MONARCH GLOBAL STRATEGIES

Monarch News

January/February 2019

Editor's Note

After a brief hiatus during the publication of our successful subscription-based *AMLO Transition Report*, we are pleased to resume the regular publication of *Monarch News* in 2019. This first issue of the year marks a shift from what has traditionally been a monthly report to a new bimonthly format. The report will still keep you informed about current developments in Mexico, but at a new interval. We hope you enjoy it and, as always, we welcome your feedback and suggestions.

Executive Summary

Since our last publication in mid-December, Mexico President Andrés Manuel López Obrador (AMLO) has invested some of his considerable political capital in an effort to thwart fuel theft in Mexico, which caused USD 3 billion in losses for the government last year. The government has reduced theft, but at the price of gasoline shortages throughout central Mexico. Nevertheless, this effort has been very popular among Mexicans fed up with corruption, including the corruption that feeds fuel theft.

As described in detail below, AMLO has also moved forward on multiple fronts to fulfill his campaign promises. He has launched his signature social programs, advanced infrastructure and energy projects, and continued to constrain the autonomy of a wide range of independent institutions (but, notably, not the Bank of Mexico or the Supreme Court), thereby mitigating their capacity to provide a counterweight to his executive authority.

In the economy, growth prospects for 2019 have been reduced again, now averaging about 2%. This reflects a combination of factors out of AMLO's control, but it is also due to sharp cuts in government spending and government generated gasoline shortages. At the same time, Fitch cut Pemex's credit rating to just above junk status, thereby telegraphing its lack of confidence in AMLO's strategy for the firm. Also in the energy sector, the government cancelled its fourth power auction and called on private electricity firms to renegotiate some contracts as part of a strategy to increase power generation and competitiveness at the Federal Electricity Commission (CFE) while keeping electricity prices in check.

On the bilateral front, ratification of the USMCA in the Unites States continues to face strong opposition from congressional Democrats concerned about enforcement of the agreement's labor and environmental provisions. This challenge has been made harder by the partisan rancor surrounding the recent government shutdown and increased tensions in the bilateral relationship. Over the past few weeks the bilateral policy environment has been further complicated by disagreements over how to manage caravans of Central American migrants passing through Mexico on their trek to the United States, and how to respond to recent developments in Venezuela.

I. Mexican Politics and Security

Andrés Manuel López Obrador's poll numbers are simply astonishing. According to *El Financiero*, a January approval rating of 72% rose to 86% by the start of February. To an important degree, this reflects popular support for his headline policies – including 80% behind his efforts to end fuel theft, 65% that back his handling of the tragic pipeline explosion in Hidalgo, and 72% that favor his daily morning news conferences.

Fuel theft cost the country at least USD 3 billion last year. This striking statistic motivated a crackdown on fuel thieves that focuses on cutting off their source of supply. The government shut down a refinery and several pipelines, and set in motion a plan to distribute fuel by truck instead. In the short term, this strategy caused severe fuel shortages throughout central Mexico, including Mexico City, forcing drivers to wait hours to fill up their tanks. All in all, and despite public tolerance, this approach to fighting fuel theft is cause for concern. In the medium term it will markedly increase the cost of gasoline distribution, and potentially the price at the pump, since tankers are far less efficient than pipelines. But it also highlights worrying aspects of AMLO's governing style…to take on multiple challenges all at once making it difficult to give each the time it requires, to take action seemingly without thinking through the possible consequences, and to discount the potentially beneficial input of experts because they are associated with "neoliberal" institutions.

The battle against fuel theft was also accompanied by the explosion of an illegal tap where hundreds of local townspeople were filling up plastic jugs with gasoline. The disaster resulted in more than 120 deaths, but, like the lines for gasoline, failed to dent popular support for this anti-corruption measure. The government also announced hundreds of arrests associated with this strategy and a sharp reduction in fuel theft.

Las mañaneras, as AMLO's morning news conferences are known, have been a public relations boon for the administration, just as they were during his time as mayor of Mexico City. They are viewed daily by thousands on YouTube allowing AMLO to speak directly to his followers, and they are well-attended by the news media, allowing AMLO to set the news agenda for the day.

One of his daily messages in February was a promise to move government spending from "republican austerity" to "Franciscan poverty" should this prove necessary to free up enough funds to pay for programs that will provide work and well-being. AMLO's austerity drive cut government spending by 25% in December. It also led to the elimination or sharp reduction of a wide range of public institutions – from the elimination of agencies promoting foreign direct investment (ProMexico), tourism (CPYM), and venture capital development (INADEM), to sharp budget cuts for scientific research (CONACYT), data collection (INEGI), and a wide range of regulatory agencies. This includes the competition commission (COFECE), election oversight (INE), transparency (INAI), the water commission (CONAGUA), the possible incorporation of COFEPRIS (Mexico's FDA-equivalent) into the Ministry of Health, and the gutting of two key energy regulators – the National Hydrocarbons Commission (CNH) and the Energy

Regulatory Commission (CRE). As we have argued previously, the consequent loss of human capital will have a serious, albeit incalculable, cost on the efficacy of the Mexican bureaucracy.

The opposition has further argued that AMLO is intentionally exploiting his austerity drive to weaken autonomous institutions that threaten to obstruct his policies, pointing particularly to the energy regulators. Indeed, AMLO has accused CRE and the Transparency Institute (INAI) of operating parallel to the government and permitting "looting" and facilitating theft under previous administrations. And Morena partisans blocked the entrance to the Supreme Court for weeks to protest a decision to hear a challenge to the constitutionality of slashing federal government wages. The opposition also contends that an effort to weaken the Competition Commission was behind Morena's recent decision to call the commission's head to testify before Congress after she questioned the competitive impact of the government's no-bid contract for disbursement services for social cash contributions provided to the poor.

Meanwhile, the president continues to use the appointment process to name AMLO loyalists to several autonomous institutions he believes are more loyal to neoliberal ideas than to the policies of the current administration. This includes his proposals for new members of the CRE and Pemex boards. The proposed members of the CRE have been particularly controversial due to the weak understanding of the electricity sector they demonstrated during their Congressional testimony. Indeed, this situation was criticized by the current president of the CRE, Guillermo García Alcocer. After this, AMLO accused García Alcocer of conflicts of interest, insisting that the CRE has been captured by private energy firms and thus fails to serve the national interest. The Public Function Ministry initiated a formal investigation into García Alcocer on February 18. The CRE president insists that he is innocent of any corruption or conflict of interest, but decided to step down temporarily while the investigation is under way. The government's use of such tactics is clearly concerning, reflecting a governance style that feeds AMLO's critics who complain about his purported "authoritarian tendencies." Attacking not just the institutions but the people who lead them is a tactic AMLO has deployed repeatedly in the past when he encounters opposition, and it is clearly something we will be watching closely.

The list of jurists proposed to occupy the open seat on the Supreme Court also caused some consternation, not merely because they were all pro-AMLO, as was expected, but because one is the wife of AMLO's favored government contractor, raising questions of influence peddling. The appointment of loyalists is, of course, nothing new in politics anywhere. But in AMLO's case, these instances seem to run counter to the narrative of transparency and anti-corruption that he has tried so hard, at least rhetorically, to make the center of his campaign and administration.

In the area of social policy, the AMLO government is developing a new model that is surprisingly more market-based than its "neoliberal" predecessors. For example, as a means to reduce corruption, the government is eliminating the direct financing of social programs, such as child care agencies, in favor of delivering the funds directly to beneficiaries. It also announced the end to Mexico's signature anti-poverty program, Prospera, arguing that its requirements for participation were too onerous, and that previous governments had exploited the program to coerce recipients to vote for the ruling party. These funds will continue to be provided directly to beneficiaries, but without requiring that children be in school and have regular medical check-ups.

Finally, the Mexican Congress reconvened on February 1 for a session that continues through the end of April. One of its first actions was Senate approval of AMLO's new National Guard, albeit after modifying the proposal to include a civilian command structure and a five year life span. This was needed to gain the support of opposition senators to reach the two-thirds majority vote required for a constitutional reform. The Morena leadership in the Chamber of Deputies has signaled that it will vote on this revised version of the initiative. This virtually guarantees that it will be approved and sent to the states for ratification given Morena's new two-thirds majority in the Chamber of Deputies created when nine PRD deputies switched their political allegiance.

Other high legislative priorities for this session include reversing former President Enrique Peña Nieto's education reform, passing labor and pension reforms, and possibly addressing the reduction or elimination of banking commissions and fees as suggested during the past legislative session by Ricardo Monreal, the Morena leader in the Senate.

II. Mexican Economy

The IMF lowered its growth estimates for the Mexican economy in 2019 to 2.1% (from 2.5%) and in 2020 to 2.2% (from 2.7%). Although AMLO insisted that this projection was too low, it was echoed by private banks. This reflects an economy that was already slowing in the 4th quarter of 2018 when growth was just 0.3% (versus 1.8% for the full year) and is consistent with the tendency of the Mexican economy to slow during the first year of an administration. The slowing trend will be reinforced by AMLO's efforts to redirect spending. In the short term, this has led to sharp spending cuts since it is always easier to cut current spending than to initiate new investments and programs. And, in early 2019, growth will be undermined by the aforementioned gasoline shortages in central Mexico, maquiladora strikes in the north, and striking teachers who blocked rail lines leading to Mexico's main Pacific port. Finally, a slowing global economy will also feed this trend.

Despite consumer confidence in Mexico being at a 12-year high, December unemployment jumped to 3.6%, its highest year-end rate in two years, and retail sales fell in January to their lowest level in five years. Reflecting slower growth and higher unemployment, inflation has finally begun to recede. In January, prices increased 4.37%, just outside the Bank of Mexico's 3-4% target range, and in the first half of February they fell 1.15%. This data set, combined the U.S. Federal Reserve's decision to pause its interest rate increases, helped inform the Bank of Mexico's February 7 decision – its first with AMLO's two new appointees to the 5-member board – to hold interest rates steady at 8.25%.

With regard to foreign exchange, the peso strengthened throughout December and January before stabilizing in the range of 19.1-19.4 Mexican Pesos per US Dollar, similar to its September 2018 level. In part this reflects the weakening of the US Dollar, but it also reflects the government's responsible management of public finances, high interest rates promoting capital inflows and a 10% increase in remittances to a record USD 33.5 billion in 2018. The bond markets, however, demonstrated declining optimism about Mexico under AMLO. Moody's warned that Pemex's faltering financial health could lead to a downgrade for Mexico. Meanwhile, 70% of respondents in a recent survey of bond traders said they expect Mexico to lose its investment grade rating in the coming years with Pemex's financial woes driving this concern.

Sector Focus: Energy

Fitch's late January decision to downgrade Pemex's credit rating to just one notch above junk dominated news in the oil and gas sector. While no other ratings agency followed suit, they all recognized the factors that led to this decision: a firm drained of wealth by the government, leaving it with little capital to battle a declining asset base or maintain a healthy balance sheet, all while facing uncertain future demand for hydrocarbons in an era of climate change. Adding to these concerns, Pemex's January crude output was the lowest on record even as the government cancelled new Pemex joint-ventures with private firms. Meanwhile, the AMLO team is planning for Pemex to make large investments in refining despite questions about the efficiency, profitability, and environmental impact of such an undertaking. The spark that motivated the Fitch move, however, was a January 9-10 New York roadshow, intended for Pemex leadership to reassure investors of its strategy, which underwhelmed and instead magnified concerns about the future of the firm.

As is his tendency, AMLO attacked the messenger, accusing Fitch of being hypocritical for failing to downgrade Pemex during years of neoliberal leadership and only acting now. But he also responded to investor concerns by promising a large cash infusion for the firm, in addition to the USD 4 billion announced in December. The effort did not impress: Fitch described it as "insufficient" and J.P. Morgan called it "disappointing". In the wake of these events, the Mexican Chamber of Deputies introduced legislation that would have increased AMLO's direct control over Pemex at the expense of the board of directors. The fact that the ratings agencies were unlikely to respond well to this initiative likely influenced AMLO's decision to distance his government from this legislative proposal.

In the electricity sector, AMLO announced that his government would spend USD 1 billion to modernize 60 hydroelectric plants and, that, after receiving majority support for the project in a public consultation, it will complete a thermoelectric plant in the state of Morelos. At the same time, the government cancelled the fourth power auction planned by the Peña Nieto administration as well as a plan to auction the construction of transmission lines to carry electricity from southeastern Mexico to the center of the country. The head of the Federal Electricity Commission (CFE), Manuel Bartlett Díaz, justified these decisions by arguing that the energy reform undermined the CFE's competitiveness by favoring private sector contracts, implying there was a need to reverse this trend by reducing the number of private production contracts and increasing CFE's own output. In addition, AMLO called on private energy firms who signed production contracts before the 2013-14 energy reform to renegotiate them in order to prevent future electricity price increases, and Bartlett threatened to sue three pipeline companies, whose contracts allow them to be paid by the CFE even though they have not completed the contracted pipelines, if they do not agree to renegotiate their contracts.

Sector Focus: Infrastructure

Following the cancellation of the proposed and partially-constructed new international airport in Mexico City, the Mexican government announced it will pay USD 1.77 billion to compensate investors (bondholders). The government also announced on February 11 that the new Santa Teresa airport in the state of Hidalgo will not only be constructed by the military but will also be operated by the defense ministry. It also plans to build a new terminal at the current Mexico City airport replacing the hangar for the presidential airplane, which is now in California awaiting a buyer.

In the meantime, tenders for work on the Mayan Train have been postponed again. According to Busines News Americas, they are now supposed to be released before the end of May, despite the lack of environmental or engineering studies for the project and questions about its economic viability. And although AMLO has budgeted USD 6.3 billion for the project (and closed the Tourism Board and ended public support for the Formula One race in Mexico City to help finance the project), much of the funding is supposed to come from private investors.

III. USMCA

Ratification of the USMCA, already complicated by the Democrats' victory in the November 2018 midterm elections, was set back further by the recent closure of the U.S. government. Shutting down the government for 35 days poisoned relations between President Trump and congressional Democrats, making them even less interested in giving Trump a win on the trade front. It also furloughed workers at the U.S. International Trade Commission thereby potentially delaying their analysis of the pact, which is due to Congress by March 15. Key lawmakers from both parties in Congress have said that a vote should not occur prior to release of the report.

Beyond the consequences of the shutdown, Democrats continue to have strong reservations about the labor and environmental provisions of the agreement, the provisions related to intellectual property rights protection for biologic drugs, and the lack of a dispute resolution mechanism for labor and environment issues. Indeed, according to *Inside Trade*, the House Ways and Means Trade Subcommitte Chair, Earl Blumenauer (D-OR), has insisted the pact will not get out of his subcommittee until the biologic drug provisions are changed, and labor-backed lawmakers insist they will not approve the agreement without tighter labor provisions. In response to their concerns, U.S. Trade Representative Robert Lighthizer has proposed using section 301 of the 1974 Trade Act as an alternative mechanism to impose tariffs on Mexican exports to the United States should there be violations of the USMCA's labor protections. Democrats in Congress seem unconvinced.

Canada and Mexico, meanwhile, are highly unlikely to bring a treaty whose provisions might change to a vote in their respective legislatures. They unsurprisingly will need to know what they are voting on. Further, both countries have made it clear that they will not consider any changes to the agreement.

At the same time, concerns about Mexico's willingness to pass the labor reforms needed to adhere to the terms of the USMCA are misplaced. A representative of the AMLO government took part in the USMCA negotiations and AMLO has expressed satisfaction with the outcome. President López Obrador has an overwhelming majority in both houses of the Mexican Congress, and his party's leaders in Congress have put labor reform on the agenda for this congressional term. Mexican approval of the needed reforms will not be an impediment to ratification.

The biggest impediment to ratification of the USMCA is the section 232 tariffs on Canadian and Mexican steel exports to the United States. Canada, Mexico, and many key U.S. legislators have made it clear they will not take up the new agreement until this 25% tax is eliminated. That said, there are signs that this is on the horizon.

Negotiations have focused on capacity utilization in the U.S. and how to ensure that metals from countries still subject to the tariff don't circumvent it by exporting through Canada and Mexico. After bogging down in January, talks seem to be progressing this month. In part this reflects the fact that the U.S. steel and aluminum industries are now over the 80% capacity utilization target set by the Trump Administration. In part, this reflects the timeline – the Mexican congressional session ends on April 30, and Trump is likely to meet with Chinese President Xi in late March and would like to have a ratified USMCA in hand by then. Finally, the dirctor of Trump's National Economic Council, Larry Kudlow, insisted on February 24 that the section 232 matter will be resolved: "We will get that done…to everyone's satisfaction. Trust me."

Meanwhile, Republican senators sent President Trump a message that his proposal to announce a U.S. withdrawal from NAFTA as a way to pressure Democrats to accept the USMCA would be a very bad idea. Rather than promoting an agreement, they argued it would undermine Republican efforts to get congressional approval.

Whatever assurances both the Trump and AMLO governments may make, it is clear that the newly emboldened Democrats in Congress will be key to the passage of the USMCA. Whether a strategy can be executed to get enough Democrats on board to get the USMCA passed is yet to be seen. Labor will obviously play an important role in all of this, and despite the strength of the labor provisions (the strongest ever included in any free trade agreement) the enforceability of the provisions remains an important issue. We will be watching this space closely....

IV. U.S.-Mexico Relations

Beyond trade, the caravans of Central American migrants passing through Mexico on route to the United States have dominated U.S.-Mexico relations. The Mexican government was determined to respect the human rights of the migrants by offering them renewable, one-year humanitarian visas that would allow them to live and work in Mexico. In the words of the director of Mexico's National Migration Institute, however, the program was "too successful." It quickly threatened to overwhelm Mexico's immigration system and had to be terminated in late January.

At the same time, the United States initiated the "Remain in Mexico" program that would force Central American asylum seekers to wait in Mexico for their day in U.S. court. Although Mexico sharply disagrees with this policy, it seems to have resigned itself to accepting the asylum seekers anyway, even in the absence of any bilateral agreement to house and feed the migrants, which has been elusive in the current context of bilateral relations.

It is unclear how Mexico will manage a growing number of asylum seekers living and likely working in Northern Mexico. Despite this, AMLO has refused to comment on the new U.S. policy. True to his U.S. policy objectives, AMLO is making a conscious effort to prevent any increase in bilateral tensions that might hinder approval of the USMCA or otherwise distract from his domestic policy priorities.

The United States has not reciprocated, however. In an effort to drum up support for his border wall, President Trump took to Twitter once again in late January. He intentionally raised fears about the murder rate and a supposed humanitarian crisis in Mexico to justify the need for a wall. He also held a February 11 rally in El Paso to emphasize the need for a wall, weirdly doing so in one of the safest middle-sized cities in the United States.

Although Trump ultimately agreed to sign government funding bills that included just a fraction of the money he had demanded for the wall, he then took the unprecedented step on February 15 of declaring a national emergency on the southern border. In declaring the emergency, which will allow him to repurpose Department of Defense construction funds to the border wall, Trump pointed to a supposed "invasion" (a word he used seven times) from Mexico of drugs, human traffickers, criminals, and gangs. Nevermind the fact that illegal border crossings are at an all time low, drugs overwhelmingly enter the United States at legal ports of entry, and that crime on the U.S. side of the border is exceedingly low. As we go to publication, Congress appears to be close to voting to invalidate the president's use of his emergency authority. Whatever happens, this is a fight that will not be over anytime soon.

At the same time, Mexico's refusal to recognize Venezuelan opposition leader Juan Guaido as the legitimate president of the country, defying the lead of the United States, the European Union, and most of Latin America, has ruffled feathers in Washington. While some of AMLO's followers support the Maduro government, AMLO does not. But he is wedded to the principle of non-intervention in the internal affairs of other countries which informs his effort to remain neutral.

This nuance is lost on Republican Senator Marco Rubio, one of the key authors of U.S. policy toward Venezuela. Rubio slammed Mexico in a tweet, saying he had hoped for a "strategic partnership" with the new Mexican government, but its "inexplicable support for Maduro has put all of that in doubt." In addition, a late January visit by Secretary of State Mike Pompeo to Mexico City to meet with Mexican Foreign Secretary Marcelo Ebrard was quietly cancelled, reportedly because of tensions over Venezuela.

V. Monarch Events, Speeches, Publications

January 9: Monarch Chairman Ambassador James R. Jones participated in the *Latin America Advisor* Q&A discussion on the potential for AMLO's Mayan Train through southeastern Mexico.

January 10: Monarch President and CEO Michael Camuñez was a featured speaker at the *XXX Reunión de Embajadores y Cónsules de México* at the Mexican Ministry of Foreign Affairs in Mexico City. Camuñez shared his views with the Mexican diplomatic corps responsible for U.S.-Mexico relations on the state of U.S. domestic politics and a strategy for achieving ratification of the USMCA in the United States.

January 11: Monarch Senior Director Pedro Niembro participated in the *Latin America Advisor: Energy Advisor* Q&A to discuss the outlook for electric vehicles in Latin America.

January 25: Monarch, together with the U.S. Mexico Chamber of Commerce and the Pacific Council on International Policy, co-hosted the "18th Annual Mexico Economic Review and Political Outlook 2019" in Southern California. Monarch's Michael Camuñez served as the program chair and delivered keynote remarks on "The New Mexican Reality: What AMLO Means for Mexico and U.S.-Mexican Relations." The event was attended by nearly 200 participants.

January 29: Monarch released the final issue of the ***AMLO Transition Report***. This edition focused on what we should expect for the first year of the AMLO government.

January 30: Monarch hosted its last monthly conference call for clients and subscribers of the ***AMLO Transition Report***.

February 25: Monarch Senior Advisor Pamela K. Starr spoke at a Los Angeles roundtable of the Council on Foreign Relations on "AMLO and the Future of U.S.-Mexico Relations."

* * * *