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Mexico will face challenges during Trump's second term

The re-election of Donald Trump as US president will put pressure on Mexico's new president, Claudia Sheinbaum, to maintain favourable cross-border ties. But, despite threats of punitive economic policy from Washington, Mexico should still benefit from 'nearshoring' over the long term as a key partner of the US.

Key Takeaways

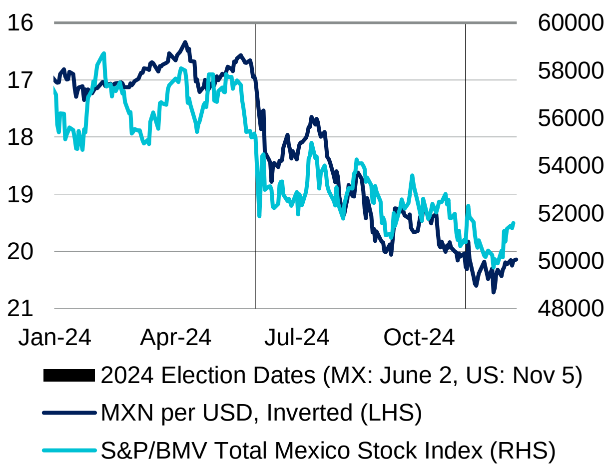
- 2025 will be a major transitional year for Mexico, with new presidents settling in on both sides of the US border.
- Mexico's large trade surplus with the US places it among the countries most at risk of punitive action from Donald Trump's administration.
- Tariff threats will be mainly used to pressure Mexico to address border security and migration. Ultimately, US dependence on Mexican inputs should disincentivise major trade restrictions, but uncertainty about the US-Mexican relationship could linger throughout 2025.
- US plans for mass deportations of undocumented immigrants pose downside risks for Mexico's remittances, though losses may be limited by US economic resilience.
- However, Mexico's integration of deported workers and its attempts to satisfy Trump's demands at the border will present logistical and fiscal obstacles.
- The implementation of the broader reform agenda that President Claudia Sheinbaum inherited from her predecessor, Andrés Manuel López Obrador, will keep the country's institutions under investor scrutiny.

New administrations on both sides of the US-Mexico border

Donald Trump's second term as US president will keep investors cautious about Mexico's short-term prospects.

Declines in the peso and Mexican equities have been relatively contained since Trump's victory. This however follows marked selloffs in the aftermath of Mexico's own general elections, where the Morena party and President Claudia Sheinbaum, whose term began on 1 October, gained sweeping legislative powers to implement a controversial reform agenda.

Figure 1: Political risk weighed on Mexican assets over 2024



Source: Haver, abrdn, December 2024

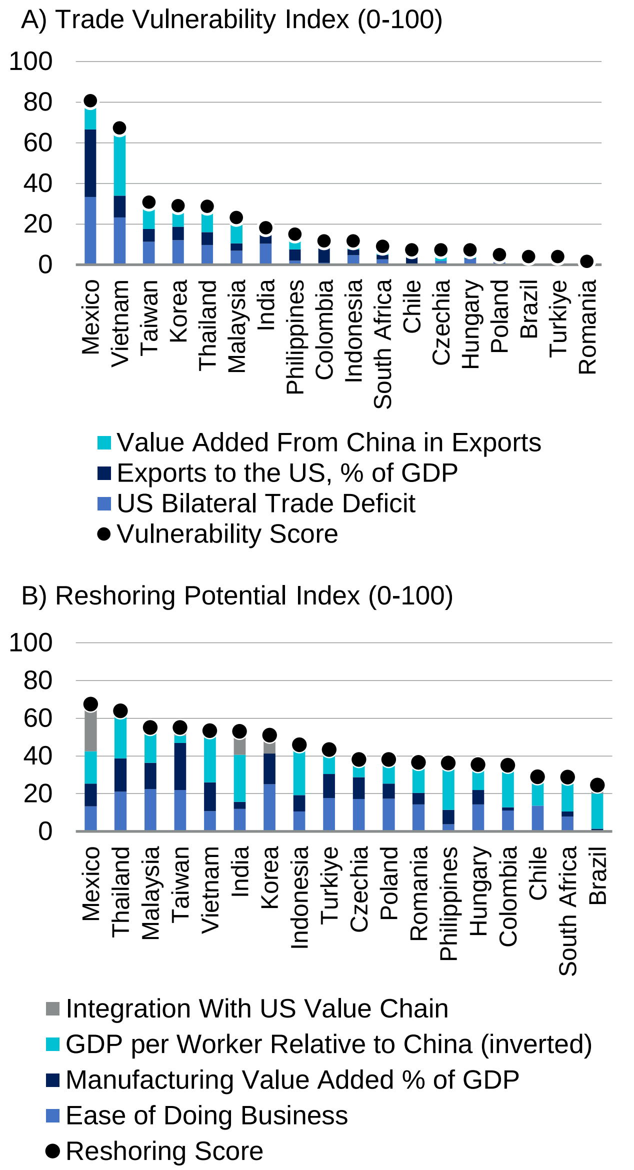
Sentiment towards Mexico will fluctuate as investors process policy developments on both sides of the border. Indeed, threats of tariffs in late November are emblematic of the uncertainty Mexico now faces. Still, we remain confident that US-China tensions and Mexico's deep integration with its northern neighbour will remain structural tailwinds over the medium and long term.

Mexican exports remain well placed to gain from US-China tensions

Though tough rhetoric from Trump will persist throughout and beyond 2025, our core expectation is for an overall positive trading relationship across the border to persist.

Mexico places first in our Trade Vulnerability Index among emerging markets excluding China (see Figure 2, panel A). This is underpinned by its outsized dependence on a large trade surplus with the US, alongside its use of Chinese inputs.

Figure 2: Mexico is highly vulnerable to shifting US trade policy, but may be the biggest long-term winner



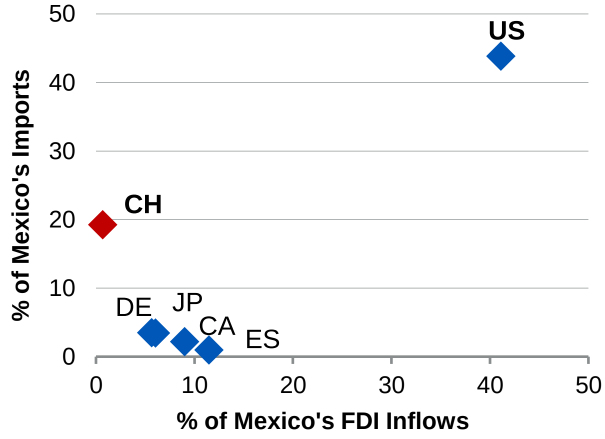
Source: Haver, OECD, World Bank, abrdn, December 2024

However, Mexico also ranks first in our Reshoring Potential Index (Figure 2, panel B). This is representative of its deep integration in US supply chains and membership of the regional free trade agreement, which position it well for further tailwinds from the US pivoting away from China.

The shock to supply chains for the US from expected tariffs on China would be exacerbated by a multi-pronged trade war including Mexico. And, while a full-blown trade war is possible, economic self-interest and corporate lobbying should deter Washington from such a move, as they did during Trump's first term, which resulted in the formation of the US-Mexico-Canada Agreement (USMCA).

US threats of tariffs, or their temporary implementation on a narrow range of goods, will rather be used to push for concessions tied to migration, border security and for Mexico to restrict its trade with China.

Figure 3: Flows of Chinese products and capital into Mexico will be scrutinised by Trump's administration



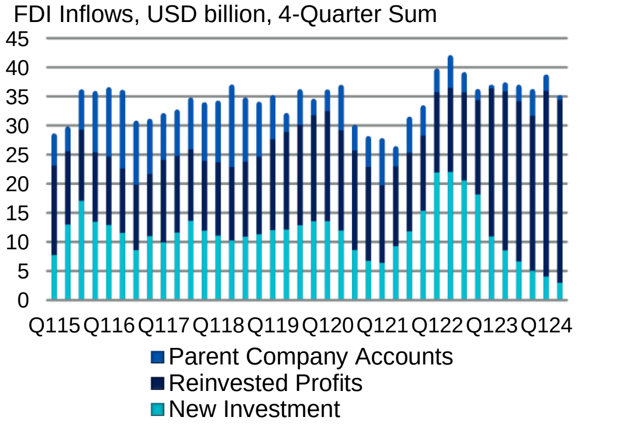
2019-23 averages. Source: Haver, abrdn, December 2024

China accounted for 19% of Mexico's imports from 2019 to 2023, and only 0.7% of foreign direct investment (FDI). US politicians have alleged that these official figures understate China's growing presence in Mexico. US and Canadian policymakers have also expressed concerns about Mexico being used as a backdoor for Chinese products, particularly autos, into North America.

Mexico may be forced to assuage the worries of its USMCA partners by bolstering rules of origin or putting tariffs on Chinese imports. This will be a difficult balancing act, as Mexico will remain dependent on Chinese imports that are supportive of domestic aims, such as green energy and transport infrastructure.

Indeed, while progress may be made quickly on migration and border security in early 2025, trade policy uncertainty may take longer to resolve, perhaps until the 2026 USMCA review.

Figure 4: FDI will remain constrained over the short, but Mexico is well positioned for long-term gains



Source: Haver, abrdn, December 2024

All of this suggests that trade-related uncertainty will stifle near-term FDI flows into Mexico. Total FDI inflows have not materially increased since Trump first entered office, with recent weakness in new investments reflecting investor caution (see Figure 4). This backdrop will delay, though in our view not derail, Mexico's gains from nearshoring-related investments in the long-run.

Mexico will bear the brunt of Trump's migration policy

Our core expectation is for renewed commitments for cooperation from the US and Mexico to bolster border security, averting a trade war.

During Trump's first presidency, then-President Andrés Manuel López Obrador (AMLO), Sheinbaum's predecessor and mentor, took measures including deploying Mexico's national guard to reinforce border management. AMLO also cooperated with the Trump administration's 'Remain in Mexico' programme, allowing the US to send asylum seekers back to Mexico for processing.

It is unclear how much rapport Sheinbaum will be able to build with Trump, but mutual interests should underscore joint efforts at the border.

Our base case also assumes that the US will pass H.R.2 – the Secure the Border Act – early in Trump's presidency. This would see increased restrictions on the asylum process and legal migration.

There remains uncertainty regarding Trump's capacity to implement mass deportations of undocumented migrants, and by extension the economic spillovers for Mexico.

Our 'Trump 2.0' scenario assumes a rise in deportations to three million over the next four years, undershooting campaign pledges. However, an especially aggressive push could reach eight million as in our 'Trump unleashed' scenario.

According to Pew Research estimates, Mexicans account for four million of the 11 million total undocumented immigrants in the US, the single largest group. The majority are believed to be employed.

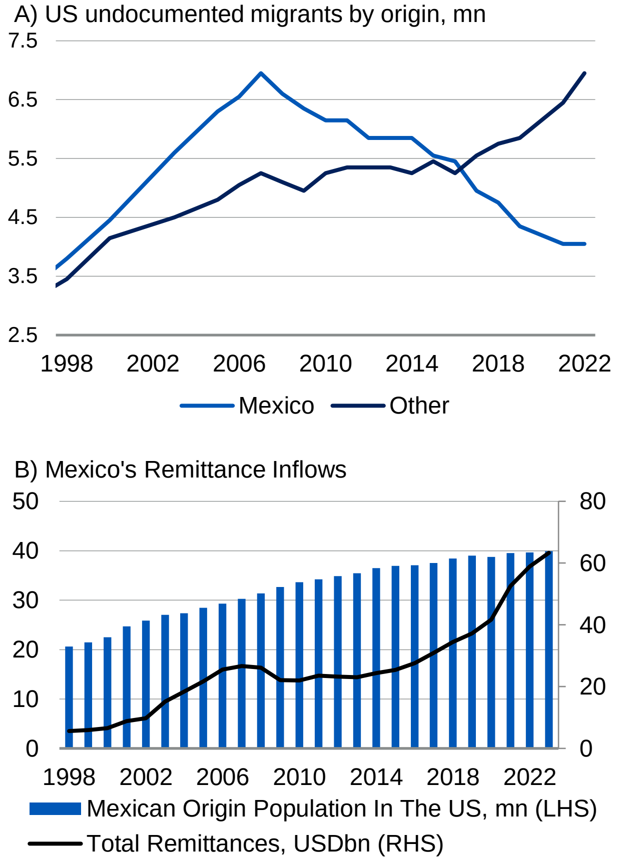
Mass deportations and tighter migration restrictions would limit Mexico's total remittance inflows, which have exceeded net FDI since 2019 at an annual average of 3.8% of GDP.

These receipts are a major support for lower-income households' consumption, and thereby indirect fiscal revenues. These would be further constrained if the US were to tax remittances, a threat that was not implemented in Trump's first term but has resurfaced among some lawmakers as a potential means of deterring new arrivals.

If one million undocumented Mexicans were deported over Trump's presidency, this would, all else equal, lower the Mexican-origin population and potential senders of remittances by 2.5%, since the undocumented and the legal populations number around 40 million. However, we would expect the decline in total flows to be more moderate.

The US population of undocumented Mexicans fell from 5.5 million in 2016 to 4.1 million by 2022 (see Figure 5, panel A). Meanwhile, continued growth has occurred for both the total US population of Mexican origin and, to a greater extent, Mexico's remittance receipts (Panel B).

Figure 5: Deportations pose limited short-term risk for remittances, but may create social and labour market shocks for Mexico



Source: Banxico, Pew Research estimates, BBVA, abrdn, December 2024

Seemingly, the value of remittance receipts has been bolstered by a combination of US economic strength, a strong US dollar, and nominal wage gains, all of which could continue alongside deportations given the inflationary outcomes of policies Trump is likely to pursue.

Past studies have pointed to a possible altruism effect. In this case, stronger growth in the host country (the US) and weaker economic prospects in the recipient country (Mexico) may motivate more money transfers. It may also result in people who were not sending remittances before increasingly choosing to do so. Indeed, from 2016 to 2023 the growth of the number of remittance transactions significantly outpaced growth of the Mexican-origin population (71% versus 7.7%). We would expect this to be an additional mitigating factor on total remittances.

Greater challenges for Mexico will stem from a potential influx of deported workers and difficulties in reducing the flow of non-Mexican migrants crossing the border.

An increase in the labour supply caused by US deportations would provide a disinflationary impulse for Mexico. But currently tepid domestic demand suggests the country has limited scope to accommodate a large wave of job seekers, which could create social strains.

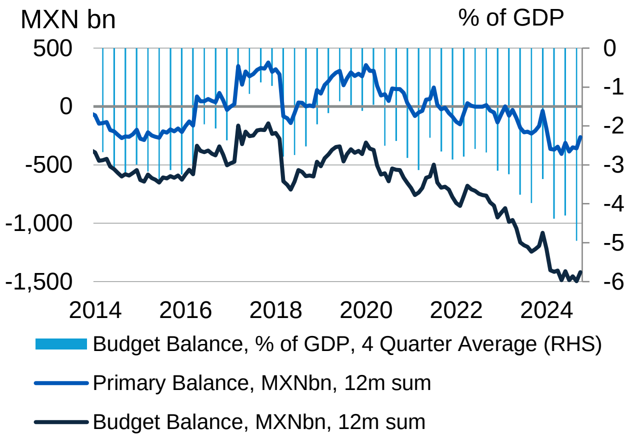
These impacts would also be exacerbated should non-Mexicans be sent en masse to Mexico rather than their countries of origin. Sheinbaum has expressed intent to ask Trump to continue an arrangement maintained by Biden's administration that limited this. However, this is one area that Mexico is at risk of having to partially concede on to appease Trump regarding trade.

Border controls will add to Mexico's fiscal challenges

Satisfying Trump's demands at the border will contribute to the difficulties Mexico's government will face in its pursuit of fiscal consolidation.

Sheinbaum inherited a widened fiscal deficit from AMLO, averaging 5% of GDP in the year to September (see Figure 6) as the outgoing president ramped up social and infrastructure spending. Sheinbaum's inaugural draft budget aims to narrow the deficit to 3.9% in 2025. This target has been positively received by investors but is too optimistic in our view.

Figure 6: Sheinbaum's fiscal consolidation efforts will face hurdles



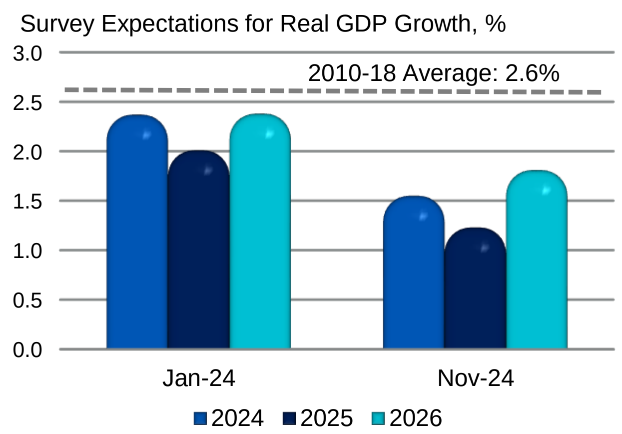
Source: Haver, abrdn, December 2024

Firstly, allocated funding has been cut by close to 40% for defence and security, while funding for agencies handling migration and refugees has been reduced by 10%. These proposals are at odds with government pledges to tackle domestic insecurity and pressures from Trump at the border and face major upside risks depending on the extent of US deportations and migrant flows from other countries.

Meanwhile, making greater spending cuts for social support and infrastructure development to compensate would be politically difficult, with risks of exacerbating economic headwinds and reducing currently high support for Sheinbaum and Morena.

The budget is based on government projections for real GDP growth of 2-3% in 2025. This is well above our own forecast of 1.3% and the current private sector expectation of 1.2% (see Figure 7), and we expect that muted domestic activity will cap potential revenue over the coming quarters.

Figure 7: Growth constraints will cap revenue generation

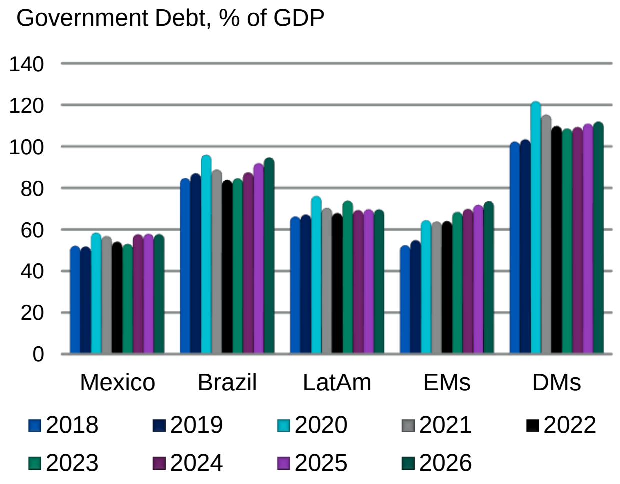


Source: Banxico survey of expectations, Haver, abrdn, December 2024

Though near-term fiscal consolidation may fall short of targets, debt sustainability is likely to remain of limited concern for investors.

The IMF projects Mexico's public debt rising from 57.7% of GDP in 2024 to 57.9% in 2025, versus 92% next year in Brazil and 71.9% for emerging markets as a whole (see Figure 8). These projections pre-dated the budget proposal and Trump's victory, and we flag risks of Mexico's debt breaching 60% over this period should fiscal consolidation fall short.

Figure 8: Mexico's debt outlook remains favourable compared to peers



Source: IMF October 2024 WEO forecasts, Haver, abrdn, December 2024

Domestic policy agenda will continue to be scrutinised by investors

While investors await clarity regarding the Trump administration's policy towards Mexico, domestic policy developments further muddy the investment outlook.

After the legislature's approval of AMLO's judicial reform in September, concerns about a more politicised legal system exacerbated the slide of the peso and Mexican equities. Markets had hoped that Sheinbaum might slow down or temper the reform agenda inherited from her predecessor. However, the popularity of the former president's plans among the Morena party will limit room for Sheinbaum to adjust course.

Indeed, hopes for a more moderate approach have since been dashed. Since Sheinbaum entered office, the Morena party has passed legislation for measures including the prohibition of court challenges to constitutional reforms, giving state energy firms priority over private enterprises in the national power grid and the dissolution of independent regulators in various sectors such as telecommunications and energy.

The plans for regulators have in particular stoked investor concerns as potential breaches of USMCA requirements, as well as risking greater difficulty for foreign firms to settle disputes within Mexico. The government has aimed to calm concerns in this area by stating that the functions of the regulators will be taken on by other government entities, which they say will comply with the USMCA.

The implementation of these reforms will thereby keep Sheinbaum's government and Mexico's institutions under investor scrutiny.

Domestic political risk and concerns regarding the rule of law in Mexico are not new for investors. But scepticism regarding the government's agenda coinciding with risks of cross-border tensions will together loom large as downside risks for nearshoring gains over the coming years. Sheinbaum will therefore have to strike a delicate balance to satisfy her electorate, maintain favourable ties with the US, and leverage Mexico's strengths to attract foreign capital.

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