Mexico's new challenges under shifts on the US politics and policy agenda

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Overview

The immediate effects of Trump's policy proposals would be for Mexican exports to decline, a reduction of FDI, and potentially a weakening in remittances sent back to Mexico. The precise magnitude of these changes is difficult to forecast until more concrete proposals are put forward by the Trump administration. Nonetheless, the fact that the magnitude of these changes is what is being discussed creates sufficient uncertainty in the Mexican economy for investors to be wary of further investing in Mexico for the time being, and some are even beginning to withdraw their investments and move them to less volatile markets.

Regardless of the short-term uncertainty and volatility in the Mexican economy, Mexico will continue to be an attractive market for investors, not only for the cheap labor, but also because the Mexico's labor force growth and increasing wealth will create larger and larger domestic markets for goods. Finally, even if there are some adjustments to NAFTA, Mexico's geographical position and proximity to the US will keep Mexican exports competitive, as they will have much lower transport costs than similar products originating in other countries. Any changes in the US-China trade relationship will have an impact on Mexico's exports to the US in the long term. Depending on what changes take place, the effects could either be positive or negative but regardless of these changes, Mexico will need to increase its productivity in order to remain competitive and to not lose market share to other countries that are seeking to expand their export markets into the US.

Remittances, although not accounting for a large share of GDP, are still an important factor that generates economic dynamism. When taking into account the knock on effect of these inflows on the economy, the secondary effects represent a larger share of GDP as these funds are mostly spent in the local economy rather than saved.

Other second tier impacts of Trump's immigration policies can also be expected, such as an increase in the unemployment rate and lower domestic wages in Mexico. These effects could further deteriorate the Mexican economy in the short term to medium term, without mentioning the uncertainty that could further deteriorate investment.

Introduction

The Mexican economy is starting to show signs of slowing down due to uncertainty in international markets – slowdown of China's economy along with low prices for oil and other commodities – and also its high interconnection with the United States (US) that could potentially change after the victory of Donald Trump as president of the US.

Trump's victory puts Mexico into a sea of uncertainties. Trump consistently used rhetoric during his campaign that implied he would significantly alter relations with Mexico and while his actual policy proposals are not known at this time, he is considering withdrawing from or significantly renegotiating the North America Free Trade Agreement (NAFTA) between these Mexico, the United States and Canada; an agreement that has been highly beneficial for Mexico. In addition, Trump has suggested changes to US immigration policy that could bring second tier effects to the Mexican economy.

This paper focuses its attention on how the potential implementation of Trump's policy proposals could affect the Mexican economy. It is divided into three sections: 1. Mexico's current economic situation; 2. NAFTA re-negotiation; 3. The wall, deportation and immigration policy.

1. Mexico's current economic situation[1]

The Mexican Government reported third quarter GDP growth of 2.0% Year-on-Year (YoY). Third quarter growth for 2016 was the weakest it has been since 2014. The service sector continues to be the main driver of the economy, while the industry sector continues its poor performance due to a decrease in oil and gas production and weak household consumption. Economic indicators have begun showing signs of slowing down.

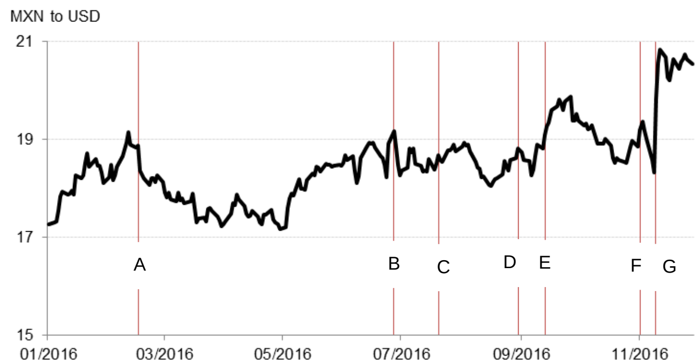
Exports have been affected by a decrease of manufacturing exports, while investment has declined due to weak industrial activity. This decline was mainly driven by a decrease in both the mining and construction sectors. The latter could continue to be affected by weak household consumption.

Monetary policy in 2016 has focused on mitigating upward pressures on the inflation rate, driven principally by the constant depreciation of the Mexican peso. The Mexican Central Bank has raised interest rates five times this year, leaving the interest rate at 5.75%; the last rate hike took place one week ago (December 15th). The Central Bank is likely to continue increasing interest rates in order to mitigate the upward inflationary pressures.

[1] For more detailed information on Mexico's economy, please refer to: *Mexico's Macroeconomic Performance: Third Quarter 2016*

Even though Mexico will close the year with modest growth, headwinds for Mexico are appearing on the horizon. External shocks, such as Trump being elected president of the United States and the resulting potential policy changes on trade and immigration policies, could put extra stress on the Mexican economy. As a result of these potential shocks, some forecasts for 2017 are already lowering their GDP growth rate to 1.9%. The Mexican Government estimates the GDP growth will be between 1.5 to 2.5%

Figure 1: Nominal Exchange Rate and External Events



A: Stronger US dollar, Central Bank increased interest rate
B: United Kingdom's Referendum on leaving European Union
C: Donald Trump formally nominated as GOP nominee for President
D: Trump's visit to Mexico
E: Hillary Clinton's health issues
F: Reopening of FBI investigation into Clinton's emails
G: Election of Donald Trump as President of the United States

Source: Bloomberg, Media, MUFG

The US presidential race has directly impacted the Mexican economy. The Mexican peso was very sensitive to events both in the US and around the world (Figure 1). Whenever Trump's odds of becoming president appeared to increase, there was a corresponding depreciation in the Mexican peso.

How will Trump's policy proposals[2], – to renegotiate the NAFTA, to build a wall on the southern border of the United States, and to deport the estimated 11 million illegal immigrants currently living in the US - impact the Mexican economy and its performance over time? In the most simplistic terms possible, any measures that impose obstacles to foreign trade and investment flows will weaken economic activity, increase interest rates, and further depreciate the Mexican peso.

2. NAFTA renegotiation

2.1 NAFTA's positive impact on the Mexican economy

For more than four decades (1940-1984), Mexico relied on import substitution policies, restrictions on foreign direct investment, and a controlled exchange rate to help foster domestic growth. Its exports were heavily oil oriented. The debt crisis in the 1980's and the resulting assistance from the International Monetary Fund (IMF) forced Mexico to diversify its exports, privatize most of its companies, relax investment policies and liberalize some of its trade measures[3].

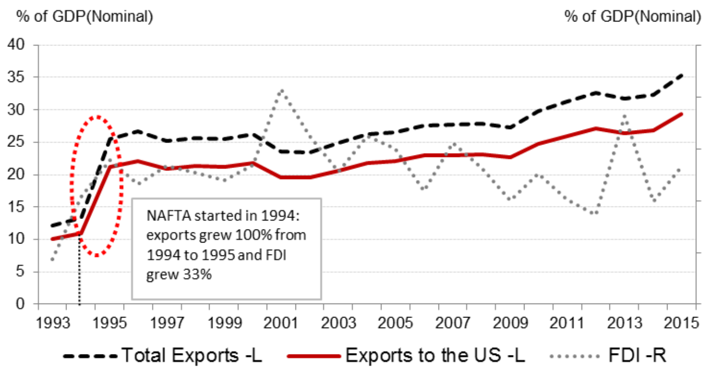
In 1986, Mexico acceded to the General Agreement on Tariffs and Trade (GATT), assuring further trade liberalization measures, and in 1994 entered into the NAFTA with the United States

[2] https://www.donaldjtrump.com/policies
[3] Miguel de la Madrid was elected president in 1982 and promoted the privatization policies mentioned above.

and Canada. On average, Mexico reduced its tariffs from around 25% during the 1980's to 10% after the NAFTA agreement. At the time NAFTA went into effect, about 40% of US imports from Mexico entered duty-free, while the remainder faced duties of up to 35%[4].

The elimination of trade barriers were in three key industries: textiles and apparel, automobiles and other manufacturing, and agriculture. The automotive industry currently comprises over a third of total manufacturing exports.

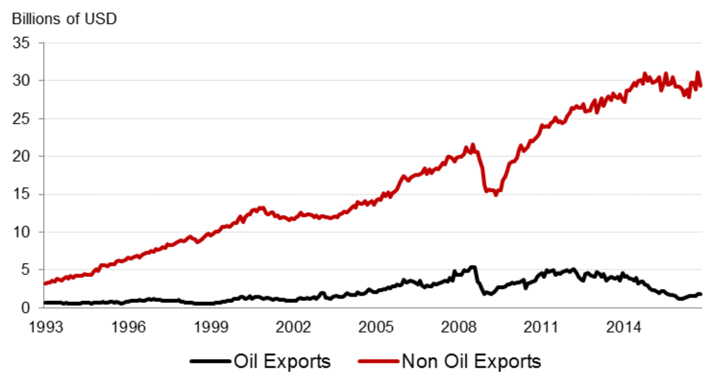
Figure 2: Mexico's Exports and Inward FDI after NAFTA



Source: World Bank, Central Bank of Mexico, MUFG

Since 1994, Mexico has experienced consistent growth in its exports. In 1993, Mexican exports accounted for around 10% of nominal GDP, but grew to almost 35% in 2015 (Figure 2). An increase in exports to the US was the main driver for this improvement. The increase in production driven by a demand for cheaper products from Mexico led to growth of FDI (Foreign Direct Investment), although this was more variable.

Figure 3: Mexico's Exports



Source: INEGI, MUFG

The improvement of market access to the United States not only led to rapid growth in Mexican exports, but also spurred development of the manufacturing sector in Mexico that allowed Mexico to become a relevant actor in global productivity chains. As seen in Figure 3, the increase in exports was mainly driven by an increase in non-oil exports, principally manufacturing exports. The automotive industry is the largest contributor to manufacturing exports, comprising 34% of total manufacturing exports in 2015, and in 2013 Mexico was one of the eight largest manufacturers of automobiles in the world[5].

Although exports levels increased over the years, Mexico's main trade partner remained the United States: receiving about 80% of Mexican exports in both 1993 and at present. This situation puts Mexico in a particularly vulnerable position in the short term and leaves Mexico and its investors with a high degree of uncertainty in the medium and long term, due to the potential changes the Trump administration could implement regarding trade, and to a lesser

[4] The North America Free Trade Agreement (NAFTA). Congressional Research Service.

[5] Carbajal Yolanda, et al. El desempeño del sector automotriz en México en la era TLCAN. Un análisis a 20 años. UNAM.2014.

extent, immigration. At the same time, these potential threats could be used by Mexico as an opportunity to diversify its export markets for the future.

2.2 Trump's proposal

> *"Tell NAFTA partners that we intend to immediately renegotiate the terms of that agreement to get a better deal for our workers. If they don't agree to a renegotiation, we will submit notice that the U.S. intends to withdraw from the deal. Eliminate Mexico's one-side backdoor tariff through the VAT and end sweatshops in Mexico that undercut U.S. workers."*[6]

In terms of the NAFTA's re-negotiation, Canada's president has said that his country is willing to renegotiate, while Mexico has indicated that although the country is open to a dialogue, a re-negotiation of the agreement is not on the table. Tensions between the US and Mexico are already increasing and any delay regarding the future of NAFTA could draw Mexico into a longer period of uncertainty.

Under Article 2205 of NAFTA, the US could withdraw from the agreement by giving the other two countries six months' notice. The Omnibus Trade and Competitiveness Act of 1988 and the Trade Act of 1974 grant Donald Trump, as president, unilateral power to negotiate, enter into a tariff and nontariff barrier agreement, or withdraw from such an agreement without needing Congressional approval. This would impact three highly interconnected economies and all three parties will likely try to avoid this scenario. However, in order to impose tariffs on Mexico, the US will need to withdraw from or, at the very least, re-negotiate the terms of NAFTA.

The re-negotiations Trump discussed during his campaign mainly focused on the Value added tax[7] (VAT) that Mexico uses to tax the sale of goods (the VAT is 16%). Donald Trump wants Mexico to eliminate this tax because he finds it "*unfair*" for Mexico to collect VAT on goods Mexico imports while exempting Mexican exports from this tax. Trump has stated that this creates an incentive for US companies to move to Mexico and has reiterated on many occasions that he wants to ensure that American companies do not move production off shore.[8] He has mentioned imposing a tariff of 35%[9] on imports from Mexico specifically to avoid these companies relocating their production. The Republican Party (GOP-Grand Old Party) leadership in congress has voiced disagreement over the tariff threat, as many republicans believe that tax cuts and deregulation will do more to encourage American companies to maintain domestic production rather than Trump's tariff proposal. However, Trump has unilateral power to impose

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[6] Donald J. Trump's 7 Point Plan To Rebuild the American Economy by Fighting for Free Trade, Trump policies/Trade, https://www.donaldjtrump.com/policies

[7] The VAT is a consumption tax that taxes the value added by businesses at each point in the production chain. It can apply to both manufactured goods and services.

[8] This policy has been extracted from interviews Donald Trump has given but is not reflected in his official policy proposals available on his web page.

[9] These numbers are used as a reference for this analysis and are based on news accounts of what Donald Trump said during his campaign. There is no concrete proposal at this time.

up to a 15% tariff for 150 days without Congressional approval[10] meaning Trump could initiate a trade war with Mexico in spite of Republican opposition.

It is still too early to know whether Trump's administration will go ahead with his campaign promises, and even if his administration follows through on these proposals, the Trump administration will face many barriers, both internally and externally, that could complicate and delay the process.

2.3 Possible scenarios and potential impacts

If the US withdraws from NAFTA and decides to impose a 15% tariff on imports from Mexico, Mexico's economy will suffer. Mexico is the third largest exporter of goods to the US, comprising about 13% of total US-imports; China has over 20% of the US market (Figures 4-5). If the US somehow manages to impose a 15% tariff, Mexican products will become less competitive. As China and Mexico export many similar products, any loss in competitiveness of Mexican products could lead to a corresponding gain in Chinese products. Some of the manufacturing goods that both countries export to the US include automobiles, electronic equipment and machinery.

Figure 4: Top 5 partners of the US, Imports-2015

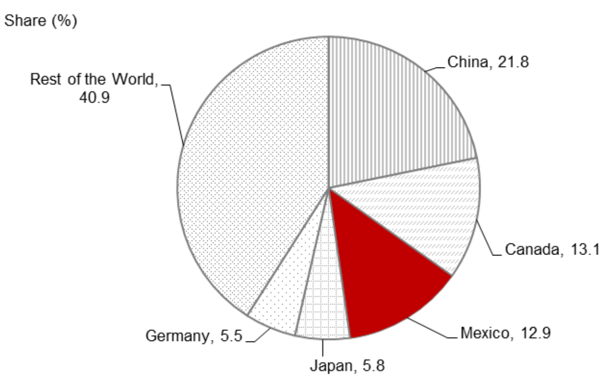
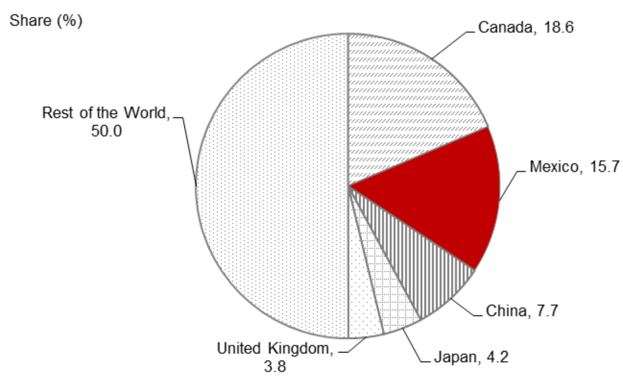


Figure 5: Top 5 partners of the US, Exports-2015



Source: United Nations COMTRADE Database, MUFG

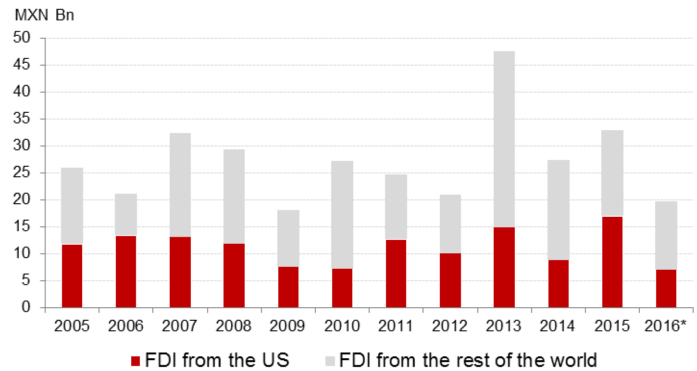
While Trump has focused much of his attention on talking about changing the United States' relationship with Mexico, other policy shifts that Trump is proposing could indirectly affect the Mexican economy. For example, Trump has talked about China in much the same way as he has talked about Mexico: that foreign trade with China is unfair, principally (in China's case) due to an undervaluation of the Chinese currency in order to improve export competitiveness. Although Trump talked less about China during his political campaign, it is not clear how the US will precede in terms of its trade relations with China. Any shift in US policy towards China will have a cascading impact on Mexico.

[10] After 150 days, Congress would either need to approve the tariff or the tariff would be vacated.

The imposition of tariffs on Mexican exports to the US could impact American companies that are considering moving (or have moved) factories to Mexico. If these tariffs accomplish what Trump hopes, fewer American companies will move production to Mexico, reducing both manufacturing exports from Mexico and FDI flows into Mexico. In 2015 almost 60% of FDI came from the US (Figure 6); FDI not only creates jobs, but also brings with it advances in technology and improved technical processes that could improve competitiveness through the improved quality of products and processes.

As previously mentioned, Mexico stated that it is not willing to re-negotiate NAFTA, but is open to having a dialogue about it. This could lead to a long negotiation between the parties involved and could be even more damaging to Mexico, with years of uncertainty discouraging new investment. The slowdown of China's economy along with low prices for oil and other commodities have led to increased international instability that is putting stress on the Mexican economy. FDI has declined more than 20% from the first three quarters of 2015 to the first three quarters of 2016, while FDI coming from the US has declined almost 50% over the same period. Under a potential NAFTA re-negotiation, FDI could decline even further. In fact, the Central Bank of Mexico said that one of the causes of increasing interest rates was that it has noticed that some firms are already selling assets, cutting capital expenditures and hedging currency risks as the Mexican peso hits new lows.

Figure 6: Foreign Direct Investment to Mexico



*Data from January to September (first three quarters)
Source: INEGI, MUFG

For any new trade agreement between Mexico and US to be agreed upon, it will need to be beneficial for both countries. Both countries are large markets for the other's goods, with around 80% of total Mexican exports going to the US (13% of the US total imports) and 15% of US exports going to Mexico. Mexico is the second largest export market for the US, even bigger than China. If the US tries to put tariffs on Mexican products, Mexico will likely do the same and start a trade war that will harm both countries.

Irrespective of any new tariffs that the US imposes on Mexican goods, there are two countervailing forces that could constrain or lessen the negative impact of the tariff imposition.

First, Mexico will still be an attractive place to invest (with some caveats), at least in the short to medium term, because of the following factors:

1. ***Relatively Low Labor Cost*** – The daily minimum wage is 73.04 Mexican Pesos (3.60USD). The National Commission for Minimum wages will increase the minimum wage by 4.0% in 2017, pushing the daily minimum wage to almost 4.0USD, four times less than the daily minimum wage ($16[11]) in China and 14 times less than in the US ($58[12]).

2. ***Growth of Mexico's Labor Force*** – The labor force in Mexico was over 52 million in the third quarter of 2016, an increase of 3% YoY.

3. ***Mexico's Geographical Location*** – Mexico shares a long border with the US and this proximity will keep Mexican exports competitive in the short and medium term: they will have much lower transport costs than similar products that originate in other countries. In the long term, this privileged position may not be sufficient for Mexico to continue to be an important trade partner with the US.

Table 1: Main US Trade Partners and Goods Exported to the US (2015)

Share to US Imports, %

	Mexico	China	Canada	Japan
Machinery and Electronics	4.8	10.5	1.2	2.0
Transportation	3.3	0.7	2.8	2.3
Miscellaneous	1.4	3.4	1.0	0.6
Fuels	0.6	0.0	3.2	0.0
Metals	0.5	1.2	1.0	0.3
Vegetable	0.5	0.1	0.3	0.0
Food Products	0.4	0.1	0.5	0.0
Plastic or Rubber	0.3	0.9	0.6	0.2
Stone and Glass	0.3	0.5	0.3	0.1
Chemicals	0.2	0.6	0.8	0.3
Textiles and Clothing	0.2	1.9	0.1	0.0
Animal	0.1	0.1	0.3	0.0
Wood	0.1	0.4	0.8	0.0
Footwear	0.0	0.9	0.0	0.0
Hides and Skins	0.0	0.4	0.0	0.0
Minerals	0.0	0.0	0.1	0.0
Total product share to US imports	12.9	21.8	13.0	5.8

Source: World Bank-World Integrated Trade Solution, MUFG

Second, while this paper mainly focuses on US policy changes and trade renegotiations with Mexico, Trump has also discussed revisiting trade relations with China. Trump has talked about increasing tariffs on Chinese goods that enter the US and if the US decides to impose a 15% tariff on Chinese goods (similar to the proposed tariff on Mexican imports), this will harm both countries equally and at least in the short-medium term, may maintain market composition as it currently it. However, even if both Mexico and China remain on level footing when compared to each other, other countries, such as Canada and Japan, could benefit from these tariff impositions and gain market share at the expense of China and Mexico.

[11] Calculation based on hourly minimum wage of 31 provinces, it has been assumed 8hrs per working day, main source, wageindicator.org

[12] Federal minimum wage per hour is $7.25. It is assumed that a person will work 8hrs a day.

3. “The wall”, deportation and immigration policy

3.1 Trump’s proposal

“Begin working on an impenetrable physical wall on the southern border, on day one. Mexico will pay for the wall. Immediately terminate President Obama’s two illegal executive amnesties. All immigration laws will be enforced - we will triple the number of ICE agents. Anyone who enters the U.S. illegally is subject to deportation. That is what it means to have laws and to have a country.”[13]

Although Trump’s immigration policies proved popular with working-class white voters, building a wall along the southern border of the US with the objective of preventing illegal immigrants from entering the US will be extremely costly. Experts estimate that the cost of building such a wall could range from 15 to 25 billion USD. Although Trump has said Mexico will pay for the wall, it is unclear exactly how he plans to make this a reality. In addition, the wall will do little to stop a major portion of new arrivals and it will face enormous obstacles in being built. Environmental, engineering and topographical challenges will need to be overcome if the wall is to be built. Historically, illegal immigration from Mexico to the US has increased immediately after Mexico has experienced an economic crisis, but since 2005 the number of undocumented immigrants residing in the US has remained stable, and some immigration experts expect this number to decrease over time.[14] This is due to a combination of factors such as: there are greater economic opportunities in Mexico now than 20 years ago (with GDP per capita almost double what it was 20 years ago); the poverty rate has decreased (10% of population living with less than 1.90 USD in 1994, compared to 3% of the population in 2014[15]); educational attainment is higher and fertility rates are lower (from an average of 7 children per women in the 1970’s to 2 children per women in 2015[16]); the cost to cross the border illegally had increased and conditions in the US for illegal immigrants have worsened.

3.2 Possible Scenarios and potential impacts

Trump’s immigration plan foresees deporting over 5 million undocumented Mexican immigrants. This will not only be extremely expensive for the US – an analysis from the Center for American Progress estimated this cost would be an average of 10,070 USD per person[17], for a total of around 50 billion USD (only taking into account Mexican illegal immigrants) – but will also have a significant impact on the US workforce and economy. There are approximately 11.3 million

[13] Donald J. Trump's 10 Point Plan To Put America First, Trump policies/Immigration, https://www.donaldjtrump.com/policies
[14] The Pew Research Center in its latest report, estimates that unauthorized Mexican immigrants make up 52% of the total and this number had been declining in recent years, while the number of unauthorized immigrants from other nations has been growing.
[15] World Bank database
[16] World Bank database
[17] Based on Center for American Progress. See References.

undocumented immigrants (from all countries) living in the US. They make up 3.5% of the population and a 5.1% of the labor force[18].

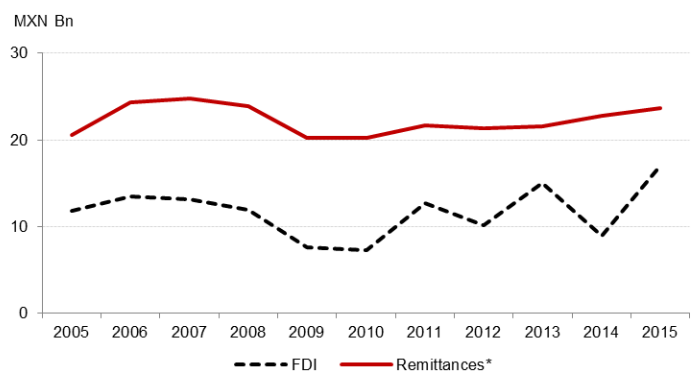
The Trump administration will face several obstacles in both building the wall and deporting these people. While Trump can unilaterally deport these people without congressional approval, he will face severe backlash from the business community (who stand to lose many workers), humanitarian organizations and even some members within his own party. Due to the high costs of building the wall and the fact that it will require a budget allocation from Congress, there is no guarantee that the Trump administration obtains the funding it needs to construct the wall.

Any changes in US immigration policies that increase deportations, reduce the number of visas, or reduce the ease with which workers can enter the country will affect remittances, unemployment levels, and the internal stability of the Mexican economy over the short and medium term.

In a country where the daily minimum wage is not even 4.0 USD, remittances constitute an important source of income for many Mexican households. During the third quarter of 2016, the average value per remittance was 297 USD and YoY remittances grew by 5.3%, reaching a total of around 20 billion USD; 95% of this total originated in the US. For households in Mexico's poorest regions, remittances from family members living in the U.S. represent a critical financial life line. Cutting off those remittances would hit households hardest that can least afford to lose that support.

In 2015, total remittances accounted for about 2.0% of GDP. As it can be seen in Figure 7, for 2015 remittances from the US were almost 30% bigger than FDI.

Figure 7: Remittances, FDI (From the US)



*2005-2012 remittances' data are estimates by MUFG, based on an average of the percentage of remittances coming from the US from 2013-2015
Source: Mexico Central Bank, MUFG

Although total remittances only account for 2.0% of GDP, they are still an important source of income that generates economic dynamism. The knock on effect of these $20 billion represents an even greater share of GDP, taking into account that this money is largely spent in the Mexican economy rather than saved or invested, thereby increasing domestic consumption.

Trump's deportation plan, if implemented, would also likely increase unemployment in Mexico. During the third quarter of 2016, unemployment in Mexico was 4.0% and has been on a recent downward trend. If illegal immigrants return to Mexico, most of them will likely look for work. This will increase unemployment rate in Mexico and may also drive

[18] Based on Moody's Analytics. See References.

down wages due to the increased supply of workers. The Mexican government would be under pressure to generate new jobs to capture these people if these people are deported. If not, Mexico can anticipate an uptick in the unemployment rate that could remain above the current level for an extended period of time.

Conclusions

Mexico's economy is slowing down due to both global trends (a slowdown of China's economy along with low prices for oil and other commodities) and uncertainties regarding the future relationship between Mexico and the US in the wake of the election of Donald Trump as President. Over the past 20 years, Mexico and the US have maintained a very close economic and political relationship that has brought prosperity to Mexico.

With the election of Donald Trump, this strong relationship is in jeopardy. Donald Trump's campaign was highly focused on trade and immigration, especially the US's relationship with Mexico. Although any specific policy proposals are yet to be defined, there were immediate concerns in Mexico upon his election as the Mexican peso depreciated, the Central Bank increased interest rates, and GDP forecasts were reduced.

As mentioned above, the immediate effects of Trump's policy proposals would be for Mexican exports to decline, a reduction of FDI, and potentially a weakening in remittances sent back to Mexico. The precise magnitude of these changes is difficult to forecast until more concrete proposals are put forward by the Trump administration. Nonetheless, the fact that the magnitude of these changes is what is being discussed creates sufficient uncertainty in the Mexican economy for investors to be wary of further investing in Mexico for the time being, and some are even beginning to withdraw their investments and move them to less volatile markets.

Regardless of the short-term uncertainty and volatility in the Mexican economy, Mexico will continue to be an attractive market for investors, not only for the cheap labor, but also because Mexico's labor force growth and increasing wealth will create larger and larger domestic markets for goods. Finally, even if there are some adjustments to NAFTA, Mexico's geographical position and proximity to the US will keep Mexican exports competitive, as they will have much lower transport costs than similar products originating in other countries. Any changes in the US-China trade relationship will have an impact on Mexico's exports to the US in the long term. Depending on what changes take place, the effects could either be positive or negative but regardless of these changes, Mexico will need to increase its productivity in order to remain competitive and to not lose market share to other countries that are seeking to expand their export markets into the US.

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