MONARCH GLOBAL STRATEGIES

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CEO's Executive Summary

The bilateral relationship whipsawed from good news to bad news to utter frustration these past few weeks. With the delivery of the International Trade Commission's economic analysis and the Mexican Congress' approval of labor reform, the door has, theoretically, creaked open for the ratification of the USMCA. Yet many U.S. domestic hurdles remain, including metals tariffs, significant Democratic (and some Republican) Party opposition, and a rapidly closing window of opportunity due to the Canadian and U.S. electoral calendars. Despite our highest hopes, we remain concerned that ratification of the agreement will likely be postponed until after the 2020 U.S. presidential election.

President Trump finally nominated a new ambassador to Mexico, but Christopher Landau waits for Senate confirmation along with 31 other ambassadorial nominees. Jared Kushner's seemingly successful March visit to Mexico was followed by a good ministerial meeting on migration, but both were overshadowed by a series of Trump tweets in which the president threatened to close the border and tax Mexican auto exports if Mexico did not meet his migration demands. And, although the president ultimately backed down, his decision to reassign border personnel away from ports of entry generated massive and costly delays at key border crossings. His constant tweets attacking Mexico remain a continuing irritant in the bilateral relationship that is very unlikely to abate.

In Mexico, President López Obrador announced that his government would stop implementing the 2013 education reform. The dubious constitutionality of this unilateral decision will almost certainly be challenged in the courts, but in the meantime AMLO has bought time and political space to deal with the radical wing of the teachers' movement. This action will do little, however, to strengthen the private sector's wavering confidence in the rule of law in AMLO's Mexico. And as for the substance of a desperately needed education reform, only time will tell…

Despite a macroeconomy stabilized by a balanced budget and large capital inflows, growth in Mexico remains anemic and investor confidence in the business climate remains weak. The private sector reacted poorly to the labor reform recently approved by Congress, the declared end to the "neoliberal policies" of the past, a legislative proposal to expand the Supreme Court and pack it with AMLO supporters, and AMLO's insistence that "justice" should outweigh the law. At the same time, a series of resignations has allowed AMLO to appoint a majority of both the Energy Regulatory Commission (CRE) and Pemex's board of directors, thus reducing the independence of two key institutions intended to provide market-informed oversight of his energy policies.

In the energy sector, Pemex is shaping up to be AMLO's Achilles' heel by requiring more capital than his government can realistically provide. His broader government-led energy strategy drives his Pemex policy-making, and it informed recent actions by leadership of the state-owned electricity company (CFE). CFE is attempting to revise contracts signed with private actors under the previous administration and to delay new power auctions on the premise that there is no need to buy energy from the private sector when CFE can produce it itself. Meanwhile, the construction of the Dos Bocas refinery in Tabasco and the Mayan Train through the Yucatán Peninsula continue to be fast tracked.

I. USMCA

Ratification of the U.S.-Mexico-Canada Agreement (USMCA) took a step forward with the April 18 delivery to the U.S. Congress of the International Trade Commission's analysis of the pact. As expected, the study reported a small positive impact on the U.S. economy from the reworked agreement – a 0.35% boost in economic growth and 176,000 additional jobs at the end of six years. It also predicted a negative impact on consumers through higher prices for autos in the years ahead. More importantly, as a prerequisite for congressional consideration of the trade agreement, its delivery opens the door to ratification of the pact by the U.S. Congress. That said, several obstacles to ratification remain.

First, the tariffs on Mexican and Canadian steel and aluminum exports to the United States remain in place despite repeated promises from members of the Trump team that they will be removed. Instead, the White House proposed in March that they be replaced by quotas, a move both Mexico and Canada immediately rejected. On April 19, *Inside Trade* (subscription required) reported that U.S. Trade Representative Robert Lighthizer stated that the metals tariffs will be at the top of USTR's agenda once the agreement with China is finalized, hopefully by mid-May. But once their attention returns to the USMCA, he will still have to deal with a president who is clearly hesitant to surrender the leverage that metals tariffs/quotas provide over Mexico and Canada.

Second, House Speaker Nancy Pelosi made it clear that the USMCA will not come up for a vote until Mexico institutes a labor reform that guarantees an independent arbitration panel and secret voting to elect union leaders and approve contracts. Two days after Pelosi's comments, AMLO called on the legislature to quickly pass a labor reform that eliminates any "pretext" for reopening the trade negotiations. The Chamber of Deputies quickly approved the reform, and the Morena majority in the Senate did the same on April 29. Pelosi, however, has also stated that passing a reform will not be sufficient; the Democrats will also need to see how effectively it is enforced, something that could take years.

Third, congressional Democrats remain concerned that the agreement's chapter on biologic drugs will undermine their efforts to reduce drug prices, despite a formal statement from USTR insisting that this will not be the case. Fourth, the bad blood between the Trump White House and congressional Democrats persists, further complicating the negotiation process. And finally, the electoral calendars of the United States and Canada, which has national elections in October and a Parliament that recesses in June, mean that time is short, especially if Canada (and Mexico) decide to wait for U.S. action before approving the agreement. The Trump administration and Republican lawmakers are aiming to have the USMCA ratification complete before the August congressional recess. We remain concerned that this deadline will not be met and ratification will be postponed until after the 2020 presidential election.

II. U.S.-Mexico Relations

On March 18, President Trump nominated Christopher Landau to be the next U.S. Ambassador to Mexico. Landau, a lawyer who speaks fluent Spanish but lacks any diplomatic experience, will fill a post that has been vacant since May 2018. Landau clerked for Supreme Court justices Antonin Scalia and Clarence Thomas and spent 25 years at Kirkland & Ellis, rising to partner before joining Quinn Emanuel 14 months before his nomination. He joins a list of 31 other ambassadorial nominations that await confirmation in the U.S. Senate.

The day after Landau's nomination, Jared Kushner flew to Mexico City to meet with President Andrés Manuel López Obrador. They reportedly discussed Central American migration, Mexico's proposed $10 billion development plan for Central America and Southern Mexico, and the USMCA. A little over a week later and following a meeting with then-U.S. Department of Homeland Security Secretary Kristjen Nielsen, Mexican Interior Minister Olga Sánchez Cordero announced a change in Mexican policy toward Central American migrants. Mexico will no longer provide large numbers of humanitarian visas to migrants transiting through Mexico and will contain migrants south of the Tehuantepec Isthmus.

Seemingly unaware of the results of this meeting, Trump took to Twitter in the wee hours of the next day, March 28, to complain that "Mexico is doing NOTHING to stop the flow of illegal immigrants" and again the following day to threaten to close the border if Mexico does not act. Perhaps most irrationally, Trump also announced the end to U.S. aid to El Salvador, Honduras, and Guatemala as punishment for allowing their citizens to migrate north.

The AMLO administration held its fire, preferring to continue its policy of not responding to Trump's rhetorical outbursts. Speaking on behalf of the Mexican Senate, Morena leader Ricardo Monreal, rejected Trump's statements as unacceptable, while many in the media demanded an aggressive Mexican response. But Foreign Minister Marcelo Ebrard merely insisted that Mexico will continue to seek understanding with the United States while demanding respect.

Four days later, on April 2, President Trump returned to Twitter, this time to praise Mexico for "starting to apprehend a lot of people at their Southern border" and, under pressure from auto companies who warned of temporary plant closures should the president take this action, he stepped back from his threat to close the border. This was surprising since one day before Sánchez Cordero announced that under no circumstances would Mexico militarize its southern border.

Given the disconnect between Mexico's actions and Trump's rhetoric, AMLO's refusal to respond may indeed be the best approach to dealing with Trump's outbursts. Nor are actions to mitigate the migrant flow through Mexico likely to hurt AMLO politically as most Mexicans favor efforts to stop Central Americans from arriving in Mexico. Indeed, while initially welcomed in Southern border towns, the never-ending flow of migrants has resulted in pushback from locals, and some Tijuana residents showed irritation with the migrants from the start.

That being said, there have been real costs at the border. Despite not closing ports of entry, Trump reassigned border agents from the ports to undertake operations in between them. This created massive delays crossing the border, which exacted high costs for businesses dependent on trade, including the automotive sector. On April 11, Customs and Border Protection announced they would send agents to the border, but the extended wait times and their associated economic losses have continued.

Dissuaded from closing the border, Trump switched gears once again and threatened Mexico with 25% tariffs on auto exports if illegal migration and drug trafficking is not stopped within a year. The president's ability to carry out this threat, however, is questionable as a USMCA side agreement exempts Mexico and Canada from such tariffs.

In a related immigration development, on April 8, a federal judge blocked the Trump administration's efforts to make all asylum-seekers wait in Mexico for their day in court, thereby eliminating another source of contention between the two countries. But as this issue faded from the agenda, another quickly took its place – the April 17 announcement of new U.S. sanctions against Cuba, Venezuela, and Nicaragua. This includes enforcing a long-waived provision of the 1996 Helms-Burton Act that allows owners of property nationalized in the early years of the Cuban Revolution to sue anyone who benefits from the use of those properties, including Canadian, European, and Mexican investors. Mexico issued a strongly worded criticism of this action, and promised to protect the interests of Mexicans operating in Cuba. Given the strength of the Mexican response, we will be keeping an eye on this issue as something that could disrupt the broad U.S.-Mexico relationship.

In the midst of these binational tensions, Mexico surpassed Canada to become the largest trading partner of the United States, and the 11th meeting of the U.S.-Mexico CEO Dialogue was held in Mérida, Mexico. Monarch's Chairman Amb. James R. Jones and President & CEO Michael Camuñez attended the meeting. The mid-April summit among leaders from the Mexican and U.S. private sectors and government focused on bilateral trade and investment. The Mexican president and several of his ministers addressed the gathering, concentrating their remarks on building confidence in AMLO's leadership, and U.S. Commerce Secretary Wilbur Ross emphasized the broader importance of the bilateral economic relationship.

III. Mexican Politics

President López Obrador's poll numbers remain sky high, averaging 78%, and show no signs of eroding significantly in the near term. This should help the Morena candidates as the country gears up for gubernatorial elections in Puebla and Baja California in July. It also has helped AMLO maintain discipline among his party's legislators to rapidly pass labor reform as discussed above and to create Mexico's new National Guard. It has been insufficient, however, to fulfill AMLO's campaign pledge to reverse President Peña Nieto's education reform.

Without the two-thirds majority in the Mexican Senate needed to change the Constitution, AMLO's Morena party must gain the support of a handful of opposition senators to abrogate the 2013 overhaul of public education. They have failed to do so. Unable to make good on a campaign promise to a rebellious segment of Mexico's unionized teachers, the CNTE, AMLO faced the possibility of continued teacher protests in Mexico City and the likely renewal of highway and railway blockades elsewhere in the country. To escape this political cul-de-sac, on April 16 AMLO issued a constitutionally questionable memo that ordered his government to suspend implementation of the reform until the Senate reaches an agreement on new education laws. It seems likely that this action will be challenged in court, but in the meantime it should keep the CNTE mollified and so weaken the reform that the new policy will be hard to reverse later.

Finally, AMLO announced the leadership of his new National Guard, most of whom are retired military and were generally well-received by security analysts. The need for this force to bring security to Mexico was punctuated by the record high number of homicides during the first quarter of 2019.

IV. Mexican Economy

Growth of the Mexican economy continues to slow. Despite AMLO's upbeat estimation of the economy's prospects in a speech marking his first 100 days in office, and his insistence three weeks later that the growth estimate put out by his own finance ministry was too pessimistic, his voice is an increasingly lonely one. From the Bank of Mexico and the Mexican Finance Ministry to Fitch and Goldman Sachs to the World Bank and the IMF, the unanimous estimate is for reduced growth in the coming months due to a slowing global economy, uncertainty surrounding USMCA, and serious doubts about AMLO's energy policy.

The IMF summed up this sentiment in its early April forecast; it revised its estimates to 1.6% economic growth in 2019 (down from forecasts of 2.5% as of late 2018 and 2.1% in January) and to 1.9% growth in 2020 (down from 2.7% in late 2018 and 2.2% in January). Reflecting this, job creation during the first quarter of 2019 was the lowest since 2014, declining February sales tax revenues point to reduced consumption, and consumer confidence fell in March for the first time in the AMLO presidency.

After receding in February, inflation nudged up to 4% in March on the back of higher gasoline prices. AMLO blamed this on high gas station profits and proposed creating government-owned gas stations to keep prices low. Still, inflation remained within the Bank of Mexico's 3%-4% target range which, combined with a stable peso, informed the central bank's March 28 decision to again hold interest rates steady at 8.25%, and led to outside speculation that the Banxico would begin to cut rates in the near future. The early April jump back to a 4.38% annual rate, however, might give the Bank pause.

The peso has stabilized around 19 pesos per dollar (in the 18.8-19.4 range), due in part to the U.S. Federal Reserve's March 20 statement that no additional rate hikes are likely during 2019. But the stable peso also reflects high interest rates that are pulling in portfolio investment and sound Mexican fiscal policy. In a very well-received April 1 budget update sent to Congress, the government announced a series of spending cuts to match reductions in revenue caused by declining petroleum production. This was followed by a statement from Finance Minister Carlos Urzúa that Mexico needs to meet its 1% primary surplus goal this year to protect its market credibility. This was music to the ratings agencies' ears, especially following Standard & Poor's March 1 decision to lower its outlook for Mexico's sovereign debt from stable to negative, and given concerns about lower budget revenues in the months ahead (due to declining consumption and petroleum production) while spending pressures will increase as AMLO's new social programs and planned investments ramp up.

The minutes from the Bank of Mexico March 28 meeting echoed the ratings agencies' specific concern regarding the potential negative impact of Pemex's financial problems on Mexico's macroeconomic stability. Cognizant of this risk, Mexico is exploring legal changes that will enable it to use a portion of its $15.4 billion public income stabilization fund to cover the $6-7 billion of Pemex debt payments due this year. This proposed one-time infusion of capital lends credibility to two complimentary theories circulating in financial markets about the future of Pemex – that AMLO will do whatever is necessary to rescue the firm and that Pemex is simply too big for the government to allow it to fail. Indeed, based on these theories, some investors are snapping up what they perceive to be deeply discounted Pemex bonds.

Beyond slow growth and concerns about budgetary stability, business perceptions of the Mexican operating environment also took a hit in recent weeks. This happened despite AMLO making peace with the bankers and his repeated insistence that the government will respect the sanctity of contracts. At the Bankers' Association annual convention in late March, AMLO promised not to regulate banking fees (after the leader of AMLO's Morena party in the Senate had proposed to do just this) and instead called for increased competition in the sector that would allow the market to drive down fees.

At nearly the same time, however, AMLO stated in a morning press conference that justice outweighs the law, which brought into question the legal foundation of contracts in Mexico. AMLO also declared the end to neoliberal policies, which by implication brought into question a wide range of policies implemented by his presidential predecessors and created additional uncertainty for businesses operating in Mexico. And the leader of the Morena party in the Senate, Ricardo Monreal, proposed legislative initiatives that would restructure the federal judiciary and expand the Supreme Court from 11 to 16 members. Proposed as an anti-corruption measure, the expansion of the court would allow AMLO to take control of an institution that has become the main check on the reach of his political authority. Finally, the Mexican business community is worried about the impact of the labor reform on private sector interests.

Sector Focus: Energy

April saw another hit to business confidence when AMLO effectively took control of Mexico's energy regulator, the Comisión Reguladora de Energía or CRE. The commission has been central to Mexico's success at liberalizing energy markets, but AMLO considered its independence an obstacle to his government-led approach to energy policy. After cutting the CRE's budget by 30% and trying to sideline its president by accusing him of conflicts of interest, AMLO took advantage of the resignations of four of the commission's seven members to pack the commission with loyalists who have only limited energy experience.

The viability of his government-led energy strategy, however, is in question. Despite directing 60% of government investment thus far to the energy sector, Pemex investment is still at the third lowest level in the past decade. Nevertheless, the energy ministry threatened to halt the National Hydrocarbons Commission's plans to hold an auction among private market operators interested in forming joint production ventures with Pemex. The government argues the winners of previous auctions have not invested quickly enough, so what is the point in holding more auctions if they do not translate into investments.

Given this context, a series of investment announcements drew our attention. Two Pemex joint venture partners announced new investments, Repsol, Petronas, and Murphy Oil announced they were moving forward with deep-water exploration investments in 2019 and 2020, and Repsol announced additional investments in gasoline stations toward its goal of controlling 8%-10% of the market.

Meanwhile, Mexico's crude output fell to the lowest level on record and proven reserves dropped another 7%. At the same time, external auditors questioned the very viability of the national petroleum company due to its recurrent losses and debt overhang, and Standard & Poor's cut its outlook for the firm (following on Fitch's January rating downgrade). AMLO's response was to accuse S&P, like Fitch before it, of punishing Pemex for the past failings of Mexico's neoliberal governments and not taking sufficiently into account the benefits of the new government's policies.

There were also unwelcome changes on Pemex's independent board of directors. *The decision of the firm to go ahead with the Dos Bocas refinery project after a majority of the board refused to support it* led to the resignations of four members of the five-person board. This allowed AMLO to appoint replacements who share his vision for the future of the firm, including his brother-in-law who is also a Morena party activist, thereby eliminating the independent oversight the board had brought to the firm's operations.

Developments in the electricity sector also reflected AMLO's government-led energy strategy. Rocío Nahle, the Energy Minister, proposed reversing the 2016 energy reform's division of the Federal Electricity Commission (CFE) into six separate firms, and reintegrate them back into a single company that will dominate the market. CFE CEO Manuel Bartlett repeated earlier threats to cancel contracts with private pipeline firms because of perceived construction delays. He also announced that the CFE will reexamine contracts that force it to buy energy from "competing" wind and solar power generators, asking "why should we buy power if we can produce it?" and arguing that "the CFE does not require third party support."

Despite Mr. Bartlett's statements, CFE has not in fact been able to meet the electricity needs of key regions of the country. Power outages in March and April affected most of Yucatán and Quintana Roo state, including the Cancun and Riviera Maya tourist destinations. The second outage was caused by a brush fire, but the first was due to a shortage of natural gas in the region, creating concerns about additional blackouts in the coming weeks.

Sector Focus: Infrastructure

The Dos Bocas refinery in Tabasco, the Mayan Train through the Yucatán Peninsula, and the Santa Lucia, Hidalgo, airport project continued to dominate the administration's infrastructure investment agenda. The refinery in particular commanded attention when Deputy Finance Minister Arturo Herrera told the *Financial Times* that construction would be delayed until the government could ensure that the cost of production would not exceed for original $8 billion estimate. In the meantime, he said, the funds that would have been used for the planned 2019 investments could instead be spent on petroleum exploration and production. Only hours later at his morning press conference, AMLO directly contradicted Herrera; not only was the refinery project moving forward, but AMLO also announced that on the following Monday, March 18 – the anniversary of the 1938 petroleum nationalization – his administration would reveal the companies who would bid on the project. Two weeks later, AMLO announced a $25 billion peso investment to rehabilitate the country's six existing refineries, which are currently operating at 30% capacity on average.

A recent study by the Mexican Institute of Competitiveness (IMCO), meanwhile, reinforced our concerns about the Dos Bocas refinery project. IMCO estimates just a 2% chance that the project will generate more benefits than costs for the country. Unsurprisingly, they recommend that it be cancelled.

Another controversial infrastructure project, the Mayan Train, is also moving forward quickly. In its haste to complete the project during AMLO's six-year presidential term, the government granted contracts to develop a master plan and cost-benefit analysis for the project without taking the time for a competitive bidding process. It also continues to insist that the public-private project will cost just $7.4 billion, with the government investing only 10% of this total, even though another IMCO study concludes the cost is apt to be multiples of this estimate and take longer than six years to complete.

The Santa Lucia airport project, meanwhile, hit a snag when estimates for its cost increased significantly owing to the "discovery" of a hill that will have to be removed for safety reasons. Nevertheless, AMLO announced that construction will begin April 29.

V. Monarch Events, Speeches, Publications

March 8: Monarch Chairman Ambassador James R. Jones and Senior Advisor Pamela K. Starr commented for the Q&A in the Inter-American Dialogue's *Latin America Advisor* on President Trump's declaration of a national emergency at the U.S.-Mexico Border.

March 28-29: Monarch President and CEO Michael C. Camuñez led a delegation from the Pacific Council on International Policy on a fact-finding visit to the El Paso/Juarez border where the participants encountered an absolute lack of a security crisis at the border but found instead a very serious humanitarian crisis that requires urgent attention.

April 11-12: Michael Camuñez and Ambassador Jones participated in the 11th meeting of the U.S.-Mexico CEO Dialogue in Mérida, Mexico.

April 12: Monarch Senior Director Pedro Niembro commented for the Q&A in the Inter-American Dialogue's *Latin America Advisor: Energy Advisor* on AMLO's plans to capitalize Pemex and what it will take for the state-owned enterprise to improve its financial situation.

April 18: Monarch Managing Director Andrew I. Rudman delivered a presentation entitled "*Mexico Under AMLO*" at the Goldfarb Center for Public Affairs at Colby College.

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