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CEO's Executive Summary

The business climate has declined in Mexico in 2020, due to government actions, the implications of the coronavirus pandemic, and persistent insecurity. In an era increasingly characterized by nearshoring, however, the July 1 start of the United States-Mexico-Canada Agreement (USMCA) combined with a surprisingly close and cooperative relationship between U.S. President Donald Trump and Mexican President Andrés Manuel López Obrador (AMLO) reminds us that there are still significant investment opportunities in Mexico.

Prior to the outbreak of COVID-19 in Mexico, it was becoming increasingly evident that AMLO's once seemingly invincible poll numbers were on the decline. In this context, AMLO has doubled-down on his entire governing project. In March, this included allowing a controversial plebiscite to go forward, which terminated a $1.4 billion brewery project nearing completion and raised further questions about respect for contracts and the rule of law in Mexico. At about the same time, however, the Canadian parliament ratified the USMCA, clearing the way for its July 1 initiation and continuation of the NAFTA-era protections for investors.

Then came COVID-19, whose health, economic, and political implications are apt to be profound. Mexico's slow response and inconsistent implementation and messaging have undercut its capacity to flatten the infection rate curve. When combined with a weak healthcare system, Mexico is expected to face a healthcare crisis when the pandemic reaches its height, currently expected in mid-to-late May.

The economic impact of COVID-19 will be severe. The 2020 economic contraction is estimated to be between 7% and 12%, magnified by Mexico's reliance on the U.S. economy and on oil and its tanking price, leading to the long anticipated downgrade of Pemex bonds to junk. Exacerbating the external issues has been the government's ineffective economic policy response.

In an April 5 speech, AMLO outlined his strategy for dealing with the coming economic crisis: make no policy changes. He promised to continue all of his social and infrastructure projects and doubled-down on his promise not to take on additional government debt. To pay for his projects and for three small lending programs for individuals and small firms, AMLO called for massive cuts throughout the budget. But he offered no government help for the vast majority of the private sector. Instead, businesses will be required to retain their employees at full wages during the crisis, and they face increasing rhetorical attacks from the president. AMLO also took this opportunity to further centralize power by demanding Congress pass legislation that will give him full authority over the budget during emergencies.

In response, Moody's downgraded Mexico's sovereign debt rating, and an appalled business elite took matters into its own hands by initiating private programs to help their small and mid-sized counterparts. Finally, in the midst of the pandemic and oil price collapse, the United States collaborated closely with Mexico to help it weather these storms, including offering its support in the OPEC+ production cut negotiations, and AMLO floated the prospect of a meeting with Trump in the United States in June or July.

I. The Business Climate pre-COVID

In the weeks prior to the outbreak of COVID-19, developments in Baja California raised concern about the environment for the private sector in Mexico. The Mexican government held a late March plebiscite to determine the future of a Constellation Brands brewery under construction outside the city of Mexicali. Despite the participation of less than 6% of registered voters, the government accepted the overwhelmingly negative vote as binding, and demanded the company abandon the 70% completed $1.4 billion facility.

Local officials insisted the outcome was an environmental victory, arguing that the facility would have used massive amounts of water in a water-scarce region, but this ignored the fact that brewery would have used only a tiny fraction of the region's water, by one estimate just 0.2%. President López Obrador insisted that there had been influence pedaling in the agreement reached under the previous administration, but no one has been charged with corruption. Instead, the plebiscite appears to have responded to the concerns of a politically significant group of local farmers.

Regardless of the reason, the decision sent another powerfully negative signal to investors about the willingness of the federal government, and state governments led by AMLO's Morena party allies, to respect contracts at a time when investment was already falling (off 4.9% in 2019) due to anemic demand and weak investor confidence. The outcome was widely condemned by local business confederations as well as the American Chamber of Commerce in Mexico. Indeed, one well-respected business columnist argued this decision was the breaking point for investors, demonstrating that building business confidence and economic growth are simply not important to AMLO.

Less than two weeks later, on April 10, the Baja California state government ordered the temporary suspension of production at the Tijuana plant of the Anglo-American firm, Smiths Medical. The facility produces parts for medical ventilators and had been exporting all its production to the U.S. market under pre-existing contracts. The governor required the production halt to force the firm to sell ventilators locally to help meet a shortage in a state hard-hit by COVID-19. The firm and the state government quickly reached an agreement, but the manner in which the governor handled the issue raised concerns about respect for property rights, especially in the wake of the Constellation Brands case.

In the same time frame, Congress dutifully met AMLO's request to enshrine his social programs in the Constitution, despite their questionable effectiveness in fighting poverty and inequality and the long-term negative impact they are expected to have on fiscal stability. This reform sailed through both houses of Congress in March, with the support of the opposition PAN party in the Senate, and on April 4 was approved by the 17th state legislature, the last one needed to ratify the constitutional change.

The USMCA, however, provided good news for the Mexican investment climate. The Canadian parliament rushed through ratification on March 13 in an effort to complete all pending business before closing down as part of the fight against the coronavirus. According to *Inside Trade* (subscription required), Canada formally notified the United States and Mexico of ratification on April 2, setting into motion a clock leading to a July 1 start date for the agreement. The United States Trade Representative's office confirmed that date in an April 24 statement. The agreement will provide strong guarantees for foreign investors in Mexico that should strengthen Mexico's appeal as a location for nearshoring as companies shorten their supply chains and relocate away from China.

We also see the continued delay in the presentation of the Mexican government's long-awaited investment program for the energy sector as a positive sign of sorts. In previous newsletters, we have highlighted energy policy decisions that reflect the ascendance of nationalist factions in AMLO's administration. In this context, the absence of a decision on this pivotal administration policy suggests that the voices of Finance Minister Arturo Herrera and Chief of Staff to the President Alfonso Romo still carry weight with AMLO. This is as good as news on the energy front seems to get these days.

II. Pre-COVID Mexican Politics

López Obrador's once seemingly invincible poll numbers continue to decline, dropping from an average approval percentage in the high 60s in December to the high 50s by March, according to the Oraculus poll of polls. (As discussed later, the fall has continued in April.) The pre-COVID-19 decline was reinforced by AMLO's tone deaf response to the March 8 women's march followed by the March 9 women's strike to protest Mexico's high and rising rate of violence against women and the 94% rate of impunity for these crimes. Rather than lend a sympathetic ear to the millions of women throughout the country who are fed up with the situation, AMLO brushed them off. And instead of recognizing the validity of their concerns, he dismissed them by arguing that the "conservative" opposition was using the march to attack his administration and its policies and insisting that his current security policies did not need to be revised.

In the midst of the preceding events, the coronavirus was spreading rapidly in the United States and beginning to make its presence felt in Mexico – with the first cases confirmed on February 28. It not only threatens to create a healthcare crisis in Mexico, but in combination with the government response, has further undermined the economy and investment climate and deepened popular and business sector discontent with AMLO's policies. And COVID-19 has coincided with another spike in violence.

III. The COVID-Generated Healthcare Crisis

Mexico registered its first two COVID-19 deaths on March 20; a month later the country's death toll had increased to 712 deaths; and just one week after that, the figure had doubled to 1,434 deaths as of April 27, showing that the pandemic is still on sharp upward trajectory. But these numbers severely understate the actual impact as indicated by a 50% increase in acute respiratory infections over last year, all likely due to the coronavirus.

As has been covered thoroughly in the press, the Mexican response to the coronavirus pandemic has been highly criticized for being slow out the gate and inconsistent in its implementation and messaging. Based on a statistical modeling approach given the extremely low availability of testing, the federal government closed schools, prohibited large events, and recommended social distancing beginning on March 23, and suspended non-essential activities in the federal government two days later. It was not until March 30 that the government declared a sanitary emergency, making social distancing mandatory and extending the suspension of non-essential activities to all public and private activities.

As a result, governors of the harder-hit states decreed earlier stay-at-home orders and closing of non-essential businesses while private actors have pitched in to help purchase needed medical supplies and develop local hospital surge capacity. Some governors have even questioned the federal government's statistics about the advance of the crisis, and are asking for more resources from the federal government to combat the crisis.

Potentially more problematic in the fight to contain the coronavirus was early federal government messaging. The president questioned the importance of social distancing, and refused to do so himself until late March, and he continues to refuse to "stay-at-home," arguing that this would allow his opponents to take advantage of his absence and dominate the political field. Meanwhile, in an interview with the *Wall Street Journal* (subscription required), the under-secretary of health leading up the coronavirus effort openly questioned whether the COVID-19 pandemic was worse than a regular flu outbreak, and advised against many measures now mandated, at least locally, such as the use of masks.

This approach was not without its logic. AMLO recognizes that in an economy where the majority of employment remains in the informal sector, stay-at-home orders will be extremely costly for this segment of the population that has no safety net. Indeed, AMLO was highly critical of the country's strict response to the H1N1 outbreak in 2009 precisely because of its impact on informal sector workers. AMLO is determined to not repeat this "mistake." In addition, with the real limitations on health care availability in Mexico, especially outside of its major cities, the president's claim that "the people will heal the people" does make some sense.

The consequently slow start at flattening the infection rate curve has combined with Mexico's weak and underfunded healthcare system, which has weakened further under López Obrador. He has cut the healthcare budget, overseen delays in purchasing due to the new, highly centralized procurement system, and generated healthcare confusion with the still incomplete replacement of the *Seguro Popular* health insurance scheme with the INSABI universal care system. The combination suggests that Mexico's healthcare system will soon be saturated with COVID-19 patients. Thus far, this has happened only in a handful of localities – including Tijuana and Mexico City – but the pandemic is not expected to peak until at least the second week of May.

IV. The Economic Crisis and Investment Climate

As has been the case throughout the world, shutting down the Mexican economy will have a profoundly negative affect on output. The impact in Mexico, however, will be exacerbated by four additional forces: first, Mexico's economic dependence on the U.S. manufacturing sector, tourism, and remittances, all hard-hit by the coronavirus; second, Mexico's continuing reliance on oil revenue at a time when oil prices have collapsed; third, and most important, the government's ineffective response to the economic damage caused by the sanitary crisis; and fourth, the negative investor reaction to this response.

Coronavirus, Oil Prices, and Downgrades

The Mexican economy is expected to shrink about 7% this year, following a -0.1% growth rate last year, and lose about one million jobs, although estimates in a worst case scenario run as high as -12% GDP growth. To be fair, economies throughout the world will be hit hard by the closing of non-essential production to fight the coronavirus with predictions for the worst global economic downturn since the Great Depression. But several factors point to an even worse situation for Mexico, starting with its extensive supply chains, which are directly integrated with now stalled U.S. manufacturing and thus will experience a steep recession. Meanwhile, the Mexican tourism sector, accounting for up to 17% of GDP, has imploded, and remittance flows to Mexico, mostly from the United States, are estimated to contract at least 17% this year and take up to a decade to recover, leaving thousands of families without this essential source of income.

Making matters worse, global oil prices fell sharply in March, set off by a Saudi-Russian price war and magnified by the coronavirus-driven collapse in global demand. Although oil producers reached an agreement to cut production by 10% on April 12, this was a drop in the bucket compared to the forecast 30% reduction in demand. The consequence was a strange moment when oil prices were actually negative due to a lack of storage space. The implications for Mexico were three-fold: collapsing oil prices, the downgrade of Pemex debt to junk status, and a sovereign debt downgrade for Mexico.

The price of the Mexican oil mix fell from a January average of $54 per barrel to less than $9 in late April after briefly turning negative on April 20. The Mexican government has hedged the price of its oil exports at $49/barrel, as we have previously noted, but these funds will not become available to Mexico for several months. And while Pemex also hedged in a way that allows it to receive payments throughout the year, this only covers the 20% of its production that is exported. Further, at prices under $15/barrel, the vast majority of Pemex's production is no longer profitable.

On April 17, Moody's downgraded Pemex debt to junk status, joining Fitch which further reduced the value of Pemex debt three steps below investment grade. This will significantly increase the costs of financing at the most indebted petroleum company in the world. Moody's decision was based on low oil prices and thus likely cash flow problems at the firm combined with the government's failure "to effectively address…Pemex's continued financial and operating problems." Nevertheless, the nationalist logic driving AMLO's energy policy makes it extraordinarily unlikely that there will be any significant policy change as a consequence of this development. The firm is thus likely to run up another multi-billion dollar loss in 2020.

The Economic Response

The Pemex downgrade fed into Moody's decision to downgrade Mexico's sovereign rating as well, in part due to the role of the Mexican government as the ultimate guarantor of Pemex debt.

The sovereign downgrade also reflected the current government's abandonment of the 2013-2014 economic reform agenda, a weakening investment climate, and an ineffective economic response to the coronavirus pandemic. This response was formally announced in AMLO's now quarterly state of the union speech on April 4, and later codified in a presidential decree. But AMLO telegraphed his intentions the previous week in his morning news conferences, including his statement that the crisis fit the needs of his Fourth Transformation of Mexico "like a ring."

These comments led to a further drop in the peso, already hit by a sell-off directly related to the coronavirus' impact on the U.S. economy and the flight to quality in financial markets. With the exchange rate at about 24.3 pesos to the U.S. dollar as we go to press, the peso is about 4% off its low but has still lost about a quarter of its value since the start of the year. The decline has come despite the efforts of the Bank of Mexico, which cut interest rates by a full point (in two separate half point cuts), taking the benchmark rate to 6%, and injected millions of dollars of liquidity into the financial system.

AMLO's April 5 speech, made in an empty courtyard of the presidential palace to adhere to social distancing demands, was a traditional state of the nation address rather than a speech to a nation facing a health and economic crisis. The president listed the successes of his administration and promised more of the same. He insisted that none of the new social and infrastructure projects undertaken by his administration will be abandoned, but will be reinforced to create a promised two million new jobs and provide further assistance to the poor. New crisis-related programs were limited to small loans for individuals and micro and small enterprises operating in the informal sector.

Absent from the speech, and thus from Mexico's response to the crisis, was a rescue plan for the millions of workers in the formal sector, poor and middle class alike, or for the firms that employ them. Arguing that such bailouts were the kinds of policies employed by the "conservative" governments of the past that privatized economic gains but socialized losses, AMLO insisted that he would not indebt the country to address what he argues will be the coronavirus' "transitory" impact on the economy. "Nothing will make us return to the past." Instead, he required companies to continue paying their workers full salaries during the crisis and banks to give borrowers a grace period on loan repayments.

He also would not take advantage of Mexico's credit line with the IMF as this would, according to AMLO, threaten Mexican sovereignty. Instead, he announced a new series of cost-cutting measures in the federal government, including another wage reduction for senior public servants, which was later made "voluntary" since Mexican labor law prohibits mid-year salary cuts. He also announced that the central government would drain what is left in the country's rainy-day fund, accumulated over the past three administrations, and take over a series of trust accounts throughout the federal government to access additional funds for his projects.

In the ensuing weeks, AMLO has refined but not reversed this approach. These actions, together with AMLO's previous suggestions that the crisis was actually good for his Fourth Transformation project because it would precipitate the end of the neoliberal model, raised a series of concerns. It seems that he is underestimating the likely economic impact of the pandemic in Mexico, that he is more interested in reducing inequality in Mexico than generating growth, and that his policies will reduce inequality by bringing down the middle class and small and medium-sized businesses rather than helping all Mexicans get ahead. In addition, in the week following the speech AMLO turned up the rhetoric, arguing that those who oppose his plan simply want to reestablish corruption in the country, accusing large firms of dismissing workers and insisting that business leaders pressure large tax cheats to pay their back taxes to the treasury.

The Investment Climate

While the Finance Ministry left the door open to additional stimulus measures in the future if needed and the Bank of Mexico took the actions noted above to inject liquidity into the financial system, this did little to calm the Mexican private sector, which sees AMLO's policy response to the crisis as wholly inadequate. Indeed, it is the second smallest stimulus package in all of the Americas, larger only than the Bahamas as a proportion of GDP.

This sequence of events appears to have been the final straw for many in the Mexican business sector. Despite repeated efforts to propose policy solutions to the economic challenge ahead, including the formation of a national accord among government, unions, and the private sector, AMLO refused to consider any of their suggestions.

Business confederations thus took matters into their own hands. The Business Coordinating Council (CCE) arranged an agreement through which large Mexican firms will "adopt" a smaller counterpart for at least a month to help them meet payroll, pay suppliers, and provide other administrative assistance. The logic behind the program is that perfectly healthy firms could otherwise disappear because of the sudden liquidity crisis caused by the pandemic-driven shut down of the economy. Meanwhile, the Mexican Business Council (CMN) negotiated a lending program with the Inter-American Development Bank that will provide up to $12 billion in loans to about 30,000 small and medium-sized businesses to help them weather the coronavirus storm.

V. U.S.-Mexico Collaboration

Interestingly, the coronavirus pandemic has led to increased cooperation between the United States and Mexico. Rather than unilaterally closing the U.S. southern border as President Trump has threatened to do in the past, the United States and Mexico jointly agreed to restrict travel across their land border. As part of its plan to ban exports of personal protective equipment during the COVID-19 outbreak, the Trump administration also exempted Mexico and Canada. And Mexico and the United States have been working together in a still unresolved effort to mitigate bi-national supply chain damage caused by Mexican government orders to close all non-essential businesses as part of its effort to flatten the coronavirus infection rate curve.

Beyond the border and trade, President Trump agreed to a request from AMLO to sell Mexico ventilators (AMLO requested 10,000; the U.S. agreed to send 1,000) to help mitigate the shortage of a medical instrument essential to the successful treatment of the sickest COVID-19 patients. Equally significant was AMLO's proposal that the two leaders meet in June or July. For a president who cares little for international affairs and has never travelled to meet with world leaders, this was a clear sign of the importance he places on a good relationship with his U.S. counterpart.

Finally, there is the unusual story of Mexico's refusal to accept its contribution to the draft OPEC agreement designed to cut global oil production by 10 million barrels to stem the price route caused by the pandemic. All other participants in the meeting agreed to make their required cuts, but Mexico refused, arguing that it had made hard fought efforts to increase petroleum production after years of decline and couldn't possibly implement the requested 400,000 barrel/day reduction. Mexico offered a 100,000 barrel cut and refused to budge from this position over a very long weekend. President Trump offered to make up the difference by increasing the U.S. reduction enough to cover Mexico's quota. Ultimately and grudgingly, this fudge was accepted by the Saudis. Mexican analysts fretted over what payment Trump would ultimately extract from Mexico in exchange for this favor, but for the López Obrador administration this represented a big win made possible by the mutual respect that has developed between the two North American presidents.

VI. Mexican Politics and Popular Discontent

According to Alejandro Moreno, the head of polling for *El Financiero*, a shift in public concern away from corruption and impunity and toward the coronavirus and the economy has combined with negative views of AMLO's management of these key issues. His handling of the coronavirus pandemic is seen negatively by 52% of the population (with only 26% having a positive view), while only 43% approve of his handling of the economy, and just 27% like his approach to fighting poverty. These underlying numbers help explain nearly four months of declining poll numbers for López Obrador and, given the expectation of a poorly performing healthcare system and a steep drop in economic activity in the coming weeks, they suggest that this trend is apt to continue.

In the midst of a crisis, AMLO continues to polarize the country between his government, which stands for the people, and their adversaries in the economic and old political elites. He also seems to be using the crisis as an opportunity to further concentrate power in the hands of the presidency. On April 23, AMLO sent a bill to Congress that will allow the Finance Ministry to reprogram budgeted funds at will during an economic emergency, as a mechanism to help the federal government better deal with the implications of the coronavirus pandemic or any other emergency. This measure dramatically reduces the spending authority of the Chamber of Deputies by allowing the distribution of federal funds they legislate be changed at will by the executive. But as a law, it only requires a majority vote in a legislature dominated by AMLO's political allies.

Meanwhile, state elections in Coahuila and Hidalgo scheduled for June have been postponed due to the pandemic. But broader questions about these and the 2021 mid-term elections remain. For example, who will replace the three National Electoral Institute counselors who stepped down on April 3 having completed their terms in office? The process of selecting their replacements has been put on hold along with many other congressional issues due to the pandemic. But as approval for AMLO and his deeply divided Morena party continue to slide, concern grows that AMLO's allies in Congress will pack the Institute with supporters. This concern is reinforced by a new electoral challenge. While it is highly unlikely that Mexico's discredited established political parties can put up a real challenge to the administration next year, a new party might. Such a party is being set up by former president and AMLO nemesis Felipe Calderón. It is apt to dovetail with initial efforts taken by some business leaders to find strong, independent candidates that can effectively challenge AMLO and Morena.

At the same time, the lack of federal funds needed to fight COVID-19 convinced five northern states to openly question the fairness of their fiscal pact with the federal government and to call for its revision. While there are clear political overtones whenever five opposition governors make such a demand, the economic logic is equally evident. These five states, Nuevo León, Jalisco, Tamaulipas, Coahuila, and Chihuahua, all collect and remit more in federal taxes than they receive back in federal transfers. Historically, their excess contributions were compensated by the distribution of the large percentage of federal revenues coming from Pemex. As that sum has declined in recent years, so has northern state satisfaction with what they consider an outdated pact. That being said, it seems unlikely that these states will formally rebel by withholding tax revenues in the near term, but neither is AMLO apt to agree to renegotiate the fiscal pact, leaving this as one more point of contention between AMLO and his opposition.

Finally, the security situation worsened markedly in the first weeks of the COVID-19 crisis. After three straight months of decline, bringing the murder rate down 10% from its historic high, homicides set a new monthly high in March and a new daily high on April 19. Organized crime is obviously not staying at home but is instead taking advantage of a distracted state to expand its territory and operations, even as some of their operations are being squeezed by the pandemic. In some cases, this has even included distributing food baskets to those in need in place of the government and as a means of winning public support for their operations.

VII. Monarch Events, Speeches, Publications & News

March 17: Monarch published a special report ***Implications of COVID-19 for Mexico***, which looked at the health impact and economic impact of the pandemic when it was still in its early stages in Mexico.

March 19: The *Los Angeles Times* quoted Monarch's special report on the *Implications of COVID-19 for Mexico* in a story on Mexico's tepid response to the coronavirus threat.

March 25: Monarch CEO Michael Camuñez wrote an article entitled "The Corona Virus Knows No Borders; We Shouldn't Either" for *Medium* in which he argued that to combat the impact of the Coronavirus pandemic and related economic fallout, the United States must turn away from its recent isolationist stance and once again become a leader on the global stage.

March 25: Monarch Managing Director Andrew Rudman, in conjunction with the Mexico Institute at the Wilson Center, published a report entitled "Pandemics and Beyond: The Potential for U.S.-Mexico Cooperation in Public Health" that examined opportunities for the U.S. and Mexico to cooperate on public health care initiatives.

April 6: Monarch and Privus Capital published the third edition of their joint newsletter on the cannabis industry in Mexico, the *Cannabis in Mexico Report*. This issue compares changes between the October draft legislation (addressed in our previous newsletter) and the version that is now on the floor of the full Senate.

April 14: Michael Camuñez commented to Reuters about the agreement between President López Obrador and President Trump for the U.S. to cover three-quarters of the oil production cuts OPEC+ countries demanded of Mexico.

April 20: Andrew Rudman argued in the *Latin America Advisor* Q&A that there are better means than compulsory licensing of pharmaceuticals for addressing the coronavirus pandemic and other health issues in Latin America.

April 28: Andrew Rudman participated in the *Latin America Advisor* Q&A discussion about what the recently announced public-private hospital partnership in Mexico means for the response to COVID-19 in the short-term and to the possibility of universal health care in the long-term.

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