Economic Outlook

Mexico

July 2024

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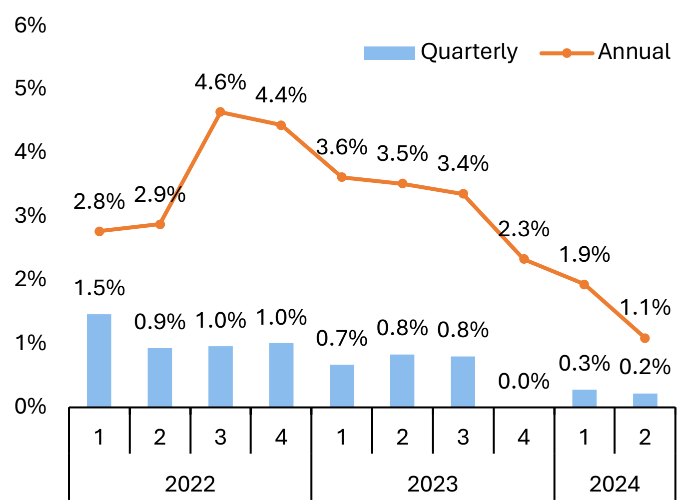
INTRODUCTION

According to the preliminary estimate published by INEGI, Mexico's Gross Domestic Product (GDP) grew by 0.22% in the second quarter of 2024 compared to the previous quarter. Although the economy continues to grow despite the uncertainty faced both internally and externally, the slowdown is noticeable. Compared to the same quarter of the previous year, the growth recorded in the second quarter is 1.09% annually (the lowest since the first quarter of 2021). Additionally, the annual growth of 1.09% is considerably lower than the 1.93% of the previous quarter and much lower than the growth of 3.21% in 2023.

Breaking down by the major economic activity groups, growth in the second quarter was observed in the secondary and tertiary sectors, with quarterly growth rates of 0.30% and 0.26%, respectively. Noteworthy is the growth in secondary activities, as it is the first positive quarterly rate after two consecutive declines in the fourth quarter of 2023 (-0.34%) and the first quarter of 2024 (-0.48%). In contrast, primary activities recorded a contraction of 1.74%, their largest decline since the first quarter of 2023.

On an annual basis, primary activities recorded a contraction of 2.23%, while the rest of the activities, despite the slowdown, continue to achieve annual growth. The secondary sector recorded annual growth of 0.48% in the second quarter, while the tertiary sector grew by 1.74% (both growth rates being the lowest since the first quarter of 2021).

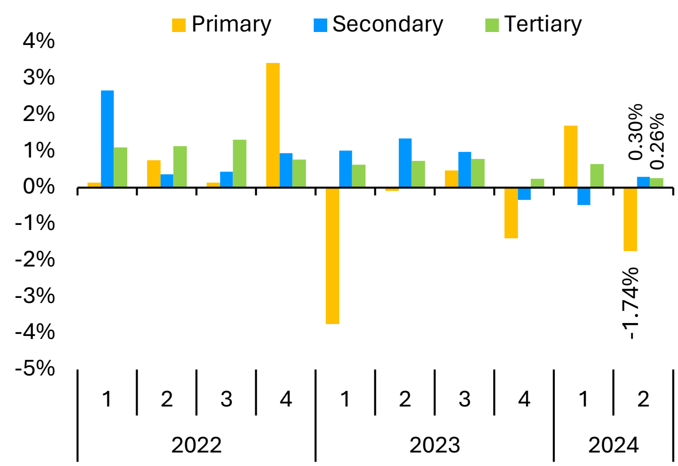
Fig. 1. GDP growth, % variation



Source: Grupo Financiero BASE with information from INEGI.

GDP by economic activity

var. quarterly % var.



Source: Grupo Financiero BASE with information from INEGI.

With today's publication and the considerations outlined below in this report, Grupo Financiero BASE revises its growth estimate for 2024 downwards from 1.6% to 1.3% annually, estimating that in 2025 it could slow down even further, with a growth rate of 0.8%.

ECONOMICS IN ELECTION YEARS

With data available since the 1980s, the average GDP growth in years of presidential elections in Mexico is 2.92%, and it falls to an average contraction of 0.62% in the first year of the administration. However, this average is heavily affected by the recessions of 1983 and 1995, years in which the GDP contracted by 4.64% and 5.91%, respectively. Even excluding these years from the sample, the historical average growth in the first year of administration has been 1.04%. This fluctuation in economic growth is explained by public spending.

According to series from the Ministry of Finance (which began in 1990), the net spending of the budgetary public sector (total spending) grows on average by 7.7% annually in years of presidential elections, including 2024, for which a real spending growth of 8.2% is projected. This contrasts with an average total spending growth of 2.3% in years without presidential elections.

Additionally, spending growth tends to be concentrated in the first half of the year to foster optimism among voters and favor the ruling party in the elections. In years without elections, spending tends to grow by an average of 2.0% annually in the first half of the year, while in the second half, the growth is 2.7% annually. In contrast, in years of presidential elections, spending grows by an average of 9.2% annually in the first half of the year and 6.3% in the second half. This also determines the slowdown in total spending and economic growth in the first year of the new administration. On average, in the first half of the first year of the six-year term, investment spending contracts by 13.1% annually, and in the second half, it grows by 4.15% annually.

It is worth noting that the deficit also shows differentiated behavior in election years. Considering the period from 1990 to 2024 (budget), a higher budget deficit is observed in presidential election years, with an average deficit of 1.7% of GDP, compared to an average deficit of 1.2% in other years. The following years stand out for the deterioration of public finances compared to the previous year: 1994, when the surplus went from 0.5% to 0.0% of GDP; 2012, when the deficit grew from 2.4% to 2.5% of GDP; 2018, when the deficit grew from 1.0% to 2.0% of GDP; and 2024, as the deficit is projected to rise from 3.4% to 5.0% of GDP, something not seen since 1988.

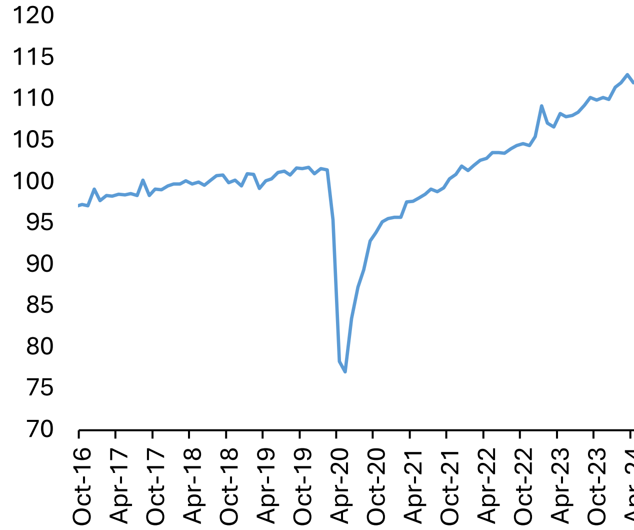
Deficits lead to higher borrowing, which generates interest and upward pressure on the interest rate due to the need for greater debt placement. This also puts pressure on future public finances and increases the likelihood of sovereign debt credit rating downgrades. Thus, a government incurring a deficit spends today what would be budgeted for the future, limiting the fiscal space for subsequent administrations. This is concerning because this year, the Mexican economy faces an economic slowdown despite the high budget deficit.

It is very unusual for the deterioration of economic growth to occur at the beginning of the year, as in the previous seven presidential election years (since 1982), growth has been concentrated in the first six months of the year, and only in one year (1988) was a higher average quarterly growth observed in the second half of the year. In election years, GDP grew at an average quarterly rate of 0.72% in the first half, slowing to an average quarterly rate of 0.16% in the second half. This is consistent with Grupo Financiero BASE's growth forecast of 1.3% annually, considering a growth of 1.51% in the first half of 2024, the economy would be growing at an annual rate of 1.09% in the second half.

PRIVATE CONSUMPTION

Consumption is the most important component of aggregate demand, representing nearly two-thirds of Mexico's GDP. Moreover, consumption is considered an indicator of economic well-being because it reflects the ability of individuals and households to meet their needs through the acquisition of goods and services. A high level of consumption generally indicates that people have sufficient income. However, household consumption decisions are not only determined by the level of income but also by factors such as consumer confidence, interest rates, and macroeconomic expectations.

Fig. 3. Private Consumption Indicator, 2013 = 100



Source: Grupo Financiero BASE with information from INEGI.

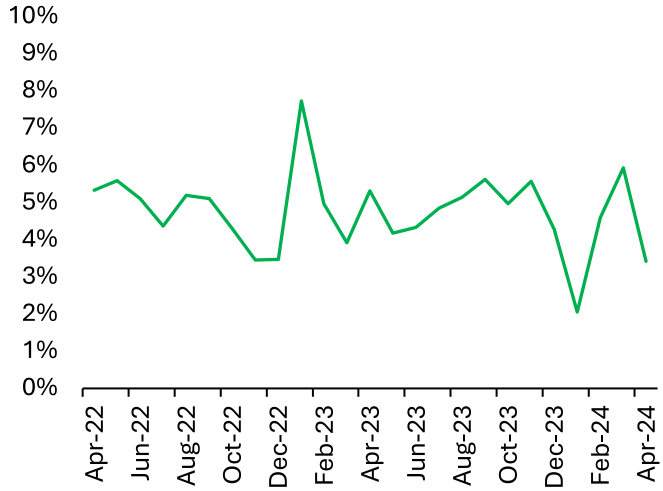
Starting with the monthly indicator of private consumption in the domestic market published by INEGI, its annual variation in April (the most recent data) showed a real growth of 3.41%. This performance has been mainly driven by the consumption of imported goods, which in April showed an annual growth of 19.98%, while the consumption of domestically produced goods and services registered a contraction of 0.08%. Within this latter component, there is a mixed performance, as the consumption of domestic goods records an annual decline of 1.56%, while the consumption of domestic services shows a growth of 1.97%. In the cumulative total for the first four months of the year, private consumption recorded an annual growth of 3.98%, the lowest growth for the same period since 2021, as it grew 5.48% in 2023 and 5.75% in 2022.

Thanks to the growth in the consumption of imported goods over the past year, the overall consumption indicator has managed to maintain its upward trend in the post-pandemic era, reaching a historic high in March 2024. In the last two years (from April 2022 to April 2024), the total private consumption indicator averages an annual growth rate of 4.75%, with the consumption of imported goods showing an average of 16.37% and that of domestically produced goods and services at 2.82%. While the consumption of imported goods has shown superior performance in the post-pandemic era, 2023 saw an additional boost due to the appreciation of the peso against the dollar, making foreign goods relatively cheaper for Mexican consumers.

For 2024, Grupo Financiero BASE estimates that private consumption in Mexico will grow by about 3.5% compared to 2023. Consumption has been supported by the rise in real wages, increased public spending on both infrastructure and transfers, the possibility of interest rate cuts, and greater credit availability. On the other hand, factors that have negatively impacted consumption include rising inflation, an increase in non-performing loans, and the loss of purchasing power of remittances. Looking ahead, additional factors include the reduction in public spending in 2025, a slowdown in remittance inflows, and generally, the economic slowdown typically observed at the beginning of each presidential term[1] .

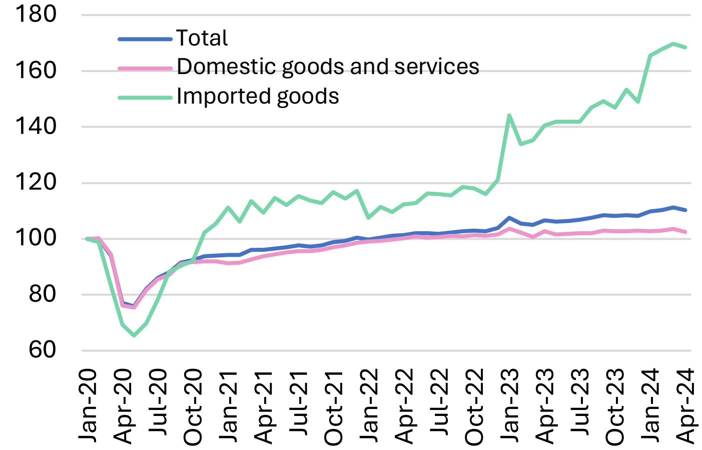
[1] Some of these factors are addressed in the following sections of this report.

Fig. 4. Private Consumption Indicator, annual % var.



Source: Grupo Financiero BASE with information from INEGI.

Fig. 5. Post-pandemic performance of the components of private consumption (Jan-20 = 100)

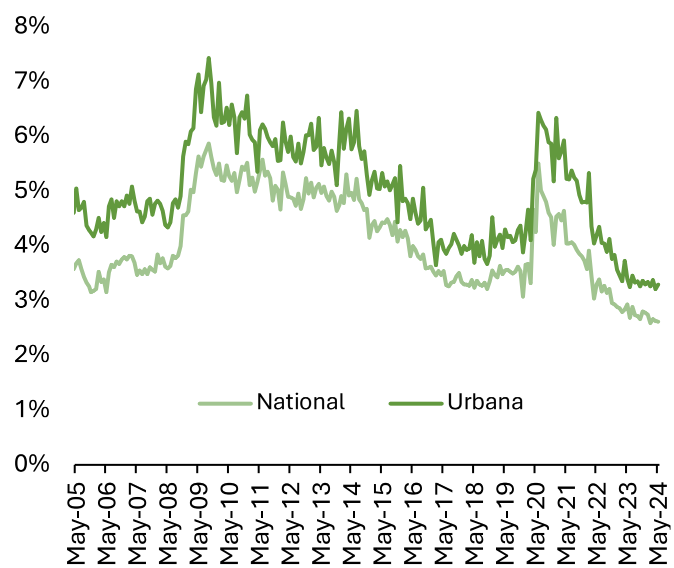


Source: Grupo Financiero BASE with data from INEGI.

LABOR MARKET

To analyze the labor market in Mexico, there are two main sources of information: the National Survey of Occupation and Employment (ENOE) from INEGI and the data from the Mexican Social Security Institute (IMSS). The ENOE provides detailed information about the labor market, capturing data on employment, unemployment, underemployment, and other labor conditions at the national level and by sector. In contrast, IMSS data only corresponds to formal private sector workers affiliated with the institute.

Fig. 6. Unemployment rates (unemployment)



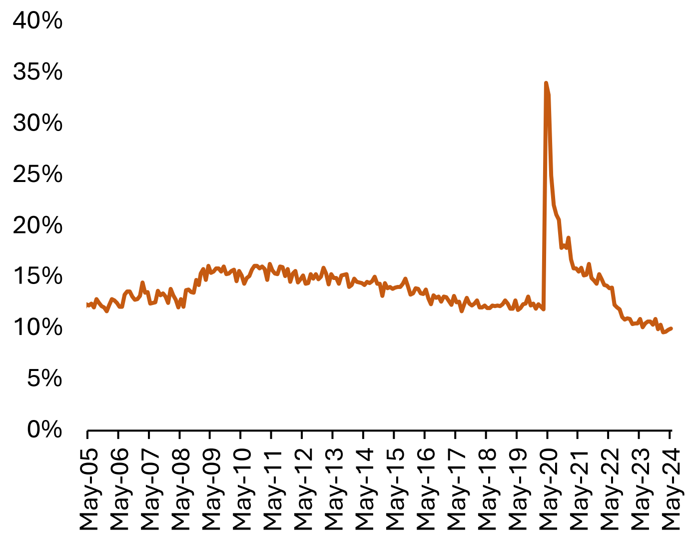
Source: Grupo Financiero BASE with information from INEGI.

The National Survey of Occupation and Employment (ENOE) published by INEGI shows that approximately 667,000 jobs were created in the first five months of the year, while the unemployed population decreased by approximately 23,000 people. As a result, Mexico's Economically Active Population (EAP) rose to 61.42 million people, with 59.81 million employed and 1.61 million unemployed. Thus, the unemployment rate, which represents the percentage of the EAP in unemployment, decreased from 2.78% in December 2023 to 2.61% in May 2024. This is the second-lowest rate since the series began in INEGI (January 2005), only surpassed by the 2.59% recorded in February 2024. Additionally, the urban unemployment rate, representing more organized labor markets with greater formality, reached its lowest level on record at 3.21% in April 2024, and in May it increased slightly to 3.29%.

It is important to remember that INEGI considers unemployed individuals to be "persons aged 15 and over who in the reference week (of the survey) were looking for work because they were not linked to an economic activity or job." Thus, if a person does not have a job but also does not seek one, they would not be considered unemployed. People who neither have nor seek work fall into the Economically Inactive Population (EIP), within which there are two groups. If these individuals in the EIP are not willing to work, they are considered in the "not available" population, which includes approximately 35.02 million people. This "not available" population mainly consists of students, retirees, and people dedicated to household chores. However, if people who neither have nor seek work are willing to work if offered a job, they are classified as "available." The ENOE of May 2024 shows that the "available" population includes approximately 5.03 million people, a figure 6.9% lower than in May 2023.

Since the available population has the willingness or intention to work, it is also known as the "discouraged" population. If this population is considered "unemployed," an extended unemployment rate can be discussed, which in May 2024 stands at 9.99%. Like the unemployment rate, the extended unemployment rate is also at historically low levels, with the historic low (9.61%) recorded in February 2024.

Fig. 7. Extended unemployment rate



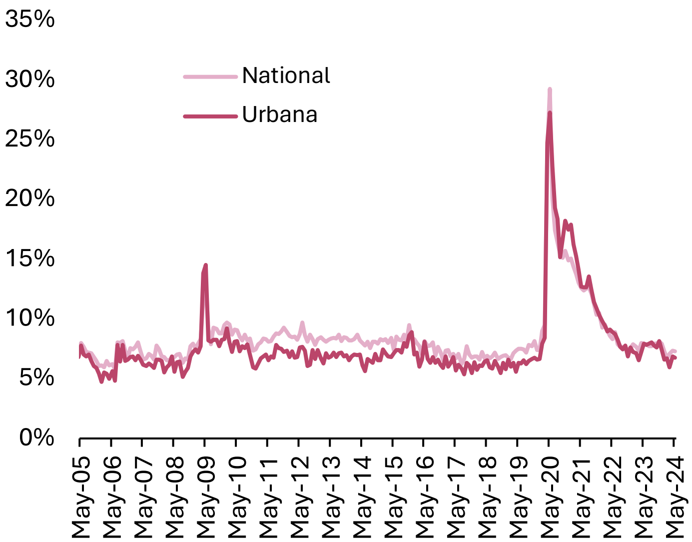
Source: Grupo Financiero BASE with information from INEGI.

Another important labor market indicator is underemployment. This indicator measures the percentage of the employed population that has the availability and need to work additional hours beyond what their current job requires. This rate is an indicator of worker vulnerability, as it means their current job does not provide sufficient income to meet their needs or those of their households. This indicator has also improved over the past 12 months and so far in 2024. In May, the underemployment rate stood at 7.29%, having slightly decreased from the 7.92% rate recorded in December 2023 and the 7.95% rate recorded in May 2023. Despite this rate being in constant decline since the peak of 29.26% reached during the pandemic crisis, the data shows stabilization around the 12-month average of 7.57%. This contrasts with the levels observed before the pandemic: in December 2019, the rate was 7.40%, and in December 2018, it was 7.00%. Furthermore, the current underemployment rate is significantly higher than the historical low of 5.79% recorded in June 2006. The urban underemployment rate stands at 6.75%, also well above the low of 4.73% recorded in January 2006.

The ENOE also provides information on labor informality, which is the situation where workers do not have access to social and labor benefits established by law, such as social security, retirement, and formal employment contracts. This includes both workers employed in unregistered companies and those who are self-employed or work in small economic units that do not comply with fiscal regulations. This phenomenon affects a large part of the working population in Mexico, as in May, the labor informality rate stood at 54.47%. This implies that more than half of the workers accounted for by INEGI are under this scheme.

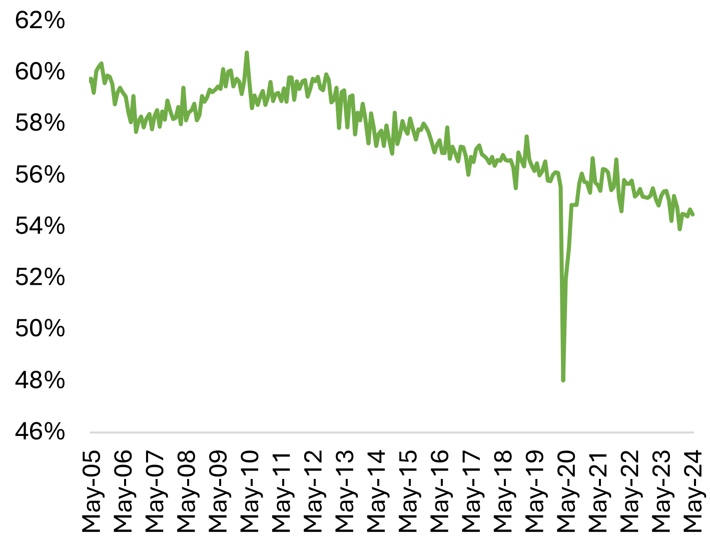
Historical data from the survey shows a clear downward trend in informality, but at a very slow pace. In 2005, the average informality rate for the year was 59.8%, which decreased to 57.8% in 2015, and over the past 12 months (June 2023 to May 2024), it decreased to 54.7%. At this linear rate (approximately 2.5 percentage points every 10 years), it would hypothetically take Mexico 120 years to reach an informality rate similar to that of Chile, which is around 25%.

Fig. 8. Underemployment Rates



Source: Grupo Financiero BASE with information from INEGI.

Fig. 9. Labor informality rate



Source: Grupo Financiero BASE with data from INEGI.

As mentioned earlier, the Mexican Social Security Institute (IMSS) publishes the number of formal private-sector jobs each month. The most recent data, corresponding to June 2024, shows a total of 22.32 million workers registered with the IMSS. This figure means that 295,000 jobs were created in the first half of the year, of which 265,000 were created in the first quarter and 30,000 in the second. This behavior is normal, as a significant decrease in the total number of insured workers at the IMSS is usually observed in December each year, which tends to recover in the first months of the following year.

In percentage terms, employment growth in the first half of the year was 1.34%. Excluding the contractions observed in the first half of 2020 (COVID-19 pandemic crisis) and the first half of 2009 ("Great Recession"), this employment growth rate is the lowest for a first half-year since 2003. Additionally, the 432,000 jobs created between June 2023 and June 2024 represent a percentage increase of 1.97%, the lowest rate since March 2021. This slowdown is consistent with what the ENOE reflects, as with the unemployment rate at historical lows, a stagnation in job creation is not unexpected.

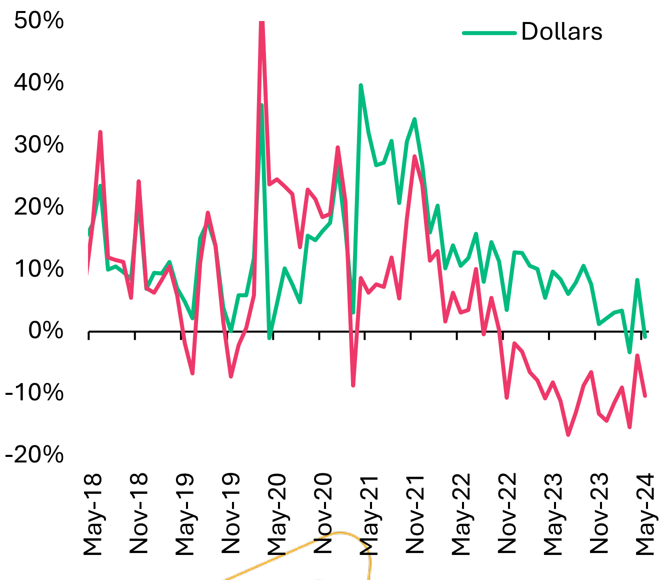
The IMSS also reports the average base salary for registered jobs. In June 2024, the average salary was 584.93 pesos per day, representing an annual growth of 9.53% in current pesos. Considering the annual inflation rate of 4.98% recorded in June, the real increase in the average salary is 4.34%, the lowest since March 2023.
Multiplying the average real salary by the total number of workers registered with the IMSS yields an indicator of the real wage mass (excluding the informal sector, which, as already mentioned, accounts for almost 55% of workers). This real wage mass indicator recorded an annual growth of 6.40% in June 2024, the lowest rate since December 2021. Nevertheless, despite the slowdown, it is evident that the growth rate of the real wage mass remains high compared to the history observed since the beginning of the series in 2001. Of the 282 months of available information, only in 50 months has the growth of the real wage mass exceeded 6%.

REMITTANCES

Remittances are a vital source of income for Mexico. This flow of money, sent mainly by Mexicans working abroad, especially in the United States, supports millions of families and boosts domestic consumption. In May 2024, the inflow of remittances recorded a decline of 0.90% compared to the inflow that entered the country in May of the previous year. This is already the second annual decline this year, as there was a 3.38% drop in March (the steepest decline since May 2013). Additionally, it is important to mention that in the past 10 years, annual declines in monthly inflows have been rare, occurring only in 7 months out of the 125 months since January 2014. The annual decline in remittances in May this year may have been due to the deterioration of the labor market in the United States and the possibility that remittances within household income are being partially replaced by government transfers.

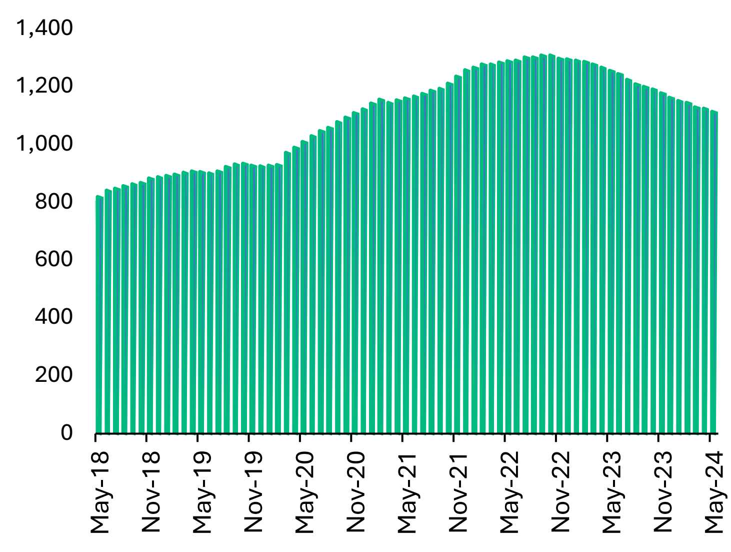
However, what matters for people receiving remittances is the purchasing power they provide, which depends on the exchange rate and inflation. Converting the inflow of remittances to Mexican pesos and adjusting these figures with the National Consumer Price Index (INPC), it is found that the purchasing power of remittances has been recording annual contractions since November 2022. For the most recent month (May), the contraction was 10.37%. For June, remittances are expected to show real annual growth due to the depreciation of the peso in that month. However, for the entire year 2024, the purchasing power of remittances is estimated to decrease by 0.74% compared to 2023. This means that Mexican households will be able to buy fewer goods and services with the remittances their relatives living in other parts of the world send them. Consequently, consumption could continue to slow down this year.

Fig. 10. Annual growth of monthly remittance inflows



Source: Grupo Financiero BASE with information from INEGI.

Cumulative flow of remittances in the last 12 months, in billions of real pesos



Source: Grupo Financiero BASE with data from INEGI.

FOREIGN TRADE

In the first half of 2024, export growth has slowed, accumulating an annual growth of 2.60%, below the 3.87% in the same period of 2023 (Figure 1) and the lowest accumulated growth for an equal period since 2020. In the first half of the year, 95% of exports were non-oil, accumulating an annual growth of 3.07%. Within this category, manufacturing represented 88.9% of total exports and grew by 2.90% in the first half, the lowest accumulated growth since 2020. Additionally, manufacturing exports showed a slowdown in their components. Automotive exports accumulated an annual growth of 6.50%, which, despite being high, is the lowest since 2020, and the rest of the manufacturing exports accumulated a growth of only 1.01% annually.

The slowdown in exports in the first half of the year is due to the close relationship between Mexican manufacturing production and that of the United States, where weakness has been observed since 2023. In the United States, manufacturing production shifted from showing an annual growth of 2.67% in 2022 to a contraction of 0.51% in 2023, while in Mexico, manufacturing production slowed from 5.62% in 2022 to a growth of only 0.91% in 2023. In the first five months of 2024, U.S. manufacturing production contracted by 0.68% compared to the same period in 2023, while in Mexico, the contraction in the same period was 0.81% (Figure 2, Table 1). The performance of manufacturing in Mexico follows that of the United States due to the integration of supply chains, and there is an 85% positive correlation between the production of both countries, considering data since the signing of the USMCA in July 2020.

Part of the impact on Mexican exports was attributed to the appreciation of the peso, which made domestic goods more expensive relative to foreign goods. However, the peso depreciated sharply in June due to the election results in Mexico, but exports continued to show poor performance that month.

Table 1. Cumulative annual growth of manufacturing in Mexico by subsector during the first 5 months of 2024.

Manufacturing subsector	Cumulative annual growth, first 5 months of 2024
Petroleum and coal products	10.10%
Other manufacturing industries	5.10%
Computer equipment, communication (...)	2.21%
Chemical industry	1.99%
Beverages and tobacco	1.07%
Alimentaria	-0.50%
Total manufacturing	-0.81%
Plastics and rubber industry	-0.97%
Transport equipment	-2.06%
Non-metallic mineral-based products	-2.55%
Accessories, electrical appliances (...)	-3.00%
Metal products	-3.16%
Basic metal industries	-3.45%
Printing and related industries	-3.64%
Furniture, mattresses and blinds	-3.65%
Machinery and equipment	-4.21%
Textile products, except garments	-5.00%
Paper	-6.20%
Clothing	-6.93%
Textile supplies and textile finishing	-7.69%
Wood	-8.16%
Leather tanning and finishing	-14.64%

Source: Grupo Financiero BASE with information from INEGI.

Why is U.S. manufacturing sluggish?

As of June, the ISM manufacturing indicator has been below the expansion threshold of 50 points in 19 of the last 20 months, due to the contraction of the order book and production, which has also resulted in the deterioration of manufacturing employment. In the United States, the adoption of a restrictive monetary stance has limited the growth of durable goods inventories since 2022 (Figure 3), negatively impacting the growth of manufacturing production.

During the 127 months of economic expansion between July 2009 and January 2020, when the Federal Reserve maintained a flexible monetary stance, durable goods inventories grew at an average real annual rate of 2.65%, significantly higher than the average annual growth of 1.23% in the last 12 months (up to June).

The decline in manufacturing production in the United States reduces the demand for intermediate and final manufacturing goods in Mexico, slowing its production and affecting exports. This also affects Mexico's imports, as the entry of intermediate goods directed at manufacturing production slows down.

In the first half of 2024, imports showed a growth of 2.20%. By type of goods, consumer goods imports accumulated a growth of 5.34%, slowing from 8.56% in the same period of 2023, while capital goods imports accumulated a growth of 10.82%, slowing from 23.23% in the same period of 2023. The lower growth in consumer goods imports is related to the weakening of private consumption in Mexico, while the slowdown in capital goods imports may reflect caution in investment due to the presidential elections in Mexico and the United States.

Finally, intermediate goods imports accumulated a growth of 0.58% in the first half, accelerating from a contraction of 1.70% observed in the same period last year. It is important to note that this growth (+0.58%) is a result of adjusting the previous year's decline and should not be considered sustained growth in intermediate goods imports. As mentioned, the stagnation of intermediate goods imports is directly related to the deterioration of manufacturing production and the slowdown in manufacturing exports, which accumulated their lowest growth since 2020.

Table 2. Breakdown of the trade balance. Original figures

Concepts	**Trade figures, first semester 2024**	
(original figures)	**Millions of dollars**	**YoY % var.**
Exports	**299,387**	**2.60%**
Oil	14,845	-5.66%
Non-oil	284,542	3.07%
Agropecuario	12,997	6.56%
Extractive	5,143	3.08%
Manufacturing	266,402	2.90%
Automotive	95,215	6.50%
Rest	171,187	1.01%
Imports	**304,885**	**2.20%**
Oil	19,143	-31.92%
Non-oil	285,742	5.75%
Consumer goods	44,235	5.34%
Intermediate goods	229,904	0.58%
Capital assets	30,746	10.82%

Source: Grupo Financiero BASE with information from INEGI.

In the second quarter, exports grew at a quarterly rate of 0.57% according to seasonally adjusted figures, driven by non-oil exports which grew by 1.05%, while oil exports contracted by 8.10%, accumulating three consecutive quarters of decline. Within non-oil exports, manufacturing exports grew by 0.83%, mainly due to a rebound in automotive exports, which advanced by 2.05% quarterly, after falling by 1.61% and 4.25% in the previous two quarters (Figure 4). This should not be interpreted as a recovery in export dynamism, but rather as a rebound in merchandise shipments after two consecutive quarters of decline. On the contrary, exports of the rest of the manufacturing sector grew by only 0.17% quarterly, slowing down from 3.53% quarterly in the first quarter.

Regarding imports, they showed moderate quarterly growth, advancing by 0.58% (Table 3), after growing by 4.11% in the first quarter. Within this, imports by type of goods showed mixed performance, with consumer goods imports falling by 0.54% (after growing by 5.46% in the first quarter), intermediate goods imports growing by 0.74%, slowing down from the growth of 3.78% in the first quarter, and capital goods imports growing by 1.07%, slowing down from 4.65% in the first quarter.

Table 3. Breakdown of the trade balance in the second quarter of 2024.

Concepts	**Trade figures, second quarter 2024**	
mdd (original)	**YoY % (original)**	**QoQ % (seasonally adjusted)**
Exports	**155,861**	**3.40%**
Oil	7,396	-9.68%
Non-oil	148,465	4.15%
Agropecuario	6,267	6.10%
Extractive	2,873	16.29%
Manufacturing	139,325	3.84%
Automotive	49,807	7.69%
Rest	89,518	1.81%
Imports	**158,653**	**4.08%**
Oil	9,253	-25.82%
Non-oil	149,400	6.75%
Consumer goods	22,810	7.30%
Intermediate goods	119,771	2.68%
Capital assets	16,071	10.59%

Source: Grupo Financiero BASE with information from INEGI.

Risks to the trade relationship between Mexico and the United States

The trade relationship with the United States is important for Mexico, as about 40% of GDP comes from exports, and around 80% of these are destined for the United States. Within the framework of the USMCA, there are three ongoing trade disputes against Mexico, one of which (concerning corn) is in the panel phase, with the resolution expected in August. These disputes represent a risk due to the possibility that the United States might impose trade sanctions on Mexico.

Panel on transgenic corn

- On April 13, 2020, Mexico published the Federal Law for the Promotion and Protection of Native Corn, shortly before the USMCA came into effect on July 1, 2020.
- On December 31, 2020, Mexico published a presidential decree prohibiting the granting of permits for the use, release, or planting of transgenic corn. On February 13, 2023, a decree was published prohibiting the use of genetically modified corn for the production of masa and tortillas.
- On March 6, 2023, the Office of the United States Trade Representative (USTR) formally requested to initiate technical consultations to address the February 13 decree.
- On June 2, the Mexican government received the USTR's request to initiate consultations under the dispute resolution mechanism (Chapter 31).
- On August 17, 2023, the Mexican government received the request to initiate a panel under the dispute resolution mechanism. On June 26 and 27, 2024, public hearings were held as part of the process, and another panel meeting is expected on August 5, 2024. The final panel report, including the resolution, is expected to be published in November this year.

Panel on rules of origin in the automotive sector

- On August 20, 2021, Mexico requested the initiation of technical consultations with the United States government regarding the interpretation of the automotive sector's rules of origin chapter.
- On January 6, 2022, Mexico submitted a request to establish a panel to determine that the United States' interpretation and application of the rules of origin provisions were incorrect.
- On January 11, 2023, the panel's final report was published, ruling in favor of Mexico and Canada, which had joined the panel request. It concluded that the interpretation and implementation of the rules of origin were inconsistent with the agreement. It was determined that under the USMCA rules, manufacturers can consider essential parts of the vehicle (such as engines and transmissions) as originating from Mexico or Canada, provided they have a regional content of at least 75%.

Consultations regarding amendments to the Electricity Industry Law in Mexico

- On July 20, 2022, the Mexican government received a request from the United States to initiate consultations regarding its energy policy under the USMCA framework. At the same time, the Mexican government received a request from the Canadian government. The requests from both countries alleged that Mexico's energy policies, such as the amendment to the Electricity Industry Law, delays in granting permits to private electricity generation companies, and restrictions on natural gas transportation services, favor Mexican state-owned companies to the detriment of foreign companies participating in the private sector.
- On January 31, 2024, the amendment to the Electricity Industry Law was declared unconstitutional by the Supreme Court of Justice (SCJN). According to the SCJN, strengthening state-owned companies is not a reason to disregard the constitutional framework regarding electricity generation, and the CFE is just one more competitor in the market.
- Neither the United States nor Canada has requested the initiation of a panel, probably due to political timing. On May 22, 2024, U.S. Trade Representative Katherine Tai expressed the importance of advancing energy consultations. Tai also expressed concerns about competitive conditions in the telecommunications market, specifically regarding the spectrum usage fee methodology.

Elections in the United States

Another risk for Mexico's trade is the electoral process in the United States. Donald Trump currently has a higher probability of winning and has used Mexico as a campaign tool. Among Trump's proposals, there are four that would directly impact Mexico:

1. **Reducing the corporate tax rate from 21% to 15%.** Mexico and the United States have an agreement to avoid double taxation and prevent tax evasion. Theoretically, this agreement would prevent the tax reduction from making a difference in a company's location decision. However, the difference in taxes implies transfer pricing and other processes that involve time and transaction costs that companies sometimes do not want to bear. In Mexico, the income tax rate (ISR) is 30%, and there is also a 10% profit-sharing requirement for companies. The reduction in the corporate tax rate proposed by Trump is an incentive for companies to bring their factories and jobs back to the United States.
2. **Designating drug cartels as foreign terrorist organizations.** There is a fear that this could lead to the U.S. military entering Mexican territory (as it has done in Afghanistan and other countries) to combat the cartels. The result would be a diplomatic crisis between Mexico and the United States, as well as the possible imposition of sanctions to force the Mexican government to take measures desired by the U.S. government. It is important to remember that public insecurity undermines Mexico's economic growth and is estimated to be one of the factors that has driven up inflation in agricultural products.
3. **Imposing tariffs of 60% to 100% on Chinese imports and 10% on all imports to reduce the trade deficit.** In fact, at the Republican National Convention, Trump mentioned that he would impose tariffs of 100% to 200% on Chinese cars manufactured in Mexico, so they could not be sold in the United States. The imposition of tariffs constitutes the greatest commercial risk for Mexico. Additionally, it would remove incentives for foreign direct investment to come to the country, and the nearshoring opportunity could vanish. Recently, Elon Musk, CEO of Tesla, said he would delay the decision to build a factory in Mexico until after the U.S. elections, which is considered evidence of the risk Trump represents for nearshoring. Musk politically supports Trump, so it is possible that if Trump wins, Tesla may never come to Mexico.
4. **Mass deportation of illegal immigrants.** According to INEGI, the Mexican-born population that emigrated abroad, almost entirely to the United States, is 11.7 million. Of that total, an estimated 30% are illegal. Mexican immigrants (both legal and illegal) in the United States send remittances to their families in Mexico, which totaled $63.78 billion in the twelve months ending in May 2024. This measure puts the flow of remittances to Mexico at risk.

Trump is known for being an aggressive negotiator who does not materialize all his threats. Therefore, the exchange rate has not reacted as strongly as it did in 2016 at the possibility of him winning the presidential election.

On the other hand, Kamala Harris has not mentioned Mexico in her campaign so far and has focused her efforts on issues such as the permanence of democracy in the United States and abortion. Likewise, the candidate has not made specific proposals for the economy and is not considered a risk to Mexico in her campaign. However, if she wins the election in November, she could be a greater risk to the U.S. economy due to the Democrats' populist measures. Additionally, it is estimated that the review of the USMCA would be as strict as under a Trump administration, but with a less dramatic and aggressive tone.

FIXED INVESTMENT

Fixed investment is the most important component for long-term economic growth, as the acquisition of physical assets, such as machinery and equipment, is essential to increase the productive capacity of an economy. This type of investment not only increases the productive capacity of the economy but also generates jobs and fosters innovation. By establishing a solid base of physical capital, fixed investment allows economies to sustain long-term growth and compete more effectively in the global market. In this context, it is crucial to analyze the trends and factors influencing fixed investment, as its dynamism is an indicator of a country's economic health and growth potential.

Investing is a difficult task, as it requires saving, which implies a sacrifice of present consumption. In the last 30 years, investment has rarely represented more than 25% of GDP, and although the percentage increased considerably after the implementation of NAFTA in 1994, it began to trend downward from 2012. Currently, this percentage is again above 25% following a drastic increase driven by investment in non-residential construction and imported transportation equipment. As a result, the gross fixed investment indicator published by INEGI is at its highest level since the series began in 1993.

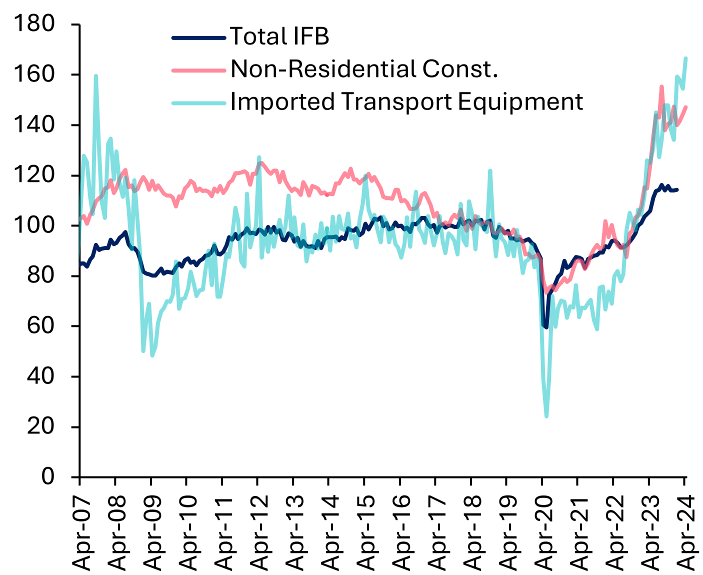
The most recent data, corresponding to April 2024, shows that gross fixed investment grew at an annual rate of 10.50%. While this represents a slowdown compared to the average observed in the third quarter of 2023 (24.3% annually), growth remains high. Investment in machinery and equipment shows an annual growth of 5.25%, and investment in construction of 13.49%. However, as mentioned, two sectors are driving the growth. Non-residential construction, which consists mainly of public infrastructure works, is growing at an annual rate of 18.66%, while residential construction grows at only 6.67%. Meanwhile, investment in imported transportation equipment is growing at an annual rate of 33.29%, while investment in domestic transportation equipment is only growing at 9.38%. Regarding machinery and equipment other than transportation, imported equipment grew at 3.05% annually (the lowest since June 2021), and domestic equipment showed an annual contraction of 7.55% (declines not seen since the pandemic crisis).

Table 4. Breakdown of Gross Fixed Investment. Figures as of April 2024.

Indicator	MoM	YoY	Accumulated in the year (YoY)	Month of maximum obs.	vs. max.
Gross Fixed Investment	**0.93%**	**10.50%**	**11.37%**	**Apr.-24**	**0.00%**
Machinery and equipment	**-0.81%**	**5.25%**	**7.00%**	**Mar.-24**	**-0.81%**
National	-3.00%	1.16%	2.94%	Dec.-16	-6.85%
Transport equipment	-5.53%	9.38%	12.52%	Dec.-16	-12.26%
Machinery, equipment, and other assets	-1.03%	-7.55%	-5.95%	Dec.-11	-14.26%
Imported	-0.11%	6.91%	9.61%	Mar.-24	-0.11%
Transport equipment	7.73%	33.29%	36.71%	Apr.-24	0.00%
Machinery, equipment, and other assets	-1.86%	3.05%	6.41%	Mar.-24	-1.86%
Construction	**1.59%**	**13.49%**	**14.89%**	**Aug.-23**	**-2.38%**
Residential	1.37%	6.67%	4.06%	Dec.-17	-17.44%
Non-residential	1.84%	18.66%	24.07%	Aug.-23	-5.32%

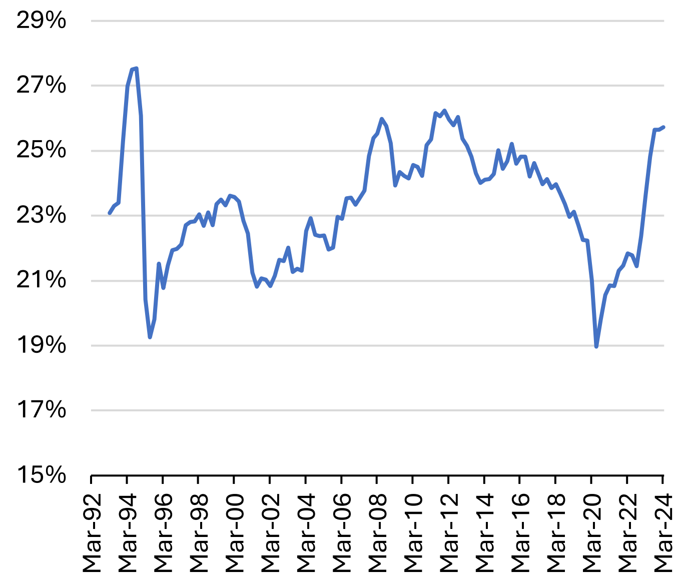
Source: Grupo Financiero BASE with information from INEGI.

Fig. 11. Gross Fixed Investment, 2018=100



Source: Grupo Financiero BASE with information from INEGI.

Fig. 12. Investment as % of GDP



Source: Grupo Financiero BASE with data from INEGI.

It is of utmost importance to consider the impact that the political and economic uncertainty caused by the succession of power, which will take place in September (Legislative) and October (Executive), can have on investment.

On one hand, private investment faces significant challenges related to the uncertainty caused by the legal reforms proposed by the current administration, such as the initiative to modify the functioning of the Judiciary or the "Plan C" to change the electoral legal framework. This undermines the confidence in the institutions of Mexico's economy[2].

On the other hand, public investment faces the challenge of the high indebtedness incurred by the federal government in 2024, which was used to complete the flagship projects of López Obrador's administration and the high public spending typical of election years. The Preliminary General Economic Policy Criteria for 2025 (Pre CGPE 2025) published by the Ministry of Finance and Public Credit (SHCP) in April, show that the Public Sector Financial Requirements (RFSP, the broadest measure of debt incurred by the public sector in a fiscal year) will amount to 5.9% of GDP in 2024. This represents an increase from the 5.4% that had been approved in the 2024 Revenue Law, a level of indebtedness that had already been criticized for being the highest since records began (1988). Following this, the Ministry of Finance predicts that the RFSP will reduce to 3.0% in 2025 in a fiscal consolidation effort that will undoubtedly have a negative impact on investment and growth.

For these reasons, Grupo Financiero BASE estimates that gross fixed investment will grow by 7.3% in 2024, but for 2025, a sharp slowdown is expected, with a high probability of declines in some months due to: 1) the mathematical effect of a high comparison base with 2024, 2) lack of fiscal space for large public sector infrastructure projects, and 3) caution from the private sector due to the reforms and the start of the next administration.

[2] See section on Public Sector.

FOREIGN DIRECT INVESTMENT

Foreign Direct Investment (FDI) plays a crucial role in the economy and economic growth of Mexico. To attract foreign capital, Mexico needs to foster the development of strategic sectors, invest in the modernization of its infrastructure and education, and generally improve the competitiveness of the economy. Similarly, the arrival of FDI further boosts these sectors, contributes to the creation of formal employment and higher wages, transfers new technologies, and opens new opportunities for Mexico in global markets.

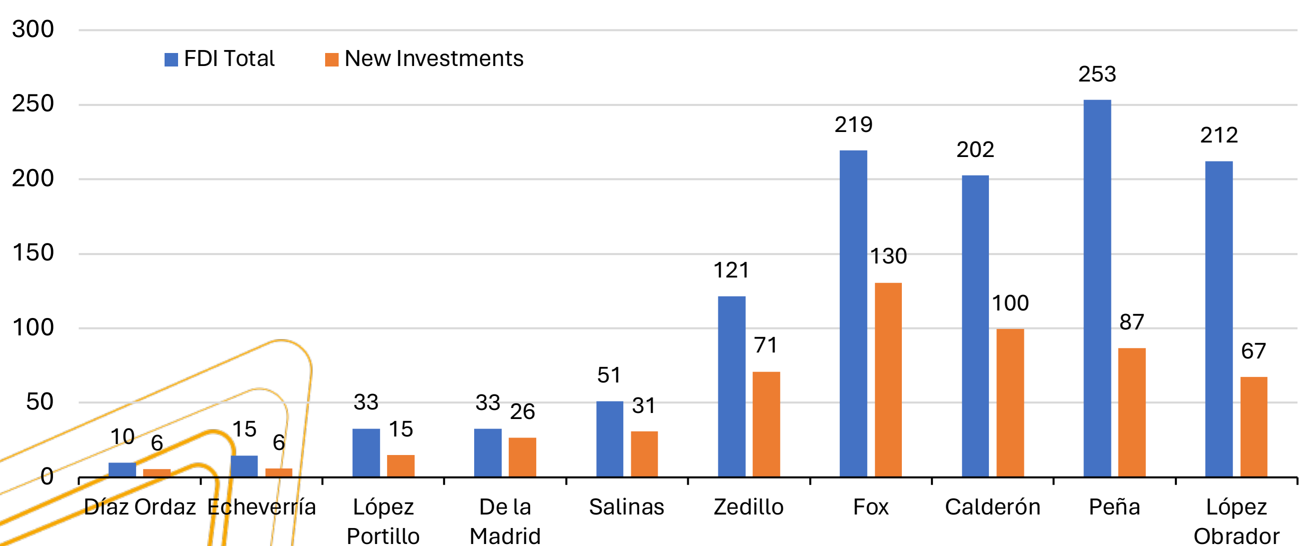
The most recent figures from the balance of payments published by the Bank of Mexico (first quarter of 2024) show that Mexico received a total of $20.3 billion in Foreign Direct Investment. The first quarter of each year usually sees the highest FDI inflow and typically exceeds the FDI that enters in the other three quarters combined. In this case, the first quarter 2024 inflow is the lowest since the first quarter of 2021 (adjusted for inflation).

In the first 21 quarters of the current administration, Mexico received $211.9 billion in FDI (at constant prices of the first quarter of 2024). This figure is 16.3% lower than that observed during the first 21 quarters of the Peña Nieto administration, but 4.7% higher than that of the Calderón administration.

However, breaking down the FDI by type of investment reveals other interesting trends. Specifically, the "new investments" category within FDI is especially important, as it represents fresh capital injected into the Mexican economy, aimed at new projects or the expansion of existing operations.

The balance of payments shows that in the first quarter, of the $20.3 billion in FDI, only $599 million were for "new investments." This means that only 2.95% of the FDI were new investments; excluding the five quarters where the percentage was negative, this is the lowest percentage since records began (first quarter of 1960). Additionally, analyzing the accumulated new FDI investments in the first 21 quarters of each administration, it is observed that the current administration has received the lowest flow for the same period since the Salinas de Gortari administration (Q1 1989 - Q1 1994).

Fig. 13. Cumulative FDI in the first 21 quarters of each six-year period. Billions of dollars, inflation-adjusted figures.



Source: Grupo Financiero BASE with information from INEGI.

PUBLIC SECTOR

The recent victory of Claudia Sheinbaum in the presidential elections on June 2, 2024, has had a significant impact on Mexico's economic landscape. The resounding triumph of the “Sigamos Haciendo Historia” coalition (comprising the MORENA, PT, and PVEM parties) not only allowed them to retain power but also considerably improved their position in the Congress of the Union. With this victory, the coalition achieved an absolute majority (with 64.1%) and came just a few seats short of reaching a qualified majority (66%), giving them substantial control over the legislative agenda and the ability to implement reforms more easily.

During her campaign, Claudia Sheinbaum presented herself as a candidate committed to continuing the agenda of her predecessor, Andrés Manuel López Obrador. However, there is considerable uncertainty regarding Sheinbaum's true intentions once she assumes the presidency. Although her campaign rhetoric was one of continuity, there is speculation that her ideology might be less radical and more orthodox compared to López Obrador's.

This potential shift in the ideological direction of the new administration generates various expectations. A moderation toward a more orthodox economic agenda could mean greater stability and predictability in economic policies, which would be well-received by investors and international markets. However, any significant deviation from current policies could provoke discontent among MORENA's electoral base, which would be very costly for Sheinbaum in the 2027 midterm elections.

In this context, Mexico's economic outlook for the coming years is marked by uncertainty between the continuity of the current agenda or the possibility of change. It is also possible that the narrative will continue to be one of continuity, but in practice, a market economy will be fostered, with the "unfreezing" of the energy reform and the return of investment spending in infrastructure.

With the legislative majority in her favor, and only a few votes short of achieving a qualified majority, Sheinbaum will have the opportunity to implement virtually any agenda she desires, with the judiciary being the only counterbalance. This is where the constitutional reform initiative proposed by López Obrador in February this year to make changes to the judiciary becomes extremely important.

The main changes proposed by the reform initiative are:

- Both the ministers of the Supreme Court of Justice of the Nation (SCJN) and the magistrates of the federal Electoral Tribunal, circuit magistrates, and district judges are to be elected by popular vote.
- Reduce the number of SCJN ministers from eleven to nine.
- The remuneration of SCJN ministers, magistrates, and judges cannot exceed that received by the President of the Republic.
- Reduce the term of SCJN ministers from 15 years to 12, and eliminate the right to a retirement benefit ("pension").
- Eliminate the two Chambers of the SCJN, which currently divide matters by subject. The SCJN is divided into two Chambers, each composed of 5 ministers. The First Chamber deals with civil and criminal matters, while the Second Chamber deals with administrative and labor matters. With the elimination of the Chambers, all matters will be resolved by the Full Court of the SCJN, which currently consists of 11 ministers, but would be 9 if the reform is approved.
- Prevent general suspensions of general norms from having general effects in amparo trials, constitutional controversies, and actions of unconstitutionality.

Before discussing the content of the reform initiative, it is important to mention that the proposal itself can harm the economy, as changes to the functioning of Mexico's judicial system (which is already a complex issue for most) can generate significant uncertainty for investors. Additionally, it represents an additional cost, as companies have to dedicate resources to understanding the content, scope, and consequences of the reform.

Now, addressing the content of the reform initiative, it is evident that the changes aim to weaken the Judicial Power to give more strength to the Executive and Legislative powers, both of which would be controlled by MORENA and its allies. One of the most concerning consequences is the possibility that the reform could facilitate corruption within the Judiciary. Starting with the Supreme Court, the initiative proposes that the election of the nine ministers be held in June 2025, meaning that the current 11 ministers would be prematurely terminated and replaced by the new Court. With fewer ministers and reduced remunerations, the possibility increases that actors in a trial could "influence" judicial decisions. For obvious reasons, the influence that could be exerted in courts below the Supreme Court would be even greater. In a context where there are already concerns about integrity within the Mexican judicial system, this reform could worsen the situation, further reducing confidence in the justice system. It is important to remember that the enforcement of ther law is one of the most basic and important roles that the State plays in an economy, as it is the set of institutions through which property rights are enforced. Without a fair and efficient judicial system, economic development becomes unattainable.

The issue of suspensions is also important, as the initiative aims to prevent them from being granted with general effects against laws. When speaking of a "suspension" (provisional or definitive) of a challenged act, it should be clarified that it is a temporary suspension. The purpose of the suspension is to prevent the rights of the parties involved from being irreversibly affected during the time it takes to resolve the trial. In cases such as an amparo filed against a fine imposed by an authority, the suspension only affects the citizen who filed the lawsuit and the authority that issued the fine. However, suspensions with general effects have a much broader scope. When a general norm, such as a law, is challenged and a suspension with general effects is granted, it not only affects those involved in the trial but also everyone under its scope of application.

President López Obrador has repeatedly expressed his negative opinion about suspensions, as this mechanism paused several of his projects and reforms, such as the construction of the Maya Train, the reform to the Electricity Industry Law in 2021 (known as the "Combustoleo Law"), or the "Plan B" to modify the electoral legal framework. This is why the president seeks to eliminate this legal figure that has been a constant obstacle during his term. However, this could leave citizens in a state of defenselessness against actions by authorities that violate their human rights.

As it is a constitutional reform, its approval requires a qualified majority in Congress (two-thirds of the quorum in both chambers) and must also be approved by the absolute majority of local congresses (17 out of 32). As mentioned earlier, the current administration does not have the necessary number of legislators in the LXV Legislature to pass the initiative. However, the LXVI Legislature is close to achieving a qualified majority and takes office on September 1, one month before the presidential succession. This gives President López Obrador a window of opportunity to secure the necessary votes in the new legislature and approve the reform. Therefore, it is expected that the initiative will be put to a vote during the first weeks of the new legislature.

The approval of this reform constitutes a risk to Mexico's economic growth, as it would hinder fixed investment and the arrival of foreign direct investment. Of course, the impact will depend on the degree of implementation of the reform, as the project could be partially approved, leaving some changes out.

Furthermore, there are other reform initiatives proposed by President López Obrador. Another concern is the proposal to dissolve various autonomous state bodies, including the National Electoral Institute (INE), the Federal Telecommunications Institute (IFT), the Federal Economic Competition Commission (COFECE), and the Energy Regulatory Commission (CRE). The dissolution of these bodies would imply transferring their powers to state secretariats. For example, the initiative aims to transfer the functions of the CRE to the Ministry of Energy, which is directly under the control of the Executive Power. Reforms of this nature would have strong implications for industrial organization and present a significant change in rules, generating uncertainty and threatening the property rights of market agents.

Last week, the Constitutional Points Commission of the Chamber of Deputies announced its schedule for discussing the reform initiatives sent by López Obrador, starting on August 1. As previously mentioned, Congress will attempt to prepare the bills to be sent to the plenary when the new Legislature is established on September 1.

It is also important to consider that President-elect Sheinbaum could come in with her own reform agenda. In a press conference, Sheinbaum mentioned the possibility of state-owned enterprises (PEMEX and CFE) becoming part of state secretaries (likely the Secretary of Energy). López Obrador had already presented an initiative to change the name from state productive enterprises to public enterprises. However, integrating these companies into the federal government could have significant implications for public finances and credit quality. For example, there is uncertainty about whether such a change would mean allocating even more resources to the oil company or an unconditional backing of the debt it has issued.

Public finances

As of the end of May, the figures show the effort made by the federal government to increase public spending ahead of the elections. Budget revenues accumulated in the period from January to May show a real increase of 5.4% compared to the same period in 2023, while in the same period, total net spending grew by 17.3% and programmable spending by 21.3%. Additionally, there is an over-expenditure of the budget, as 1.5% more has been spent than was planned by the spending program.

A large part of the increase in spending was financed by debt. In fact, the collection of Income Tax (ISR), the largest source of revenue, shows a decline of 0.9%. However, this drop is offset by a 3.9% increase in the collection of Value Added Tax (IVA) and a 62.6% increase in the Special Tax on Production and Services (IEPS).

The increase in spending is widespread: capital expenditure increased by 56.7% (physical investment by 33.5%) to complete the flagship infrastructure projects of the López Obrador administration, while current expenditure increased by 13.3%, within which the subsidies and transfers category rose by 28.5%.

With budget revenues of 3.22 trillion pesos and net spending of 3.80 trillion, the budget deficit amounts to 557.4 billion pesos. However, it is important to consider that this includes the financial cost of the debt, which as of May amounts to 391.9 billion pesos. Subtracting the financial cost from the net spending, the primary budget balance results in a deficit of 165.5 billion pesos. Even when adding the "savings" generated by entities under indirect budgetary control, the primary deficit reduces to 150.9 billion pesos, which is still significant and represents approximately 1.1% of GDP (using the average GDP of the last 4 available quarters, from the second quarter of 2023 to the first quarter of 2024).

This figure is important because it indicates that even without considering the spending allocated to paying the cost of existing debt, the federal public sector continues to incur debt. Maintaining a positive primary balance is seen by rating agencies as an indicator of the health of public finances. During the early years of López Obrador's administration, the Ministry of Finance (SHCP) managed to maintain primary surpluses in 2019 and 2020 through some savings and financial management maneuvers. Additionally, in 2021, 2022, and 2023, primary deficits were kept below 1% of GDP. However, the current level exceeding 1% and expected to close the year at 1.4% would be the highest since records began (1990).

Table 5. Summary of budget revenues and public sector spending. Cumulative figures from January to May 2024.

	Observed	Δ % actual	Program	Diff. vs. prog.	Diff. % Diff.
Budgetary income	**3,222,382.7**	**5.4%**	**3,134,971.7**	**87,411.0**	**2.8%**
Oil	473,551.9	12.7%	463,359.2	10,192.7	2.2%
Non-oil	2,748,830.8	4.2%	2,671,612.5	77,218.3	2.9%
Tax income	**2,132,374.8**	**5.9%**	**2,126,861.7**	**5,513.1**	**0.3%**
Income Tax	1,220,162.3	-0.9%	1,234,489.7	-14,327.4	-1.2%
VAT	559,128.2	3.9%	524,152.0	34,976.2	6.7%
IEPS	261,317.4	62.6%	284,262.7	-22,945.3	-8.1%
IEPS gasoline and diesel	161,326.9	148.4%	n.a.	n.a.	n.a.
Other IEPS	99,990.5	4.4%	n.a.	n.a.	n.a.
Non-Tax	160,432.9	-13.5%	122,598.0	37,834.9	30.9%
Total expense	**3,779,777.0**	17.3%	**3,759,387.8**	**20,389.2**	**0.5%**
Programmable expense	**2,778,510.9**	**21.3%**	**2,736,510.7**	**42,000.2**	**1.5%**
Current expense	2,115,391.6	13.3%	n.a.	n.a.	n.a.
Capital expenditures	663,119.3	56.7%	n.a.	n.a.	n.a.
Physical investment	472,261.5	33.5%	n.a.	n.a.	n.a.
Non-programmable expense	**1,001,266.0**	**7.5%**	**1,022,877.1**	**-21,611.1**	**-2.1%**
Financial cost of debt	391,884.0	5.7%	n.a.	n.a.	n.a.

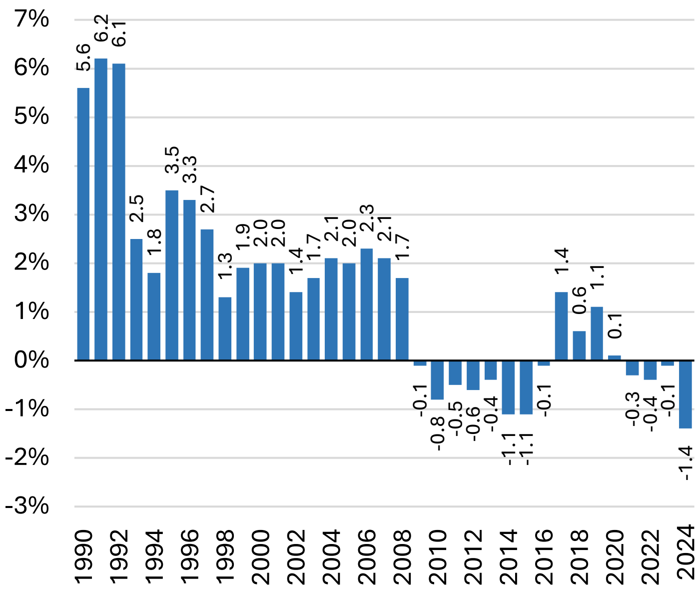
Source: Grupo Financiero BASE with information from INEGI.

Additionally, the Public Sector Financial Requirements (RFSP), which represent the total financial obligations of the federal public sector acquired in a period, amounted to 645.7 billion pesos in the first 5 months of 2024. This amount is equivalent to approximately 4.8% of GDP. As previously mentioned, the SHCP estimates that by the end of the year, the RFSP will be equal to 5.9% of GDP, which means the pace of indebtedness will increase in the remaining months of 2024.

Finally, the Historical Balance of the Public Sector Financial Requirements (SHRFSP), which is the total financial obligations of the public sector, amounts to 15.58 trillion pesos as of the end of May. This level of debt is equivalent to 48.37% of GDP, and the SHCP estimates that by the end of 2024, it will be 50.2%. Thus, the debt-to-GDP ratio would close the term well above the 43.6% with which Peña Nieto's term ended, which was the same level observed at the end of 2020 during the pandemic crisis. Furthermore, the SHCP expects that by the end of 2025, even with the fiscal consolidation planned for the year, the debt-to-GDP ratio will remain at 50.2%.

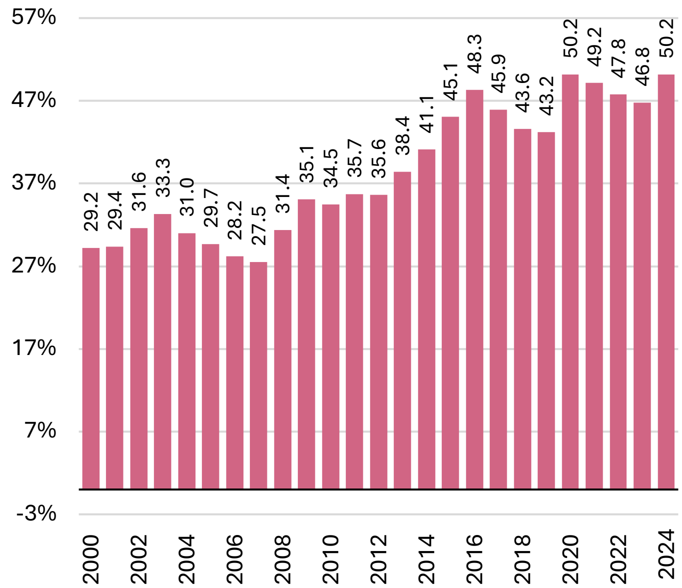
It has been said that in 2025 there will no longer be public spending on the major infrastructure projects of this administration, but this would only reduce the deficit to 4.3% of GDP. This means that the SHCP will need to cut spending in other areas or collect more revenue, but the latter will be challenging with the economic slowdown expected for 2025 as it is the first year of the new administration.

Fig. 14. Primary balance as % of GDP



Source: Grupo Financiero BASE with information from INEGI.

Fig. 15. SHRFSP as a % of GDP



Source: Grupo Financiero BASE with data from INEGI.

INFLATION AND MONETARY POLICY

Headline (or general) inflation accelerated in the second quarter, showing an average monthly rate of 4.77%, compared to the average monthly rate of 4.57% in the first quarter of the year. As of June, consumer inflation in Mexico has been rising for four consecutive months, moving away from the Bank of Mexico's target of 3%. In the first half of July (latest available data), inflation was at an annual rate of 5.61%, the highest since the second half of May 2023.

Inflationary pressures have been concentrated in the non-core component, which registered a fortnightly inflation of 2.32% in the first half of July, the highest for the same fortnight since 1988. Within the non-core inflation, the sharp increase has been explained by all its subcomponents.

In the first half of July, the agricultural subcomponent saw a fortnightly price increase of 3.49% (the highest rate for the same fortnight since 1988), with fruits and vegetables registering a fortnightly inflation of 6.15%, historically high for the same fortnight. The rise in fruit and vegetable prices is due to various reasons, including concerns such as: 1) public insecurity, which generates uncertainty and increases costs for farmers, 2) the yellow dragon disease, which threatens to spread and reduce the global supply of citrus fruits, and 3) possible sanctions that the U.S. government may impose, as happened with avocados.

On an annual basis, all elements of the non-core component accelerated and registered high levels of inflation, not seen in some cases for several years:

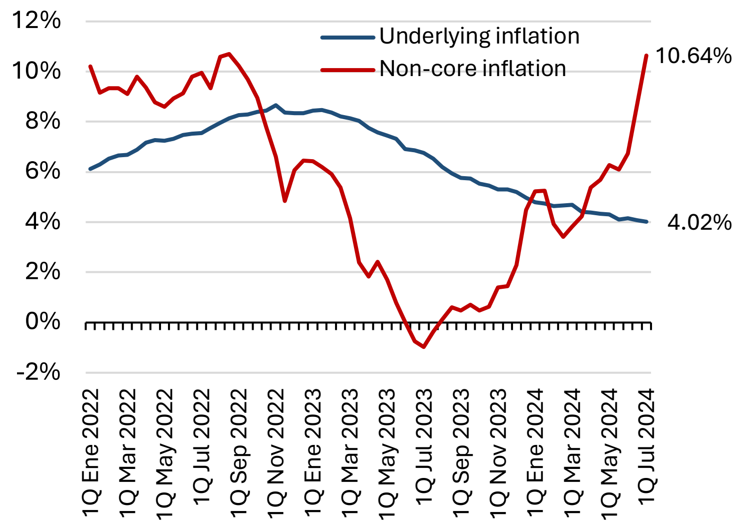
- Non-core inflation (10.64%): highest annual rate since the second fortnight of August 2022 and acceleration for three consecutive fortnights.
    - Agriculture and livestock (14.33%): highest rate since the first fortnight of October 2022 and accelerating for three consecutive fortnights.

    - Fruits and vegetables (25.69%): highest rate since the first fortnight of August 2017 and acceleration for three consecutive fortnights.
    - Livestock products (4.82%): highest rate since the second fortnight of May 2023 and acceleration for six consecutive fortnights.
  - Energy and government-authorized tariffs (7.30%): highest annual inflation since the first fortnight of August 2022 and acceleration for five consecutive fortnights.
    - Energy (9.16%): highest annual rate since the second fortnight of December 2021 and acceleration for five consecutive fortnights.
    - Government-authorized tariffs (3.38%): highest inflation since the first fortnight of March 2024 and acceleration for four consecutive fortnights.

Inflationary pressures within the non-core component are typically not a concern, as this component includes products with the most volatile prices, which can rise one day and adjust downwards a few days later. However, the persistence of high inflation threatens to pressure general inflation in the future by deteriorating medium- and long-term inflation expectations.

On the other hand, the core component registered an annual inflation of 4.02%, the lowest since the second half of February 2021. On an annual basis, all elements of the goods component decelerated, while those of services (except educational services) accelerated.

Fig. 16. Core and non-core inflation. Annual rates



Source: Grupo Financiero BASE with information from INEGI.

- Core inflation (4.02%): lower annual rate since the second fortnight of February 2021 and deceleration for two consecutive fortnights.
  - Merchandise (3.08%): lowest annual inflation since the first fortnight of February 2016 and deceleration for two consecutive fortnights.
    - Food commodities (4.03%): lowest rate since the first fortnight of September 2016 and deceleration for 37 consecutive fortnights.
    - Non-food merchandise (1.94%): lower rate since the second fortnight of May 2024 and deceleration for two consecutive fortnights.
  - Services (5.17%): highest annual inflation since the first fortnight of June and acceleration for the first time after three consecutive fortnights of deceleration.
    - Housing services (3.96%): highest annual rate since the second fortnight of March 2009 and acceleration for five consecutive fortnights.
    - Educational services (6.30%): lower inflation since the second fortnight of August 2023 and deceleration for three consecutive fortnights.
    - Other services (5.92%): highest annual rate since the first fortnight of June 2024 and first acceleration after 4 consecutive fortnights of deceleration.

The lower inflation in the core component has helped prevent inflation from skyrocketing. However, inflation remains at elevated levels with the risk of continuing to rise. Within the core component, there are concerns about

1) inflation in the services sector continuing to be under upward pressure, and 2) exchange rate volatility, which could generate upward pressure on the prices of goods.

Among the risks for core component inflation are the high budget deficit, higher labor costs, and possible disruptions in supply chains due to global geopolitical conflicts. Additionally, the rise in energy prices threatens to pressure core component inflation.

With the recent inflation data, the year-end inflation forecast has been revised upwards from 4.4% to 4.95%, which, if confirmed, would be the highest year-end inflation since December 2022 (7.82%). It is estimated that the Bank of Mexico will be cautious but will continue with interest rate cuts, taking advantage of the cuts that the Federal Reserve is expected to make this year. With this, the reference interest rate could close this year at 10.50%, down from the current 11%. This implies that the Bank of Mexico will maintain the interest rate differential with the U.S. Federal Reserve, but there will be less monetary tightening in Mexico, both due to the lower nominal interest rate and the higher expected inflation at the end of the year. For 2025, it is estimated that the Bank of Mexico will be more aggressive with interest rate cuts, due to the expected greater economic slowdown and also because Irene Espinosa Cantellano, the deputy governor who has been most resistant to interest rate cuts and who has included dissenting opinions, ends her term at the Bank of Mexico in December. It will be Claudia Sheinbaum, as President of Mexico, who will have to appoint someone for this position. Claudia Sheinbaum said in a press conference that it would be a woman, but as of now, the possible candidates are not known.

For 2025, it is estimated that the reference rate could close at 8.5%.

EXCHANGE RATE

In June, the peso faced its worst depreciation against the dollar since 2020, when the pandemic began. The election results in Mexico were a key factor, but not the only one. The Mexican peso is the most liquid currency in Latin America—it operates 24 hours a day, 365 days a year, and is also used as an investment asset. In fact, almost 80% of transactions with the peso are related to speculation and only 20% to the real economy, in operations related to trade and remittances, according to data from the Bank of Mexico. Like any investment asset, its demand depends on its yield and risk relative to other investment assets.

With the election results in Mexico, the perception of risk regarding Mexico increased due to the possibility of constitutional reforms being carried out before the end of this administration. Thus, with higher risk, some investors decided to unwind their investment positions in pesos, causing the exchange rate to rise. With the depreciation of the peso, its yield fell, leading to a spiral of lower yield and higher risk, which in turn prompted more unwinding of investment positions in pesos, causing further increases in the exchange rate. In this context, the exchange rate reached a high of 18.98 pesos per dollar in June.

The election news in Mexico was followed by comments from members of the MORENA party about the judiciary reform, doubts about the possibility of reducing the fiscal deficit from 2025 onwards, comments from Trump against Mexico, and recently the appreciation of the Japanese yen.

It should be remembered that part of the appreciation observed in the Mexican peso in 2022, 2023, and part of 2024 was due to the investment strategy called carry trade, in which investors borrow at low-interest rates in one country (usually Japan) and move their capital to another where there is a high-interest rate, such as Mexico. However, with the changing expectations about the Bank of Japan's monetary policy, the yen appreciated, reducing the incentive to carry trade with pesos.

Several events this year could again trigger high exchange rate volatility. On September 1, the next Legislature begins, giving the president one month to carry out his reforms. On October 1, Claudia Sheinbaum will take office as president, who could propose new reforms. Then, on November 5, the U.S. presidential elections will take place, in which Donald Trump has a high probability of winning. Finally, November 15 is the deadline for the Mexican Executive to present the 2025 Economic Package, which must clearly detail the plans to reduce the fiscal deficit, with the new public spending structure, revenue projections, and how they will support Pemex.

In a central scenario, it is possible that the exchange rate will trade around 18.50 pesos per dollar at the end of the year. In an optimistic scenario, where risk aversion towards Mexico decreases and capital returns to the country, the exchange rate could drop and trade around 17.50 pesos per dollar. In a pessimistic scenario, where fear about Mexico increases and carry trade flows decrease further, the exchange rate could rise to 19.50 pesos per dollar. For now, exchange rates of 20 pesos (or more) per dollar have a low probability of occurrence, as they could happen in a scenario of possible capital outflows from the country, due to lower carry trade incentives and higher risk aversion towards Mexico. This last scenario could be activated if 1) the Bank of Japan raises its interest rate by more than 25 basis points and signals further interest rate hikes, 2) the Bank of Mexico signals to cut the interest rate faster than the U.S. Federal Reserve, 3) the trade relationship with the United States deteriorates, 4) the probability of credit rating downgrades of Mexico's sovereign debt increases, and/or 5) global risk aversion increases due to various factors.

RISKS TO ECONOMIC GROWTH

Although Mexico's economy has great potential, it is not exempt from challenges and risks that could affect its growth and development. It is essential to understand that the economic environment is subject to both internal and external uncertainty, which can influence the country's growth trajectory. Here are some factors that could significantly impact Mexico's economic performance, both in the short and long term.

<u>Internal risk factors</u>

- The succession of power: On September 1, the new Congress of the Union (the LXVI Legislature) will take office, which will be mostly composed of members of the coalition led by MORENA. One month later, on October 1, Claudia Sheinbaum will be sworn in as President of the Republic. While the campaigns seem to indicate a continuation of the agenda promoted by López Obrador, there is a possibility that Sheinbaum may shift towards a more moderate and orthodox ideology. The risk for the economy lies precisely in the continuation of López Obrador's policies, which have been characterized by increasing the role of the State in various sectors of the economy at the expense of private sector participation.
- The possibility of approving the judicial reform proposed by López Obrador: This is also a very important risk. Its approval could leave citizens and market participants defenseless against acts by the authorities, which would undoubtedly significantly diminish Mexico's potential for economic growth and development.
- Reduction in public investment due to lack of fiscal space: Following the debt incurred in 2024, the federal government will need fiscal consolidation without resources for physical investment.
- Other reform initiatives proposed by the president: These could have a significant impact on the economy, particularly those aimed at eliminating autonomous bodies in the areas of economic competition and industrial organization.

External risk factors

- The United States elections in November: The presidential race will be between former President Donald Trump and current Vice President Kamala Harris, who was nominated by the Democratic Party to replace Joe Biden's candidacy. Forecasts indicate that Trump will emerge victorious in the elections. During his administration, from January 2017 to January 2021, Trump painted Mexico more as a main economic competitor of the United States rather than an ally. This led to a renegotiation of the North American Free Trade Agreement (NAFTA), resulting in the new United States-Mexico-Canada Agreement (USMCA). While the substance of the treaty did not change significantly, the process caused a lot of uncertainty and affected the business environment for Mexico, especially in the eyes of foreign investors. Now, with trade disputes between Mexico and the United States related to agricultural and energy issues, there is a possibility that Trump will seek reprisals against Mexico, something he has alluded to in his campaign speeches.
- A slowdown in the U.S. economy: This would negatively affect Mexican exports, as well as the inflow of remittances and foreign direct investment.
- The possibility of geopolitical conflicts causing disruptions in supply chains and upward pressures on production costs: This could translate into higher inflation.

Economic growth expectations

Grupo Financiero BASE estimates that in 2024 the Mexican economy will grow by 1.3% compared to 2023. With an annual growth of 1.51% in the first half of the year, the forecast anticipates a slowdown in the annual growth rate to 1.09% in the second half. Furthermore, for 2025, the economy is expected to slow down even further, growing only 0.8% compared to 2024.

With the growth already observed up to the second quarter of 2024, Mexico's GDP shows a growth of 5.2% compared to the pre-pandemic level (2019). In the previous quarter, the growth compared to the 2019 GDP was 4.9%. Comparing this recovery (as of the first quarter of 2024) with that of other countries, Mexico ranks 28th among the 45 largest economies in the world (see Annex 1). This is an improvement from the 31st position it held in the fourth quarter of 2023. However, it is important to note that the data for some of the countries considered in the comparison (Vietnam, China, and Russia) are not reported with seasonal adjustment.

These growth forecasts imply that the GDP per capita at the end of 2024 would be 1.01% below its 2018 level, prior to the recession that began in 2019 and turned into a crisis due to the pandemic. Additionally, by the end of 2025, the lag in GDP per capita compared to the 2018 level would increase to 1.15%.

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ANNEX 1: RECOVERY OF THE 45 LARGEST ECONOMIES IN THE WORLD

Real changes in local currency, seasonally adjusted figures except where mentioned

Country	Variations											
	Annual				Quarterly				vs. 2019			
	2020	2021	2022	2023	3T 2023	4T 2023	1T 2024	2T 2024	3T 2023	4T 2023	1T 2024	2T 2024
Turkey	1.7%	11.8%	5.3%	4.5%	0.3%	1.0%	2.4%		26.0%	27.2%	30.3%	
India	-4.9%	10.0%	6.3%	7.2%	0.8%	4.0%	5.7%		17.2%	21.8%	28.8%	
China *	2.2%	20.8%	3.0%	5.2%	5.9%	9.4%	-14.7%	6.0%	36.3%	49.2%	27.2%	34.8%
Ireland	6.2%	15.7%	8.7%	-5.7%	-1.7%	-1.5%	0.7%	1.2%	24.9%	23.0%	23.8%	25.4%
Taiwan	3.4%	6.6%	2.6%	1.3%	2.1%	2.4%	0.3%		15.5%	18.3%	18.6%	
Israel	-1.8%	9.7%	6.4%	1.9%	0.6%	-5.9%	3.4%		19.2%	12.1%	16.0%	
Indonesia	-2.1%	3.7%	5.3%	5.0%	1.6%	0.5%	-0.8%		14.2%	14.7%	13.7%	
Philippines	-9.3%	5.5%	7.6%	5.6%	3.1%	1.8%	1.3%		9.7%	11.7%	13.2%	
Colombia	-7.2%	10.8%	7.3%	0.6%	-0.4%	1.0%	1.1%		10.3%	11.4%	12.6%	
Singapore	-3.9%	9.7%	3.8%	1.1%	1.0%	1.2%	0.1%		11.0%	12.3%	12.4%	
Poland	-2.0%	6.9%	5.9%	0.1%	1.1%	0.0%	0.5%		11.5%	11.5%	12.0%	
Malaysia	-5.5%	3.3%	8.9%	3.6%	5.2%	3.1%	-3.1%		11.8%	15.3%	11.6%	
South Korea	-0.7%	4.6%	2.7%	1.4%	0.8%	0.5%	1.3%	-0.2%	8.6%	9.1%	10.6%	10.3%
Denmark	-1.8%	7.4%	1.5%	2.5%	1.1%	1.7%	-1.4%		9.9%	11.8%	10.3%	
Australia	-2.1%	5.5%	3.9%	2.0%	0.2%	0.3%	0.1%		9.5%	9.9%	10.0%	
United States	-2.2%	5.8%	1.9%	2.5%	1.2%	0.8%	0.4%	0.7%	8.7%	9.6%	10.0%	10.8%
Romania	-3.5%	5.7%	4.1%	2.1%	0.9%	-0.5%	0.7%		9.4%	8.8%	9.6%	
Chile	-6.4%	11.4%	2.1%	0.3%	0.9%	0.1%	1.9%		7.0%	7.1%	9.2%	
Brazil	-3.6%	5.1%	3.1%	2.9%	0.1%	-0.1%	0.8%		7.8%	7.8%	8.6%	
Saudi Arabia	-3.6%	4.9%	7.7%	-0.8%	-2.3%	-0.6%	1.4%		7.0%	6.4%	7.9%	
Switzerland	-2.3%	5.4%	2.7%	0.7%	0.3%	0.3%	0.5%		6.5%	6.9%	7.4%	
Portugal	-8.3%	5.7%	6.8%	2.3%	-0.2%	0.7%	0.8%	0.1%	5.6%	5.7%	7.3%	7.4%
Norway	-1.8%	4.0%	3.0%	0.7%	-0.5%	1.6%	0.2%		5.2%	6.8%	7.0%	
Netherlands	-3.8%	6.2%	5.0%	0.1%	-0.4%	0.1%	-0.5%		7.2%	7.2%	6.7%	
Belgium	-5.3%	6.9%	3.0%	1.4%	0.3%	0.3%	0.3%	0.2%	5.9%	6.0%	6.5%	6.7%
Sweden	-2.2%	5.7%	1.5%	0.1%	0.2%	0.3%	0.5%	-0.8%	4.9%	5.2%	5.7%	4.9%
Canada	-5.0%	5.3%	3.8%	1.2%	-0.1%	0.0%	0.4%		5.1%	4.8%	5.6%	
Mexico	-8.5%	6.3%	3.7%	3.2%	0.8%	0.0%	0.3%	0.2%	4.6%	4.4%	4.9%	5.2%
Italy	-9.0%	8.3%	4.1%	1.0%	0.4%	0.1%	0.3%	0.2%	3.7%	3.0%	4.2%	4.4%
Spain	-11.2%	6.4%	5.8%	2.5%	0.5%	0.7%	0.8%	0.8%	2.7%	2.6%	4.2%	5.0%
France	-7.6%	6.8%	2.6%	1.1%	0.1%	0.3%	0.2%	0.3%	2.6%	1.6%	3.1%	3.6%
United Kingdom	-10.4%	8.7%	4.3%	0.1%	-0.1%	-0.3%	0.7%		1.8%	1.9%	2.2%	
Thailand	-3.2%	2.5%	2.2%	2.0%	-1.2%	0.3%	-0.9%		2.2%	0.7%	1.6%	
Czech Republic	-5.3%	4.0%	2.9%	0.0%	-0.4%	0.3%	0.2%	0.3%	1.1%	-0.7%	1.6%	1.9%
Austria	-6.7%	4.4%	4.9%	-0.7%	-0.2%	0.1%	0.2%	0.0%	0.9%	0.8%	1.2%	1.1%
South Africa	-6.4%	5.3%	1.8%	0.7%	-0.3%	0.3%	-0.2%		0.9%	0.9%	1.1%	
Peru	-10.9%	13.4%	2.7%	-0.6%	-2.0%	3.9%	-5.2%		2.3%	2.2%	0.8%	
Germany	-4.2%	3.1%	1.9%	0.0%	0.1%	-0.5%	0.2%	-0.1%	0.8%	0.5%	0.5%	0.4%
Japan	-4.2%	2.8%	1.2%	1.8%	-1.0%	0.0%	-0.7%		1.1%	1.0%	0.4%	
Finland	-2.4%	2.8%	1.3%	-1.2%	-1.2%	-0.7%	0.2%		0.2%	1.3%	-0.3%	
Russia*	-2.2%	6.3%	-0.3%	3.8%	7.7%	9.2%	-17.9%		11.1%	9.5%	-0.4%	
Hong Kong	-6.5%	6.5%	-3.7%	3.3%	5.9%	3.9%	-4.5%		0.2%	1.1%	-0.6%	
Argentina	-9.9%	10.4%	5.3%	-1.6%	2.3%	-2.5%	-2.6%		4.3%	4.7%	-0.9%	
Vietnam *	2.6%	42.1%	8.2%	4.8%	53.1%	39.6%	-76.0%	107.8%	96.4%	174.1%	-34.2%	36.7%
Nigeria	-1.8%	3.6%	3.3%	2.9%	10.9%	11.2%			10.4%	22.7%		

* Figures without seasonal adjustment.
Source: BASE Financial Group with information from the statistical offices of each country.