# Mexico - Less Lucha Libre, more sober negotiation

Market Insight


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## *US economic ties are high on the agenda, but could home-grown populism become a greater threat?*

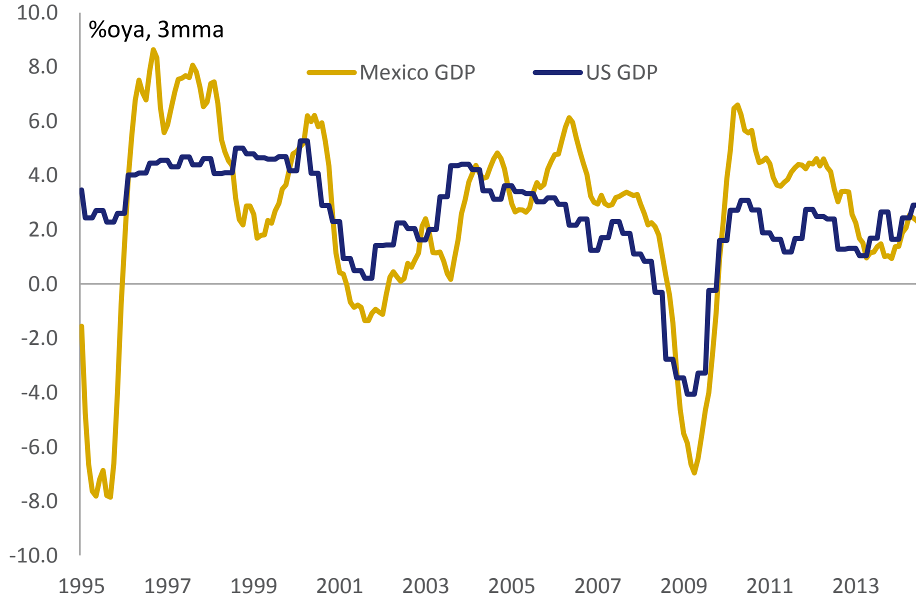
Following his recent research trip to Mexico, Senior Sovereign Strategist Graham Stock provides his views and insights on the current situation in Mexico, its close ties with the US and how he believes the impact of policy initiatives from the new US administration are likely to play out. He also explores the country's political profile; the Mexican Presidential elections are due next year and the increased scope for a more nationalistic government should not be ruled out.

### Mexico is deeply integrated with the US economy

Simple geography, reinforced by trade integration under World Trade Organisation (WTO) and North American Free Trade Agreement (NAFTA) rules, means that important parts of the Mexican economy are entwined with the USA. Daily cross-border trade amounts to US$1.4 billion, and 36 million people of Mexican origin live in the USA, of which a third are still Mexican nationals. Between them, they sent US$27 billion back to their families in Mexico in remittances in 2016.

The flow is not all one-way, however. Mexican visitors spend almost as much each year in US border towns and trips to major US cities. Mexico is the USA's second biggest export market. Some six million US jobs are reckoned to depend on trade with Mexico, not just along the border but as far away as the manufacturing heartland of Detroit, due to the close integration of the auto industry in particular.

Fig. 1: The Mexican and US economies are closely integrated




Data source: INEGI; OECD, as at 30 December 2016

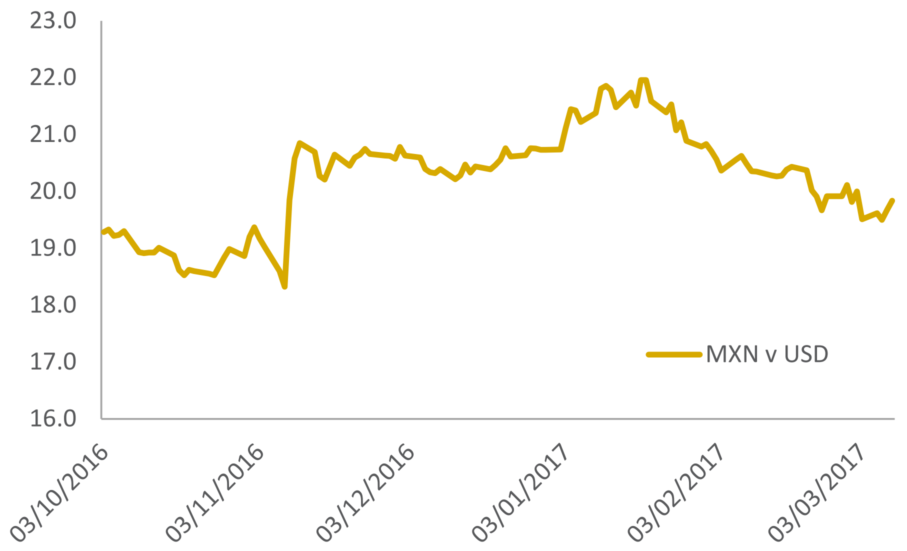
## The Mexican economy is therefore vulnerable

The election of Donald Trump as US President on a platform of economic nationalism and anti-immigrant sentiment potentially poses major risks for Mexico. In economic terms, they fall into three buckets:

1. Those remittances could be at risk if access to the US labour market is restricted, or the flows are otherwise disrupted.
2. Obstacles to export activity would directly challenge key sectors of the Mexican economy, whether in the form of tariffs, quotas or distortionary adjustments to the US tax code.
3. The prospect or threat of such obstacles would weigh on foreign direct investment into the same sectors.

Taken together, fear of these elements prompted the 14% sell-off in the peso (MXN) in the days following Donald Trump's election victory, and further weakness to a low of almost 22 per US dollar (USD) at the time of his inauguration. The currency has now recovered some of those losses to trade around MXN20/USD, although this is still 10% weaker than the average observed in the year before the US election.

Fig. 2: Moves in the peso are closely aligned to US events




Data source: Bloomberg, 03/10/2016 – 09/03/2017

### The response to hostile US policy initiatives is evolving

President Trump has railed against Mexico's trade deficit with the US, against NAFTA, against Mexican immigrants in the USA, and against US companies that invest in Mexico (on the grounds that they should instead favour domestic production). He did this on the campaign trail, and continued once elected, often in 140-character Tweets.

The Mexican authorities have struggled to respond effectively to these attacks. An attempt at engagement during the campaign went awry when then-candidate Trump was invited to Mexico but maintained his hostile rhetoric. Finance Minister Videgaray, who had brokered the visit through his friendship with Senior Advisor Jared Kushner, lost his post in the ensuing criticism that President Peña Nieto had been made to look weak.

In recent meetings with the Mexican government and outside observers, however, we note a much more coherent strategy in place now. It boils down to efforts to move the bilateral relationship on to a more formal footing, engaging in a context of renegotiation of the NAFTA and other dialogue through official channels.

The thin staffing of the Trump administration poses its own challenges in this regard, but already US Secretary of State Tillerson and US Secretary of Homeland Security Kelly have made well-received visits to Mexico City. Trade discussions will be handled for the Mexican side by Economy Minister Ildefonso Guajardo, who has been involved in NAFTA since its inception.

For now, engagement is limited, but President Trump has signed an Executive Order committing to renegotiation and Mexico has announced a 3-month consultation period with domestic industry on the assumption that negotiations will start around May.

## US domestic lobbies are sure to play their part too

The lobbying effort is by no means limited to Mexican companies. The authorities are churning out rafts of data points highlighting the importance of bilateral trade for individual US states and industries, particularly in Republican constituencies. These include:

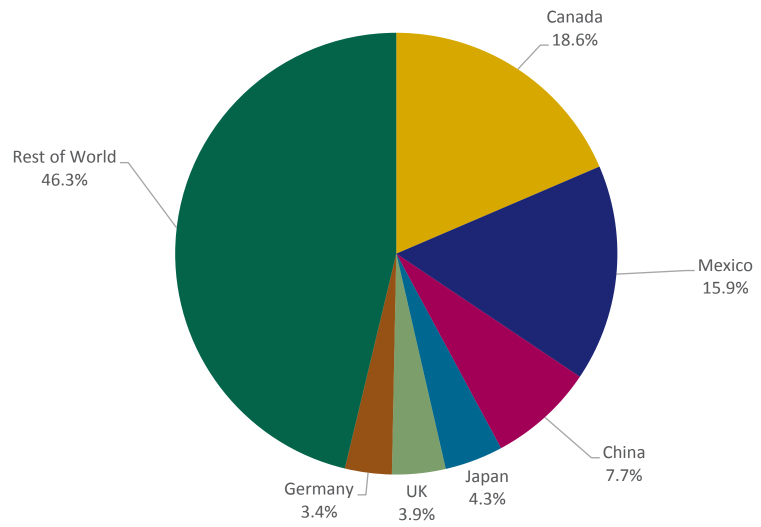
- Some 40% of the content of manufactured goods exported north from Mexico originated in the USA, putting US jobs at risk if those integrated supply chains are disrupted
- Bilateral trade between Texas alone and Mexico is greater than between the USA as a whole and any single country barring China, Canada and naturally Mexico itself – and Texas runs a trade surplus with Mexico
- US agriculture (again well-represented in Republican states) depends heavily on Mexico – for labour and as a market for exports

Brazilian and Argentinian producers of corn, beef and soybeans have been quick to explore opportunities for their products in the event of disruption to trade across the Rio Grande. Mexico has successfully targeted exposed US interests in previous trade disputes, such as over access for Mexican trucks to US roads.

## Good-bye NAFTA; Hello NAFFTA

So is there a win-win outcome available? The Mexican government believes there is. The first line of defence rests on emphasizing NAFTA's mutual positives, as outlined above, and downplaying the US$60bn trade deficit that troubles the mercantilists in the White House. That figure, for example, is partially offset by the US$25bn that Mexicans spend every year on visits to border towns, Miami and New York, as well as wherever else their relatives are working.

Fig. 3: US exports by country




Data source: US Bureau of Economic Analysis, as at 6 December 2016

If NAFTA is to be renegotiated, however, they see common ground for improvements incorporating sectors that either did not exist or were protected back in 1994, such as telecoms, energy and e-commerce.

The three signatories have also already agreed new rules on labour and environmental protection, admittedly under the doomed auspices of the Trans-Pacific Partnership, but they could be incorporated now to counter US fears that Mexico competes unfairly in these areas.

Finally, Mexico suggests tightening the rules of origin to on-shore production from the rest of the world to North America, at least, if not necessarily to the USA. Under NAFTA, 62.5% of a car must originate 'in-treaty' to be exported duty-free (compared with just 30% in the US-South Korea free trade deal).

In other sectors, however, the rules are more lenient. Mexico is the biggest exporter of flat-screen TVs in the world, but only 30% of the value originates in North America, with more than 60% coming from Asia. Even if jobs are initially only created in Mexico, the USA still benefits because Mexican workers' propensity to consume US products is estimated to be ten times higher than that of Chinese workers.

In some combination of the above, and in line with the recent more moderate rhetoric from the Trump administration, but without abandoning the gains of the last 23 years, Mexico will be pushing for a rebranded North America Free **and Fair** Trade Agreement.

## Fight fire with fire, and everything goes up in flames

If fears of disruption to trade, remittances and inward investment prove overblown, are there sunny skies ahead for Mexico? Not necessarily. The main cloud on the horizon arguably lies not in US populism but in a home-grown version.

President Peña Nieto's successor will be chosen in July 2018 elections. He cannot stand again, and in any case his very low approval ratings would rule him out even if the constitution did not. His PRI is also undermined by popular perceptions of rampant corruption and security challenges.

The centre-right PAN has largely supported the government, and therefore struggles to differentiate itself. So far the main beneficiary in the polls has been Andres Manuel Lopez Obrador (widely known as AMLO), the former mayor of Mexico City and runner-up in both the 2006 and 2012 elections. His brand of anti-establishment nationalism resonates as a potential antidote to Trump's bullying, and beneficiary of the populist wave seen in other recent elections. His poll lead is nevertheless more likely due to superior name recognition compared to undefined and relatively unknown potential candidates from the main parties.

Much of the business community fear an AMLO presidency. They worry that his populist instincts would threaten fiscal discipline, and that he would unwind the important structural reforms implemented under President Peña Nieto. Increased competition, lower user prices and rising investment in key sectors such as energy and telecommunications could be in jeopardy. The legislation underpinning the reforms is most likely safe, because AMLO's MORENA party will not have the legislative super-majority required to amend the constitution, but their implementation could be dramatically undermined by his appointees to regulatory agencies and state-owned enterprises such as PEMEX.

## Unmasking the future

As a vitriolic presidential candidate, unafraid of voicing strong views on the campaign trail, President Trump appears to have somewhat softened his rhetoric towards Mexico following his inauguration. Talks of a wall seem to have diminished; the Mexico/US relationship is perhaps too strong and intertwined to sever and hopes of a renegotiation of NAFTA could prove beneficial to both parties. However, populism continues to rear its head globally. With the Mexican presidential elections due next year, Mexico could have a new, unpredictable luchador to face off against Trump. This might make for a riveting spectator sport, but the consequences for investors would be less appealing.