reason why we estimate that the probability of imposing 25% tariffs on Mexico and Canada for an extended period is low is that it would translate into a significant increase in inflation (especially in agricultural products, since of the total imports that the United States makes in this area, more than 40% come from Mexico). In addition, the United States would lose global competitiveness, given that Mexican imports reduce the production cost of many exports. In addition, many of Mexico's export industries demand up to 30% of US exports in terms of added value.

2. Macroeconomic effects of tariffs on Mexico

2.1 Likely effects on economic activity: 10% tariffs could be offset by exchange rate depreciation (which has primarily already occurred) and should not affect Mexico's relative competitiveness or the opportunity to boost nearshoring. However, 25% tariffs would have a very negative impact on the country's investment and competitiveness.

GDP growth of 1.0% is foreseen for 2025 if 10% tariffs are imposed on Mexico with a downward bias due to persistent uncertainty about migration flows, and 25% tariffs could negatively affect investment.

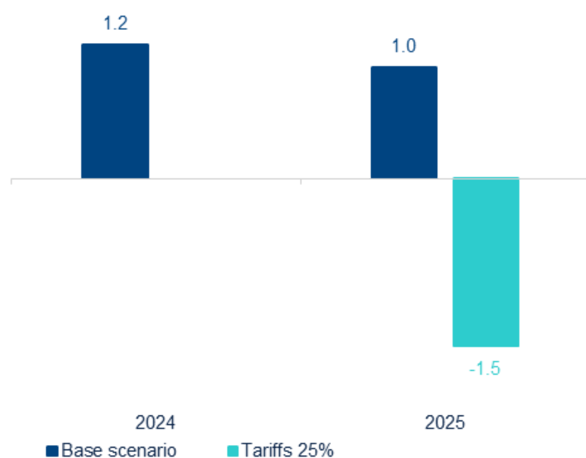
Based on our preliminary estimate, implementing a 25% tariff on final and intermediate goods for most of the year could lead to a GDP fall of (-)1.5%. This estimation assumes a price elasticity of Mexican exports of around 0.67, amplified by a significant drop in investment due to high levels of uncertainty; the effect on investment alone could represent (-)1.8 pp of GDP growth this year, doubling the negative impact on investment recorded in 2019 after the cancellation of the Mexico City airport. Even if the announced changes do not materialize, prolonged uncertainty will hurt investment projects, particularly in regions with higher export sector participation. A permanent 25% tariff would make it impossible to sustain the current agreement. Free trade cannot be discussed when 25% tariffs affect member countries. We anticipate an additional impact of up to (-)1.0 pp if job creation and real wages take a significant hit due to increased uncertainty about the future of the USMCA.

2.2 Likely effects on the exchange rate and interest rates in the 25% tariff scenario: lower monetary policy rate despite a substantial depreciation of the peso

The exchange rate will show high volatility until it is clear what the equilibrium will be in the tariff matter. If the 25% tariff prevails, the peso could initially exceed 24 pesos per dollar (we wrote this note before the opening of the markets in Asia), with a subsequent correction to 23 pesos per dollar at the end of the year. If this scenario holds, Banxico would temporarily remain on the sidelines before resuming rate cuts at the end of the third quarter. Weak demand would offset part of the transmission to inflation. Banxico would begin to reduce rates after a relatively brief pause under a favorable inflation outlook and a rapid deterioration of economic growth.

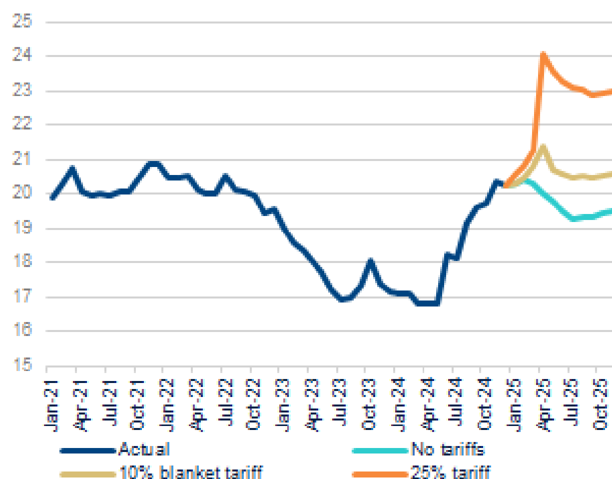
If, after these threats of 25% tariffs, tariffs of 10% are imposed as proposed during the campaign, we estimate there would be no significant effects on the exchange rate compared to the closing level of this Friday, January 31. If tariffs are avoided, the peso could appreciate to around 19.5 pesos per dollar, and Banxico could raise the monetary policy rate to 7.5% by the end of this year.

Figure 1. **GDP MEXICO**
(GROWTH YoY %, SA)



Source: BBVA Research with data from Inegi

Figure 2. **MXN EXCHANGE RATE PATHS**
(PESOS / DOLLAR)



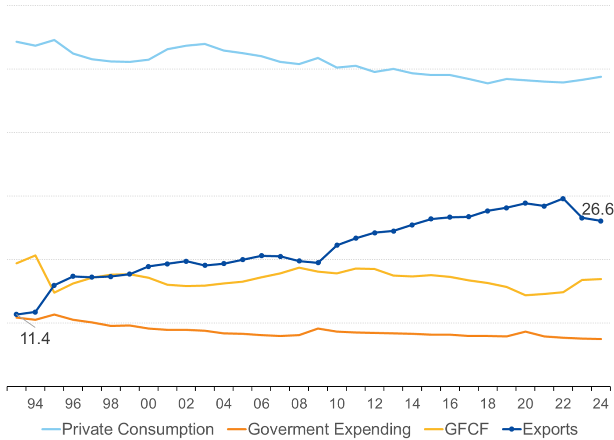
Source: BBVA Research with data from Bloomberg

Effects by industry

Mexico has become a very open economy to international trade since incorporating the GATT, and even more since 1994 with NAFTA. Since then, exports and imports have become more relevant to the Mexican economy. Exports went from just under 11.4% of aggregate demand in 1993 to 26.6% at the end 2023. Meanwhile, imports also increased their weight within the aggregate supply, since in 1993 they represented 13.6%, and by the end of 2023, 31.1%. In addition, by boosting the manufacturing sector, some industries managed to be highly competitive globally, including the steel industry, electrical and electronic equipment, machinery, and especially the automotive industry. Mexico substantially increased its industrial profile. At the same time, some state economies in the north of the country and the Bajío improved markedly thanks to international trade.

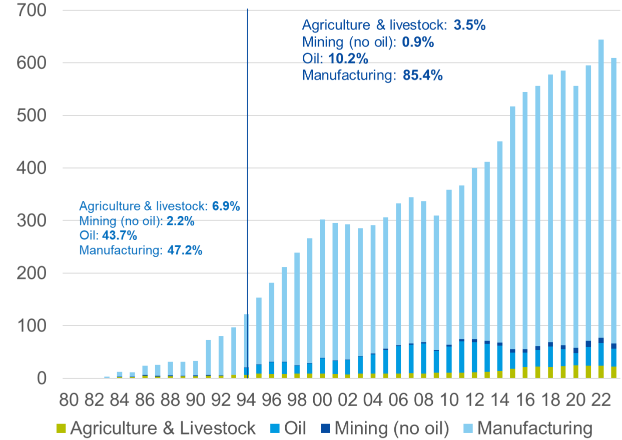
In particular, the trade relationship with the US has increased significantly because most of the investment in the export sectors has originated in that country, as well as the high integration between the manufacturing sectors of both countries. With accumulated figures from January to September 2024, Mexican exports to the US represented 83.2% of the total, while 40.4% of Mexican imports came from this country, the leading Mexico supplier. Similarly, it is also the leading investor in Mexico; up to the third quarter of 2024, it totaled 14.5 billion dollars, just over 40% of the total. Therefore, if the tariffs are implemented, they would significantly affect the Mexican economy and the bilateral relationship.

Figure 3 . **AGGREGATE DEMAND BY COMPONENT (PERCENTAGE)**



Source: BBVA Research with data from Inegi

Figure 4 . **MEXICAN EXPORTS (BILLIONS CONSTANT USD)**



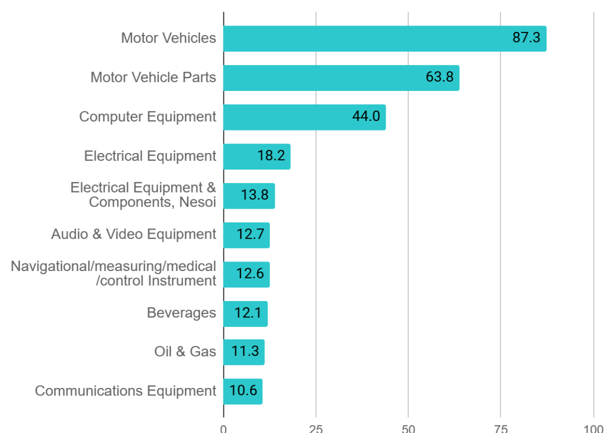
Source: BBVA Research with data from Inegi

Tariffs at industry level

Given the above, we estimate that the effect of a fixed tariff on all Mexican exports to the US would have a differentiated impact depending on which industries are more integrated with manufacturing production in the US and which are not because the elasticity of goods from integrated industries should be lower than that of non-integrated industries. Therefore, it will be difficult for the US industry to replace supply chains in the short term, leading both parties to absorb part of the price increases. In contrast, goods from non-integrated sectors would have a proportionally more significant effect. In terms of amount, the sectors with the higher weight, such as the automotive industry, would have the most significant impact.

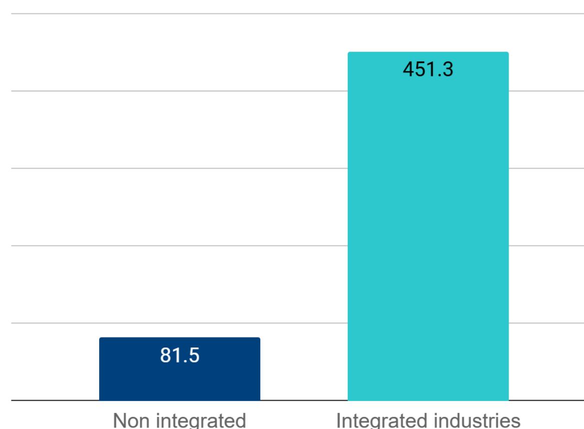
Among the sectors that we consider integrated are Mining, Oil, Agribusiness, Chemicals, Plastic, Steel, Electrical Equipment and Electronics, Machinery, and Automotive. The non-integrated sectors are agriculture, livestock, fishing, minerals, textiles, wood products, pharmaceuticals, petroleum derivatives, non-metallic minerals, and furniture. In addition, the states on the northern border, Bajío, and some in the West would be the most affected. The non-integrated sectors would have more significant impacts as a percentage of their income.

Figure 5. **US IMPORTS FROM MEXICO (BILLIONS USD)**



Source: BBVA Research with data from Inegi

Figure 6. **MEXICAN EXPORTS 2023 (BILLIONS USD)**



Source: BBVA Research with data from Inegi

Foreign Direct Investment

Manufacturing is the primary recipient of foreign direct investment (FDI), followed by financial services and mining. These three sectors account for 75% of the total FDI in the country. Manufacturing, agriculture, and mining produce internationally tradable goods, making them attractive to FDI. However, this type of investment is not only due to international trade. We estimate that a large part of recent FDI flows are directed to sectors that serve domestic markets, such as FDI in financial services, processed foods and beverages, and wholesale and retail trade.

FDI by country is also highly concentrated. The largest investor remains the United States, with 40.5% of total FDI, or 14.5 billion dollars. Japan and Germany are Mexico's second and third most prominent investors, with a share of 12.5% and 10.9% respectively. These three countries significantly invest in the automotive industry and other manufactured goods.

Despite global and regional uncertainty, Mexico could continue receiving FDI. On the one hand, the current government has shown openness to private investment in energy once the CFE has a 54% market share. In addition, the Plan Mexico, the Federal Government's industrial policy, seeks to attract even more FDI through tax incentives for this type of investment. On the other hand, if the US imposes export tariffs with rates of 60% for Chinese goods and 25% for the rest of the countries, the terms of trade would continue to favor Mexico. It's quite simple: it will be cheaper to produce and export from Mexico to the US than from Asia.

Nearshoring will continue to be an opportunity since the United States will be more restrictive with the rest of the world, particularly with China, than with Mexico and Canada (except in the scenario of tariffs on these two countries of 25% for a prolonged period)

Within FDI, new investments during the first three quarters of 2024 reached US$2.1 billion in Mexico, representing a 45.6% decrease from the same quarters of the previous year. In addition, new (greenfield) FDI from Asian countries was only US$41 million in the same period, although Japan disinvested US$36.0 million; therefore, net new FDI from Asia was only US$5 million until the third quarter of 2024. In terms of total FDI, Japan and Korea are the most prominent Asian investors in Mexico, but if we only consider new FDI, China ranks first in 2024. This country invested US$14.0 million, Hong Kong US$14.2 million, and Taiwan US$5.9 million, much less than the US$77.0 million China invested in Mexico during the first three quarters of 2023 as new FDI. This trend could be explained by the uncertainty caused by the new governments in Mexico and the US.

The opportunity for nearshoring in Mexico is still alive and may even strengthen. Despite the threat of tariffs from the current US government, trade conditions continue to favor Mexico. It is still more profitable to produce in Mexico and export to the US from this country than from other countries, especially from China, where everyone would pay a tariff of 25% or even more. In addition, the new Mexican government is more open to private investment. In this sense, the current energy secretary has commented that once the CFE has a 54% market share, the government will more efficiently authorize private investment in the sector, mainly in sustainable energy. In addition, the Mexico Plan establishes that the federal government will grant tax incentives to FDI and investment in human capital in all sectors of the economy. One point to consider is that the "America First" Trade Policy will evaluate whether any country subsidizes exports to the US in any way to take action to prevent potential damage.

New Nearshoring Decree

On January 21, President Claudia Sheinbaum published a decree providing tax incentives to support the "Plan Mexico" national strategy, which aims to encourage new investments, promote "dual education" programs, and boost innovation.

The decree allows deductions on investments in machinery, equipment, and fixed assets during 2025-2026, ranging from 41% to 91% for Mexican and foreign companies, and applies to all sectors of the economy. The deductions would be slightly reduced (between 2 and 7 percentage points) for 2027-2030. The maximum deductions will be 30 billion Mexican pesos, of which 28.5 billion pesos will be allocated to the tax incentive for investment in new fixed assets and the remaining 1.5 billion pesos for training and innovation expenses. The types of assets with the highest deductions are desktop and personal computers, printers, external storage units, and computer network hubs; those directly intended for research into new products and the development of technology in the country; for molds, dies, and tools; airplanes used for agricultural fumigation; electric, hybrid and hydrogen vehicles; and manufacturing, assembly, and transformation of magnetic components for hard drives and electronic cards for the computer industry, among others.

In addition, companies will be able to apply an additional 25% deduction on training or innovation expenses from 2025 to 2030. Companies interested in obtaining these incentives must submit their application to an Evaluation Committee, which will be composed of the Ministries of Finance and Economy and the Regional Economic Development and Nearshoring Council (made up of 15 entrepreneurs). This Committee will evaluate investment projects, a collaboration agreement in education, and plans for the development of innovation.

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