Monarch News

November 2017

CEO Executive Summary

NAFTA renegotiation talks again dominated U.S.-Mexico relations in October. The fourth round was particularly contentious as the United States tabled a series of controversial proposals, most notably on dispute resolution, rules of origin and a sunset clause that would end the agreement in five years unless all three parties agreed to extend it. Mexico and Canada rejected these proposals outright but also committed themselves to continuing the talks, now scheduled to last through March 2018. In our assessment, the overall outlook for the negotiations has turned palpably pessimistic as many interested parties now openly discuss their expectations that the discussions could soon fall apart unless things change quickly.

Through all of the uncertainty around NAFTA and despite dislocations caused by the September earthquakes, the Mexican economy held up surprisingly well in October. Estimates of future growth, however, vary widely depending on the outcome of the NAFTA renegotiation.

Meanwhile, continued good news on the energy reform front was punctuated in early November by the largest onshore oil find in 15 years. This Pemex discovery came none too soon for a firm whose September production hit a 37 year low. In telecommunications, following a recent Mexican Supreme Court ruling, the federal regulatory agency (IFT) reestablished interconnection fees for América Móvil's competitors, albeit at a low and asymmetric rate. And in Mexican domestic politics, the Citizen's Front for Mexico alliance ran into difficulties in the candidate selection process, a close political ally of AMLO was charged with corruption, and Finance Minister José Antonio Meade appears to have become the front-runner for the PRI presidential nomination.

I. U.S.-Mexico Relations/NAFTA

The fourth round of NAFTA negotiations, held October 11-17 outside Washington, D.C., opened the same day as the publication of an interview with President Trump stating his belief that the agreement "will have to be terminated if we are going to make it good." This seemed an appropriate start to a highly contentious negotiating round in which the U.S. clarified its core negotiating objectives and Canada and Mexico laid out the strategies they will pursue in response.

The U.S. proposals point to an effort to dilute the impact of the treaty on the investment decisions of U.S. companies. The U.S. demand that the investor-state dispute resolution mechanism be voluntary, which would effectively replace the trilateral approach to dispute resolution with a reliance on national courts to resolve disagreements, is more than an effort to protect U.S. sovereignty: it is designed to increase the risk for U.S. firms investing in Mexico. The U.S. demand for a "sunset provision" that would end the agreement after five years unless all three countries agree to extend it is intended to create uncertainty for U.S. companies investing in Mexico.

Equally, the U.S. proposal to increase the percentage of an automobile that must be produced in North America to receive tariff-free treatment from 62.5% to 85%, and to add a requirement that a minimum of 50% of each vehicle be produced in the United States to receive such treatment, is designed to influence firms to invest in the United States rather than in Mexico or Canada.

In response, Mexico and Canada made it clear that all three proposals are completely unacceptable, but neither country is prepared to leave the talks over these issues. They will instead remain in the negotiations through their new estimated completion date of March 2018 and counter the United States with their own proposals in the upcoming fifth round of talks. Both Mexico and Canada remain committed to an agreement that will benefit all three countries, although it is increasingly hard to see how such an outcome can be reached. All of these differences were evident in the trilateral statement on the conclusion of the fourth round of talks. The fifth round is scheduled for November 17-21 in Mexico City, although some negotiating groups will get started on the 15th.

In the last week of October, U.S. Commerce Secretary Wilbur Ross made the clearest statement yet of the U.S.-centric position being advanced by the Trump team, which is an effort to force Mexico and Canada "to give up some privileges that they have enjoyed for 22 years." Shockingly, he also noted that the United States is "not in a position to offer anything in return" and stated that President Trump would make every effort to take the U.S. out of NAFTA if the U.S. doesn't secure substantive changes in the agreement. The President's previous comments to Republican Senators dove-tailed neatly with Ross' statements – Trump insisted that there is little chance of reaching the desired U.S. objectives without withdrawing from NAFTA as a negotiating tactic.

Reactions from the business community in all three countries and from the Mexican government were swift and telling. Mexican business groups announced their preference to leaving NAFTA over adhering to U.S. demands, while the U.S. Chamber of Commerce accused the U.S. government of intentionally making "poison pill proposals" to sabotage the talks. Major U.S. automakers, suppliers and dealers formed a coalition to lobby the administration to remain in NAFTA. The agriculture sector was equally vocal in response to Secretary Ross' calling potential damage to the agriculture sector an empty threat. Eighty-six food and agriculture industry groups sent Ross a detailed letter pointing out the "substantial harm" a U.S. withdrawal would cause their sector.

While the Mexican government is committed to the negotiation process, it also prefers a NAFTA of two, between Mexico and Canada, to a trilateral agreement containing the U.S. demands tabled in the fourth round, a position supported by the Mexican public. And Mexico has said it will leave the talks rather than negotiate under the gun following a U.S. announcement of its imminent withdrawal from NAFTA.

What is one to make of all of this? Is the Trump administration bluffing? Are they taking extreme positions to create, as some believe, "negotiating space" to reach a final agreement? We are not so convinced. Our own assessment is that the Trump administration is making a dangerous bet, and, if so, it could well back fire on them to the detriment of the United States. And if it's not a negotiating tactic, but instead a genuine belief that the U.S. can advance only self-serving, unilateral positions and miraculously expect our partners to succumb, then it seems all the more misguided and naïve. As we have stated publicly in press interviews, our sense is that there is, regrettably, more ideology behind USTR's positions than we had anticipated, and these positions may well be intended to force the kind of result that the President himself has stated he wants all along – to withdraw from NAFTA. If the President scores a victory on tax reform, look for a potential softening in the administration's negotiating position. *But don't hold your breath.*

It is worth noting that the impact of the Trump administration's rhetoric and policies toward Mexico on Mexican opinion about the United States was evidenced in a new Pew Research Center poll. The United States is now seen less favorably in Mexico than Russia or China. And beyond NAFTA, the tax reform proposal before the U.S. Congress will directly impact Mexico. If the U.S. corporate tax rate falls to 20%, Mexico will feel pressure to reduce its 30% corporate rate in its continuing effort to attract U.S. investment.

II. Mexican Economy

Hammered by two major earthquakes and a string of hurricanes, the Mexican economy shrank 0.2% in the third quarter when compared with the second quarter of 2017. But according to preliminary data from the National Statistics Agency (INEGI), the economy actually grew 1.7% when compared with the third quarter of 2016. This reflects in part the polemic decision to shift the base year for INEGI's statistical analysis from 2008 to 2013. But it also reflects the inherent strength of the economy, as evidenced in the IMF growth forecast for 2017. Despite the natural disruptions caused by two major earthquakes in September, the IMF raised its forecast from 1.9% to 2.1%, in line with the Bank of Mexico's 2%-2.5% estimate but below Santander Bank's bullish 2.5% forecast. All of these estimates are based on an assumption that the NAFTA talks will go smoothly.

After the challenging fourth round of NAFTA talks, the *Financial Times* reported on a Santander analysis of three NAFTA-related scenarios for 2018: A transition to a new NAFTA in which Mexico grows by 1.8%; a return to WTO rules in which growth is limited to an anemic 1%; and a worst case scenario of a trade war between Mexico and the

United States in which the Mexican economy shrinks by 2.6%. A late-October Fitch report added that if the U.S. withdraws from NAFTA, a modest medium-term impact would be punctuated by a short-term confidence shock and significant market volatility.

Concerns about NAFTA's future, and an anticipated Fed decision to raise U.S. interest rates before the end of 2017, drove the peso from its September close of 18.2 pesos to the U.S. dollar to a six-month low of over 19 pesos per dollar by the middle of October. After a NAFTA round marked by poisonous U.S. proposals, the announcement that the talks will continue until March 2018 rather than race to a year-end finish helped detain the peso's fall. When the peso's decline renewed a week later, Mexico's exchange rate commission authorized a market intervention that stabilized the currency at 19.1 pesos to the dollar. Despite an easing of inflation in the first half of October, the exchange rate turbulence suggests the Bank of Mexico is unlikely to cut interest rates before 2018.

In an effort to take control of the investment narrative, President Peña Nieto announced that foreign direct investment during his administration has totaled $156 billion, including $80 billion in the energy sector. But at the same time, amid the noise surrounding the NAFTA negotiations, Toyota announced a 30% cut in a planned Mexico investment, and anecdotal evidence suggests that other firms are hesitating to invest in Mexico until they know what the rules of the road will be.

Owing in part to the lobbying efforts of Finance Minister José Antonio Meade, the Mexican Congress overwhelmingly approved the income side of the 2018 budget at the end of October. This portion of the budget neither creates new taxes nor increases existing ones. It instead engaged in minor budgetary alchemy to generate revenues to pay for earthquake reconstruction. It increased the estimated oil sales price for 2018 from $46 per barrel, the price at which the finance ministry hedged its 2018 oil sales, to $48.50/barrel and shifted the peso-dollar exchange rate from 18.1 to 18.4. The budget process now turns to the Chamber of Deputies which must approve the spending side of the ledger by November 15.

Sector Focus: Energy

Pemex announced its largest onshore oil find in 15 years on November 3. The field is in Veracruz state where existing infrastructure will help bring the light oil field into production by late 2018 or early 2019. Pemex has not yet decided if it will develop the field on its own or if it will seek out an equity partner. The National Hydrocarbons Commission (CNH) announced Pemex's new partners for two onshore field farm-outs while Pemex said it will seek farm-outs for another 10-15 fields later this year and in early 2018. The firm also announced that it had reduced oil theft by 30% during the first nine months of 2017. All of this is particularly good news for a company whose oil production in September was at the lowest level in 37 years, and whose credit outlook remains negative according to Moody's.

Beyond Pemex, Mexico hopes to attract $3.8 billion in petroleum sector investment through the upcoming third round of tenders for shared production contracts. Energy Undersecretary for Hydrocarbons, Aldo Flores, emphasized that the calendar for round three will not be affected by the Mexican Presidential election. Meanwhile, Gulf Oil opened the first two of a planned 2,000 gasoline stations in Mexico, and Costco opened its second Mexican station in October, with both companies doing so even though they are still prohibited from competing on price. And in the gas sector, Undersecretary Flores announced that Mexico is in talks with shale drillers in West Texas to build a pipeline to Western Mexico, where their gas could be liquefied and shipped to Asia more cheaply than the current route through the Panama Canal.

Sector Focus: Telecommunications

The Federal Telecommunications Institute (IFT) ruled unanimously on November 2 that competing phone companies would have to pay América Móvil for calls completed on its cellular network. This ruling overturned a portion of the 2014 Telecom reform which had required América Móvil to complete its competitor's calls for free. It comes in response to an August Supreme Court ruling that the zero rate was unconstitutional because it had been set by the Congress instead of the regulatory entity. The new rate maintains an asymmetric fee structure designed to promote competition in what remains a highly concentrated market. But that fee structure is now four to one (América Móvil pays four times as much as its competitors to complete calls), compared with the 19 to zero structure set by the Congress. Arguing that the zero rate was an integral part of the reform that encouraged it to invest in Mexico, AT&T expressed its profound disappointment with the ruling, and some analysts have suggested it might try to insert the issue into the NAFTA modernization talks. The IFT defended its ruling arguing that beyond retaining asymmetry, Mexico's fee structure is now one of the lowest in the world for a service that is becoming less significant to telecom companies' bottom line as consumers shift from using their cellular phones for making calls to using data.

III. Mexican Domestic Politics

In presidential politics, the Citizen's Front for Mexico, the alliance among the PAN, PRD and Citizen Movement parties, ran into difficulties solidifying the coalition in several states. The alliance's selection of a presidential candidate was also complicated by two events in October. Mexico City Mayor Miguel Ángel Mancera, who appeared to distance himself from the race in the aftermath of the September earthquake, threw his hat into the ring. Previously, Margarita Zavala, the wife of former President Felipe Calderón and erstwhile candidate for the PAN's presidential nomination, surprised PAN party leaders by announcing her resignation from the party and her intention to run as an independent candidate for President. This decision split the electoral preferences of PAN voters. While many observers believe this division makes it highly unlikely that Zavala will prevail in 2018, it further complicates the political calculus of PAN party leader Ricardo Anaya, who aspires to become President as the candidate of a Citizen Front, which is now polling in third place.

Andrés Manuel López Obrador's (AMLO) route to the presidency was also complicated last month by corruption charges brought against Alberto Anaya, the leader of the Labor Party, the only party allied with AMLO's MORENA party. Anaya and his wife are accused of stealing public money destined for child care centers and distributing it to their personal associates. Although the charges look serious, López Obrador made the politically questionable decision to dismiss them as another attack on his presidential aspirations by the "Mafia of Power."

The PRI party agreed that party delegates will select its presidential candidate, a process that ensures President Peña Nieto will have a great deal of influence over the outcome. At the same time, Mexico's acting attorney general fired the country's anti-corruption prosecutor, Santiago Nieto, for having made public confidential materials relating to the potential prosecution of former Pemex director Emilio Lozoya. While Nieto's actions were illegal, his dismissal in the midst of the prosecutions of several PRI governors and an investigation into potential illegal foreign financing of President Peña Nieto's 2012 campaign was seen as highly suspect by the opposition and an already skeptical public. In this context, the growing popularity of Finance Minister José Antonio Meade, the outsider candidate for the PRI's presidential nomination, appears to position him as the front-runner for the nomination, which is expected to be announced in late November.

Beyond party politics, the 2018 Mexican presidential race is shaping up to be complicated. This is due in part to the effort of 87 citizens to become independent candidates for president. But it also reflects deepening enmities among parties and the proven willingness of all parties to bend electoral rules to their benefit, coupled with vacancies in two key government posts: not only was the electoral prosecutor fired, but the President's controversial choice for attorney general resigned under pressure on October 16, leaving no one to oversee the election process.

IV. Monarch Events, Speeches, Publications

October 1: MGS announced that Giselle Fernandez, a five-time Emmy Award winning journalist, has joined the firm as a Senior Advisor in the Los Angeles office. Fernandez will be advising clients on strategic communications, brand development and management, capital formation, and marketing strategies, with an emphasis in multicultural markets.

October 6: MGS President and CEO Michael Camuñez spoke to *The Washington Post* about the current state of NAFTA talks and how U.S. negotiators have not been able to push around Canada and Mexico as they expected.

October 10: MGS Senior Advisors Juan Casillas and Pamela Starr participated in the Inter-American Dialogue's *Latin America Advisor* Q&A addressing what Mexico should do in the aftermath of the devastating earthquake that struck Mexico City last month.

October 10-12: Michael Camuñez attended the U.S.-Mexico CEO Dialogue in Mexico City.

October 11: Michael Camuñez spoke with Global Trade Review about the unlikely chances for a "UK Nafta" in response to reports that government ministers in Britain are considering joining the trade alliance with the US, Canada and Mexico.

October 11: Michael Camuñez spoke to ***The New York Times*** about the potential for the U.S. delegation's aggressive proposals in key areas of NAFTA negotiations to provide President Trump with an opening to withdraw from the agreement.

October 11: MGS Managing Partner Luis Ricardo Rodríguez spoke at INDEX Nuevo Leon on the implications of modifications to the rules of origin under NAFTA.

October 12: Luis Ricardo Rodríguez gave an update of the NAFTA negotiations at Tecnológico de Monterrey.

October 14: Michael Camuñez published an Op-Ed in *La Opinión*, the largest Spanish-language publication in the U.S., urging California Governor Brown to sign SB-357, a bill to establish a California trade and investment office in Mexico.

October 17: MGS Senior Advisor Pamela Starr was interviewed on the status of NAFTA negotiations on the Phoenix NPR affiliate, KJZZ.

October 17: Michael Camuñez was interviewed live on national television on Canada's Business News Network (BNN) about the state of NAFTA renegotiations at the end of Round 4, observing that the Trump administration's heavy-handed approach has set a negative tone to the proceedings.

October 17: MGS Chairman Ambassador James R. Jones, in an interview with the Associated Press, was quoted as asking, "Who would want to make an investment if they don't know what is going to happen in five years?" in regard to the U.S. proposal for a sunset clause in an updated NAFTA.

October 20: Ambassador Jones participated in the Inter-American Dialogue's *Latin America Advisor* Q&A on the influence of independent candidates in Mexico's presidential election in 2018.

October 26: Ambassador Jones participated in the Inter-American Dialogue's *Latin America Advisor* Q&A on the chances negotiators will be able to rework NAFTA in a way that will be acceptable to all three countries.

October 30: Ambassador Jones and Michael Camuñez spoke with POLITICO Pro about the state of NAFTA renegotiations and President Trump's need for a win. *Subscription Required.*

October 30: MGS Associate Patricio Martínez spoke at INDEX Nuevo Leon on the implications of the implementation of the Trade Facilitation Agreement in Mexico.

October 31: MGS Senior Advisor José Carlos Rodríguez Pueblita commented on banking sector profits in Mexico in the Inter-American Dialogue's *Financial Services Advisor*.