Monarch News

September 2017

CEO Executive Summary

The NAFTA renegotiation dominated the bilateral agenda in August, and the participants' opening statements set the tone for the talks. The United States came out swinging, demanding major changes in rules of origin, dispute resolution, and labor rules to eliminate the U.S. trade deficit with Mexico. Mexico and Canada responded diplomatically but firmly, defending NAFTA and the benefits it has provided North America. President Trump dialed up the tension by threatening to pull the United States out of the agreement if Mexico and Canada did not negotiate fairly, a tactic that motivated Mexico to announce it would cease negotiations should the U.S. initiate its withdrawal. In the actual negotiations, the first two rounds registered progress, but the most contentious issues will not be formally presented until the third round to be held in Ottawa, September 23-27.

August was a largely good news economic story for Mexico. Growth exceeded expectations, unemployment fell, consumer confidence improved, and the peso held steady. This story was marred by high inflation and further reductions in petroleum production. But these bits of bad news were tempered by the Bank of Mexico's estimate that inflation is peaking, a government estimate that the collapse in petroleum production is bottoming out, Pemex's return to profitability, and the continued advance of energy reform in both the hydrocarbon and power sectors. Mexican politics revolved around partisan maneuvering in advance of the 2018 Presidential campaign and the President's annual state of the union address, the greatest applause line of which was a promise to protect Mexican sovereignty and dignity in its relations with the United States.

I. U.S.-Mexico Relations

The bilateral relationship was dominated in August by the start of NAFTA modernization talks. The United States came out swinging on the first day of the negotiations. U.S. Trade Representative Robert Lighthizer's August 16 introductory comments briefly noted the areas where there is consensus on the need to modernize NAFTA. He then insisted that agreement needs to be substantially restructured to benefit of the "countless Americans" for whom the agreement has failed.

NAFTA, he argued, requires a "major improvement" to end the U.S. trade deficit with Mexico, which hit a record high during the first half of 2017. This would include, at least: a revision of NAFTA's dispute resolution mechanisms (DRM), including the elimination of the DRM chapter; modified rules of origin to increase North American content, and substantially increasing U.S. content in automobiles and other regionally produced goods; and enhanced labor standards that are as strong as possible. Despite *The Wall Street Journal* branding this "bizarre economics" and "dangerous to U.S. prosperity," and strong opposition from within the U.S. business community, these U.S. demands have dictated the content of the renegotiation.

Following these U.S. demands for major concessions, Mexican Economy Secretary Ildefonso Guajardo took a much more diplomatic tone in his opening statement. He emphasized the need to protect NAFTA's benefits and, while acknowledging that hard negotiations lie ahead, he was optimistic that common ground could be found.

The first round of the negotiations, held in Washington, D.C., August 16-20, reflected this offensive U.S. posture and Mexico's (and Canada's) defensive stance. It also reflected the ambitious time frame within which the delegations plan to complete the negotiations. The United States is reported to have formally presented the text for 10 to 14 of an expected 30 chapters of the revised agreement, a striking number when a typical first round of a trade negotiation is largely devoted to logistics. No consensus text was "bracketed," however.

Having remained silent to this point, President Trump dialed up the tension via his usual Twitter Diplomacy. Just days after the conclusion of round one, he revived his demand that Mexico pay for a border wall and his threats that the U.S. would withdraw from NAFTA if the Mexicans and Canadians were not more forthcoming. While Mexico initially dismissed these comments as posturing, Secretary Guajardo made it clear that Mexico would leave the negotiations should Trump initiate a U.S. withdrawal from the pact. Back home, he estimated the threat of the U.S. abandoning NAFTA as "real" and "high," leading Mexico to redouble efforts to diversify its trade.

In advance of the second round, opposition presidential contender Andrés Manuel López Obrador added to the pressure by arguing that the NAFTA talks should be postponed until after Mexico's presidential election and promised to renegotiate any element of the agreement that harmed Mexican interests.

In this tense context, the United States did not formally introduce the text for the three most controversial chapters – rules of origin, dispute resolution, and labor – during the second round of the negotiations held in Mexico City, September 1-5. Controversial issues were discussed, including the U.S. proposal to create a U.S. domestic content requirement in automobile production of 30%-50% and to increase regional content from 62.5% to 70%-80%, and a U.S. proposal that Mexico and Canada raise their duty-free e-commerce imports to $800 (from $50 and $20, respectively). Both proposals garnered significant Mexican and Canadian push back. The text for several non-controversial chapters was introduced, said to have included small business, competitiveness, digital trade, services, and the environment. No chapter text, however, was formally accepted in the second round.

The joint statement issued at the end of the second round struck an optimistic note, emphasizing the progress that has been made. All eyes are now directed toward the third round, to be held in Ottawa, Canada, September 23-27, where the United States has promised to table the text for the three most controversial chapters, likely making this round much more contentious than the first two. The pressure will be on the U.S. to finally come forward with concrete ideas to back the heated demands it is making. The third round could well reveal the deep divisions that have thus far remained politely buried, at least externally.

II. Mexican Economy

According to the Mexican statistics agency, INEGI, the economy grew at a seasonally adjusted 3% rate in the second quarter of 2017, the largest quarterly expansion since 2014. Growth was driven by the service sector, which expanded at a 4.1% clip, and rapid export growth, producing the highest value of exports ever recorded. This growth translated into the lowest rate of unemployment in 11 years and, in conjunction with the largest budget surplus in 25 years, helped convince the last of the big three ratings agencies, Fitch, to change Mexico's debt outlook from negative to stable. These developments also led the central bank to raise its growth estimate for 2017 to between 2%-2.5% (from 1.5%-2.5%). The third quarter got off to a good start with July consumer confidence at its highest level in a year and news that the Mexican poverty rate had declined by 3.5% in 2016.

The peso was fairly stable in August despite the noise surrounding the NAFTA modernization talks and stubbornly low oil prices. It fluctuated between 17.6 and 18 pesos per U.S. dollar throughout the month, and closed August at 17.8. The peso benefited from traders increasingly discounting President Trump's anti-NAFTA rhetoric, a weak U.S. dollar, and the release of data revealing Mexico's record export levels, as well as a 12% increase in foreign tourist arrivals during the first half of the year.

The one dark spot in the economic story is inflation, which increased to 6.6% during the first half of August, the fastest rate in the first half of any month since 2001. Still, the Bank of Mexico believes inflation has reached its peak and will return to 3% levels by the end of 2018. Although the Bank board has not completely dismissed the possibility of raising interest rates in the future, they did not raise rates in August, keeping the benchmark rate at 7%. Analysts predict the 2017 inflation will be 6%.

Sector Focus: Energy

While Mexico's monthly crude oil production hit a 22-year low in July, Finance Secretary José Antonio Meade predicted that output would grow by 1% in 2018. Should that pan out, it will be the first annual increase since 2003. Helping to back up this conviction are the numbers for direct foreign investment in oil extraction, which reached a historic high in the first half of 2017, totaling $253 million with billions more promised.

Natural gas production, meanwhile, is at its lowest level in 15 years with output at just 57% of what it was ten years ago, leading the Energy Ministry to make public its plans to add an auction round 2.5 for shale gas fields prior to the end of the Peña Nieto Administration.

While results for the first half of 2017 were Pemex's best in over 14 years, the firm is still deeply in debt and slashing investment spending. Its weak investment prevented the firm from completing the minimum level of work required to retain control of the fields it was granted in Round 0. The Energy Ministry thus granted Pemex two additional years to develop these fields.

The biggest Pemex-related headlines in August, however, related to the accusation that former Pemex CEO Emilio Lozoya received a $10 million bribe from the Brazilian construction company Odebrecht, money that is rumored to have been used in President Peña Nieto's presidential campaign. Both Lozoya and the President vehemently deny the charges.

In the power sector, Energy Minister Pedro Joaquín Coldwell announced that Mexico will hold its first medium-term power auction in February 2018 while the agency that manages Mexico's state-owned gas pipelines, Cenagas, is scheduled to launch three tenders before the end of 2017 to assign pipeline capacity, operation and maintenance services, and to regularize rights of way. This was coupled with bad news for the Federal Electricity Commission. Rising fuel prices slashed the profits of Mexico's state-owned electric utility, CFE, by 91% during the first half of 2017, despite a 49% cut in investment spending over the same period.

Finally, the Supreme Court ruled that federal judges cannot grant injunctions (*amparos*) that suspend the norms or resolutions of the Federal Hydrocarbons Commission or the Energy Regulatory Commission.

Sector Focus: Telecommunications

The Mexican Supreme Court ruled on the constitutionality of the 2014 telecom reform's prohibition on Telmex and Telcel charging their competitors interconnection fees. Carlos Slim's firms had argued this was confiscatory and thus unconstitutional. The court, however, did not rule directly on this issue. It instead ruled that this portion of the reform was unconstitutional because the zero tariff was set by Congress instead of the appropriate regulatory body, the Federal Telecommunications Institute (IFT). The court also did not require competitors to pay for past usage, giving AT&T and Telefonica a reprieve. It gave the IFT until the end of the year to set the interconnection fee.

III. Mexican Domestic Politics

Positioning in advance of the 2018 presidential election campaign dominated Mexican domestic politics in August. On August 12, the ruling PRI party held its national assembly and laid the groundwork for President Peña Nieto to select the party's presidential candidate in late November. It also approved a rule change that will allow Finance Secretary José Antonio Meade to enter the race despite not being a party politician. The President's selection will take place following a series of meetings throughout the fall of four to five pre-candidates with party sectors. These meetings are designed to determine which of the leading pre-candidates – Interior Secretary Miguel Ángel Osorio Chong, Education Secretary Aurelio Nuño, Health Secretary José Narro, Tourism Secretary Enrique de la Madrid, or Meade – enjoy sufficient party support to unify the base for the July 2018 election.

The National Council of the left-leaning PRD opposition party met on September 3 to confirm the leadership's decision to seek out an opposition alliance with the right-leaning PAN. This decision split the PRD. The leaders of one of its most powerful factions resigned from the party and threw their support behind Andrés Manuel López Obrador and his Morena party. At the same time, divisions within the PAN deepened over its candidate selection process, its role in any opposition alliance, and whether to support President Peña Nieto's preferred candidate, the current attorney general Raul Cervantes, for an 8-year term as the new public prosecutor.

President Peña Nieto's fifth *Informe*, or state of the nation address, on September 2 lauded the country's economic stability and highlighted the effectiveness of his economic reforms, especially the education reform. He implicitly took a swipe at López Obrador when he argued the county should avoid a return to the past or any backsliding on the reform front. And he highlighted government action to deal with the country's continuing security challenge. But Peña Nieto's most enthusiastic applause came when he vowed never to accept "anything that goes against our dignity as a nation" in its relations with the United States.

Finally, rising violence in Mexico has begun to impact tourist areas. Acapulco is now Mexico's murder capital, and the U.S. State Department issued travel warnings for Los Cabos and Cancun after a surge in violence related to drug-trafficking.

IV. Monarch Events, Speeches, Publications

August 2: MGS Managing Director Andrew Rudman commented in the *Latin America Advisor*, a publication of the Inter-American Dialogue, on the importance of medical tourism for Latin America.

August 10 & 29: MGS Senior Advisor José Carlos Pueblita presented the study "Health and Productivity of the Automotive Industry in the State of Guanajuato" to representatives of the OECD and to the National Health Committee of the Consejo Coordinador Empresarial (CCE) respectively.

August 14: MGS President & CEO Michael C. Camuñez and Senior Advisor Pamela K. Starr discussed the first round of the NAFTA renegotiations in the *Los Angeles Times*.

August 14: Michael Camuñez spoke to *Forbes* in advance of the first round of NAFTA renegotiations, stating that an updated agreement should incorporate aspects of TPP.

August 15 & 16: Michael Camuñez discussed the importance of NAFTA to both California and North America with Southern California Public Radio.

August 16: MGS Chairman Ambassador James R. Jones discussed ways to modernize NAFTA to make it a win-win-win for all parties on CNBC.

August 17: Michael Camuñez spoke to Reuters about the Mexican Supreme Court ruling on América Móvil interconnection fees.

August 22: Ambassador Jones spoke with the *Latin America Advisor* about the current state of Mexico's justice system reforms.

August 23: Ambassador Jones told the Associated Press he believes that "sanity will prevail" and that the United States will stay in NAFTA.

August 28: Pamela Starr gave a presentation on U.S.-Mexico relations for the Belisario Dominguez Institute of the Mexican Senate.

August 30: Michael Camuñez spoke with *Global Trade Review* about the impact of Trump's rhetoric on the current state of NAFTA talks.

August 31: Ambassador Jones spoke with Inside U.S. Trade about why Trump's rhetoric is unlikely to deter Mexico in NAFTA renegotiations. *Subscription required*.

September 1: Michael Camuñez discussed why Trump's focus on the trade deficit with Mexico is wrong in *The Washington Post*.

September 2: Ambassador Jones discussed the need to modernize NAFTA in a *USA TODAY* opinion article.