# Monarch News

## January 2018

### CEO Executive Summary

***The entire Monarch team wishes all of our clients and friends a very happy and successful new year!*** 2018 is already off to a fast start, and we are expecting it to be a dynamic year.

With respect to NAFTA, while the intersessional discussions in early December toned down what had been quite heated rhetoric and made modest, workman-like progress on non-controversial issues, the upcoming sixth negotiating round in Montreal is expected to bring many of the most difficult issues to a head. We anticipate it will be a pivotal round where sparks may once again fly. With the U.S. tax reform package passed and signed into law in late December, the private sector, congressional leaders and governors are now focused like a laser on the NAFTA negotiations. This should create significant pressure on the Administration to be more flexible to nudge the negotiations forward. And the pressure seems to be working, at least for now. Whereas the general mood and expectation at the close of the year seemed to be quite pessimistic (with many analysts expecting a definitive U.S. withdrawal from NAFTA potentially early in 2018), as this newsletter goes to print President Trump is sending signals he is in no hurry and may wait until the Mexican presidential elections before deciding whether to withdraw from the agreement. But as we've seen in other contexts, predicting this President's behavior can be a fool's errand, so stay tuned.

Meanwhile economic conditions in Mexico continue to decline. Mexico's economy finished off 2017 on pace for annual growth in the range of 2.0 to 2.6%, but with the highest inflation rate in 17 years and substantially renewed peso volatility. While analysts disagree about the precise impact of the U.S. tax reform legislation on the Mexican economy, they generally agree that it will not be positive. In the energy sector, Pemex's problems persist as electricity reform moves forward. The energy ministry announced a project to connect Baja California's electricity grid with the rest of the nation and proposed rules to regulate Mexico's new electricity market.

In Mexican domestic politics, the first phase of presidential campaigning began in December between José Antonio Meade of the PRI-led electoral coalition, Andrés Manuel López Obrador of the Morena-led coalition, and Ricardo Anaya of the PAN/PRD-led coalition. At the same time, independent candidates continued their efforts to get on the ballot with Jaime "El Bronco" Rodriguez and Margarita Zavala well positioned to succeed by the February 19 deadline. December and early January also saw changes in President Peña Nieto's cabinet with more expected in the coming weeks.

## I. U.S.-Mexico Relations

The NAFTA intersessional meeting that took place December 9-15 in Washington, DC, was a low-key affair. Absent the lead negotiators, this technical session lacked the posturing of Round 5 and focused squarely on issues where the three countries could make progress. The negotiators completed an energy efficiency annex and made progress on several less controversial chapters, including digital trade, telecommunications, trade facilitation, state-owned enterprises, and anti-corruption. Still, the broader positions of the parties came through loud and clear. Mexico's lead negotiator summed up Mexico's message to the United States as #nobacktracking, and the USTR continued to lament the lack of serious engagement on core U.S. demands from Mexico and Canada.

The sixth round of NAFTA talks, to be held January 23-28 in Montreal, Canada, is expected to be pivotal as the three countries directly address controversial U.S.

proposals on rules of origin, dispute resolution, government procurement, and a sunset clause. *The outcome of the round will depend to an important degree on U.S. flexibility,* which could be difficult given the central importance for President Trump of cutting the U.S. trade deficit. In fact, the U.S. trade deficit reached a five-year high in November 2017 while the deficit with Mexico, specifically, hit a seven-year high, and both are expected to rise further. There is also concern that President Trump's persistent promises to terminate NAFTA if he doesn't get a good deal could corner him politically, making it hard to accept the compromises needed to reach agreement.

There are, however, at least two new factors this past month that suggest the possibility of greater U.S. flexibility going forward: the approval of the Republican tax cut bill and the outcome of recent meetings between administration officials and Republican senators and governors. The approval of the tax cut has freed U.S. business and Trump's pro-trade economic advisers to concentrate their lobbying efforts on NAFTA – specifically on preventing the administration from announcing a U.S. withdrawal from NAFTA and on modifying the administration's so-called poison pill demands. And it has freed them to employ a new argument in favor of NAFTA – namely that withdrawal from the agreement could undermine the gains to U.S. growth that are expected to arise from the tax bill stimulus.

At the same time, renewed intensive lobbying of the White House seems to be gaining some traction. *Inside Trade* reported on three separate meetings in December and early January between administration officials and Republican Senators and Governors who pressed the administration to soften its position on NAFTA. Participants in the meetings came away convinced that the Administration heard their concerns about the costs of a potential NAFTA withdrawal. While some continue to fear that Trump could use the January 30 State of the Union Address to announce a U.S. withdrawal (something we think is unlikely), the President's most recent comments, made to *The Wall Street Journal*, suggest he is "in no rush" to withdraw and may wait to see the outcome of the Mexican presidential election to make his decision.

Beyond NAFTA, even as arrests along the U.S.-Mexico border drop sharply, the Trump administration formally requested $18 billion to expand the border wall and is demanding that any legislative extension of DACA be contingent on this funding.

## II. Mexican Economy

The Mexican economy in late 2017 continued to be characterized by slow growth, high inflation, and a volatile peso exchange rate. October growth figures were released last month that showed the economy expanding 1.5% for the month, consistent with the Finance Ministry's estimated 2.0%-2.6% expansion for the year. This anemic growth is due in part to high interest rates and continuing weakness in the mining (read petroleum) sector, counterbalanced by increased auto production, improved consumer confidence driven in part by record high remittance flows that augment family income, and an improvement in labor productivity. Inflation increased again in early December to 6.7%, driven by higher energy prices, rising prices for fruits and vegetables, pressure on the exchange rate, and the expected impact of the 10% minimum wage increase approved in late November. Overall, 2017 inflation reached a 17-year high of 6.8%. When combined with the tightening of U.S. monetary policy and the inflation-fighting bias of Mexico's new central bank chief, markets are primed for the Bank of Mexico to raise interest rates in 2018 above the current 7.25% level for the benchmark rate.

The peso recovered from its early 2017 lows by early December, only to lose more than 5% of its value during the remainder of the month, reaching a level not seen since March, due to uncertainty created by the U.S. fiscal reform and rising inflation. Still, the peso closed out the year with a 5.15% gain against the dollar, its first yearly gain since 2012, reinforced by high portfolio inflows, record high remittance flows for 2017, and rising oil prices. But after a nearly 2% gain in the first days of 2018 the peso fell again on reports that the Canadians are becoming increasingly convinced that Trump will eventually pull the United States out of NAFTA. The peso closed on January 10 at 19.4 pesos to the U.S. dollar with analysts expecting continued volatility in early 2018.

The precise impact of the U.S. fiscal reform on the Mexican economy remains unclear. The finance ministry has dismissed as fiscally irresponsible any reduction of Mexico's 30% corporate tax rate to something closer to the new U.S. rate of 21%. But it remains to be seen to what extent the government will respond to private sector requests for increased deductions to reduce the effective corporate rate. Economists note that when U.S. state-level corporate taxes, which are lacking in Mexico, are added in, total U.S.

corporate taxation is actually much closer to Mexico's 30% rate. In addition, the cost of production in Mexico continues to benefit from significantly lower wage rates than in the U.S.

That being said, there are concerns that U.S. investment in Mexico could be negatively impacted by two elements of the law. The 15.5% rate charged on repatriated foreign income could reduce the reinvestment of U.S. firms' Mexico-based earnings, and capital-intensive firms such as auto companies might opt for investing in the United States rather than Mexico to take advantage of the immediate 100% depreciation on capital expenditures in the new law. Fiat Chrysler has just announced, in fact, that as a result of the recent tax bill it will invest more than $1 billion to modernize the company's Warren Truck Plant in metropolitan Detroit, adding 2,500 jobs and moving production of its Ram Heavy Duty trucks from Mexico.

## Sector Focus: Energy

In the energy sector, Pemex announced 2018 plans to issue a total of 47.5 billion in bonds and to seek out partners for 40-50 farmouts to develop petroleum tracts assigned to it in Round Zero of the petroleum reform process even as a January 31 tender for a joint venture was abandoned due to lack of interest. The firm, which continues to operate deep in the red, exported the largest amount of crude oil in November since 2010, but this reflected reduced domestic demand rather than increased production. In electricity news, the Energy Ministry announced plans to auction the rights to build a transmission line that will for the first time in Mexican history connect Baja California with the national electric grid. Also, as required by the energy reform, SENER delivered to the Energy Regulatory Commission (CRE) a proposed set of rules to regulate the country's new electricity market.

## III. Mexican Politics

Campaigning for the Mexican presidential election got underway in December with the start of the pre-campaigns. Although this "pre-campaign" period is technically designed to determine the candidates of Mexico's political parties or coalitions, the outcomes are already known: José Antonio Meade will be the candidate for the PRI-led coalition, Andrés Manuel López Obrador ("AMLO") for the Morena-led coalition, and Ricardo Anaya for the PAN/PRD-led coalition.

For Meade, the core objective of this early campaigning is to improve his name recognition and solidify his support among the PRI base. For AMLO, with his comfortable lead in the polls, early campaigning should be about crafting a more moderate image that can attract independent voters. To this end, his shadow cabinet announced December 21 included a moderate U.S.-trained economist as finance minister. But it also included an outspoken critic of energy reform as his energy minister, which did little to calm private sector concerns about the candidate and his policies. For Anaya, early campaigning is about holding the PAN/PRD alliance together while positioning himself as the only viable anti-PRI/anti-AMLO candidate in the race.

Independent candidates, meanwhile, are focused on gathering the large number of signatures they will need to qualify for the July ballot. The current governor of Nuevo León, Jaime "El Bronco" Rodriguez, appears to have obtained the 866,953 signatures needed (the signatures still must be validated by the National Electoral Institute) while Margarita Zavala is quickly closing in on this goal. Neither has yet fulfilled the second requirement, however – to obtain signatures from at least 1% of registered voters in 17 states (according to the INE, both have met this requirement in five states). They have until February 19, 2018, to collect the needed signatures.

The campaign season is driving other changes on the political scene. On December 7, Education Secretary Aurelio Nuño stepped down to become Meade's campaign manager and on January 10 Interior Minister Miguel Ángel Osorio Chong and Social Development Secretary Luis Miranda resigned to run for a Senate seat. Chong was replaced by Labor Secretary Alfonso Navarrete, who is considered to be effective and loyal to both the President and Candidate Meade. Rumors are circulating about further election-related changes to President Peña Nieto's cabinet. Others listed as likely to depart include Transportation and Communication Secretary Gerardo Ruiz Esparza (although rumors of his departure have been circulating for several months now) and Public Function Secretary Arely Gomez.

In an additional change, PAN Senator Javier Lozano resigned from both the Senate and the PAN to become communications director for the Meade campaign. Although Lozano had been voting with the PRI and against the PAN in the Senate for some time, this move was a surprising coup for Meade.

Other political developments in Mexico worth noting include the approval in December by the Mexican Congress of a new domestic security law that was strongly supported by the Mexican military and designed to institutionalize the military's role in the fight against organized crime. The law, however, has been sharply criticized by human rights groups within and outside of Mexico, who are fearful of incorporating the military formally into a domestic law enforcement role. The level of opposition has been such that President Peña Nieto announced after signing the measure into law that it will not be applied until the Supreme Court rules on its validity. A thirty-day window now exists for such a challenge to be brought. Court analysts argue it is unclear how the justices will rule, and a decision could come as early as February.

Finally, December was a difficult month for Mexico in the international press. *The Financial Times* published an analysis of the rising costs of doing business in Mexico due to high rates of violence and insecurity. *The New York Times* and *The Wall Street Journal* published a pair of articles on government obstacles to the effective operation of Mexico's anti-corruption system. And *The New York Times* published an article identifying a close ally of the President as the mastermind of a scheme to transfer government monies into PRI political campaigns. These were all relevant reminders of the security and corruption challenges that continue to confront Mexico.

## IV. Monarch Events, Speeches, Publications

Due to the holidays, December was a quiet month for the firm in terms of events, remarks, and press appearances.

*December 4 and 5:* MGS President and CEO Michael Camuñez participated in the Wilson Center Mexico Institute's winter meeting in Mexico City. Both Camuñez and Ambassador Jones serve on the Institute's board.

*December 6:* MGS Chairman Ambassador James R. Jones participated in the Inter-American Dialogue's *Latin America Advisor* Q&A discussing the recent announcement that former Finance Minister José Antonio Meade will be the PRI's candidate for president in 2018.

*December 8:* Monarch published NAFTA News – Volume 5, a periodic newsletter from Monarch, Manatt, Phelps & Phillips, and TACTIX, jointly offering information and insight on NAFTA renegotiations from experts in the three NAFTA national capitals.